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NEWSLETTER

Oral Suggestion That Company Settle a Potential Suit Gives Insured a "Reasonable Basis" for Believing That a Claim Might Be Made

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The United States District Court for the District of Maryland, applying Virginia law, has held that an oral suggestion that a company settle a potential suit gave an insured a "reasonable basis" for believing that a claim might be made, and that the insured's failure to report this in response to a question on an insurance application was a material misrepresentation. *Prosperity Mortg. Co. v. Certain Underwriters at Lloyd's,* No. 12-2004 (D. Md. July 15, 2013).

A mortgage financing company issued a home equity line of credit to a couple. Two years later, the couple sued the mortgage financing company for alleged high loan values arising out of a faulty appraisal. The couple hired an attorney, who initiated settlement negotiations with the finance company. This attorney also represented a second couple. During those settlement negotiations, the attorney orally suggested that the mortgage financing company also settle with the second couple, even though the second couple had not yet filed a lawsuit. The mortgage financing company ultimately settled only with the first couple.

After the settlement, the mortgage financing company applied for an E&O policy with a carrier. The application asked the mortgage financing company whether it had "knowledge or information of any act, error or omission which might reasonably be expected to give rise to a claim(s), suit(s), investigation(s) or action(s)" and to identify "any claim(s), suit(s), demands for arbitration, or administrative/regulatory actions" pending prior to the application. The mortgage financing company did not identify the attorney's reference to settlement with the second couple in response to either question. After the policy was issued, the second couple filed a putative class action lawsuit against the mortgage financing company. The carrier sought rescission of the policy, arguing that the oral suggestion to settle with the second couple was a "claim" within the meaning of the application, and the failure to identify that claim on the application was a material misrepresentation.

The court agreed with the carrier that the oral suggestion was a "claim" or a potential claim within the meaning of the application, and that the failure to identify it as such was a material misrepresentation. Although "claim" was defined in the policy in a manner that did not include oral demands for relief, the court did not apply this definition because the policy had not yet been issued at the time of the application. The court thus applied the "ordinary and customary meaning" of the word "claim," which, under Virginia law, was merely a "demand for something as rightful or due." Although the court indicated that the oral suggestion may or may not be construed as a "demand," it deemed it unnecessary to decide this issue because the application merely required identifying "any act, error or omission which might reasonably be expected to give rise to a claim," and the oral suggestion was sufficient to give the company a "reasonable basis" for believing that a claim might be made. Accordingly, the court concluded that the company's answer to this question was a misrepresentation. Additionally, the court deemed the misrepresentation to be material under Virginia law because the carrier had stated in a counterclaim that "had [the carrier] known about the [non-settling couple's] claims . . . it would not have agreed to issue the [policy], or would not have issued the [policy] on the same terms and conditions, or for the same premium." As a result, the court entered judgment on the pleadings in favor of the insurer and declared the policy at issue rescinded.