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NEWSLETTER

Insurer's Rescission Claim Dismissed Because of Failure to Establish Condition Precedent and Failure to Demonstrate Reliance

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A New York state trial court has dismissed an excess insurer's attempt to rescind a D&O policy based on alleged material misstatements contained in the insured company's financial statements issued prior to the policy's inception, ruling that the insurer could not rely on the financial statements, as they were not specifically incorporated in the policy. *Nat'l Union Fire Ins. Co. of Pittsburgh v. Xerox Corp.,* 2004 WL 2715603 (N.Y. Sup. Ct. Nov. 10, 2004). The court also addressed a number of other coverage defenses asserted by the carrier, dismissing most as not yet ripe.

The coverage dispute arose from securities fraud lawsuits, derivative actions and SEC enforcement proceedings based on the allegedly fraudulent financial reporting of a public company from 1997 through 2000. Though the private lawsuits were still pending, the insured company and a number of its directors and officers settled with the SEC in separate enforcement actions. Neither the individuals nor the company admitted guilt in connection with these settlements. The insureds subsequently sought coverage from the insurer, who had issued a "follows form" excess policy incepting on June 25, 1999. The insurer denied coverage and brought this declaratory judgment action seeking to rescind the policy based on the breach of a condition precedent contained in the binder as well as alleged fraudulent inducement. In the alternative, the insurer sought declarations of non-coverage based on various policy provisions.

The insurer argued that it was entitled to rescission based on a condition precedent contained in the policy's binder, but not in the policy itself. The binder, issued on January 12, 1999, contained the condition that no material change in risk occur between the issuance of the binder and the issuance of the policy. The carrier maintained that this provision was breached because of the inaccuracies contained in the financial statements. The policy, issued on June 25, 1999, did not contain the condition, and the alleged fraud was not discovered until after the issuance of the policy. Despite the insurer's contention that the condition precedent in the binder was meant to be incorporated into the policy, or, alternatively, that the binder and policy should be read together, the court held the condition did not apply to the policy. In reaching its decision, the court concluded that there was no evidence that the parties intended to incorporate the condition into the policy. The court also rejected the insurer's contention that a binder and policy are to be read together, noting that, "[a] binder provides interim insurance, usually effective as of the date of the application, which terminates

when a policy is issued or refused." Further, the court rejected the insurer's rescission claim based on the alleged breach of the covenant of good faith and fair dealing, indicating that the insurer could not "transform this non-viable contract claim into a valid [breach of covenant claim]" because the covenant of good faith and fair dealing could not "nullify other express terms of a contract, or...create independent contractual rights."

The court then dismissed the insurer's claim for rescission based on fraudulent inducement, concluding that the insurer could not establish the requisite reliance. In doing so, the court first indicated that the policyholder's alleged reliance on false financial statements was contradicted by the express terms of the policy because the policy "provides coverage for claims arising from conduct . . . such as the filing of false financial statements, occurring prior to the Policy Period." Thus, the court concluded that any alleged reliance on financial statements was unreasonable as a matter of law. Further, the court noted that the terms of the policy provided that the "representations contained in the application for insurance are the basis for the coverage provided." Thus, according to the court, the insurer was "precluded from claiming reliance on financial statements" because they were not incorporated in any application. In that regard, the court noted that no application had ever been submitted by the policyholder.

The court then turned to the insurer's coverage defenses. The court dismissed the insurer's attempt to deny coverage under the policy's fraud exclusion, holding that this cause of action was premature because it required a "final adjudication" of the alleged fraudulent conduct, which had not yet been made. Accordingly, the court dismissed this count without prejudice.

The court then determined that the contentions relating to the improper profit exclusion and the definition of "Loss" were ripe as to sums already voluntarily disgorged by insureds pursuant to settlements with the SEC. Thus, the court denied dismissal of these counts as a whole. However, the court granted dismissal of these counts with respect to all defendants who had not yet settled with the SEC, holding that the causes of action were premature as to these defendants.

The court also denied dismissal of the cause of action based on the alleged breach of the duty to cooperate. The court held the cause of action was properly pled because the insured had failed to procure the carrier's consent prior to its settlement with the SEC.

The insurer also argued that any award of damages in the underlying derivative lawsuit should not be covered as to amounts paid by the company because such payments would constitute unjust enrichment, in that they would be payments for the company's own misdeeds. The court rejected that argument, noting that the derivative claims were against the directors and officers, not the company, and that the insurer had failed to offer any support for its legal assertion that it would be contrary to "equity and good conscience" to permit insurance recovery for damages assessed in the derivative lawsuits.

The court then considered the insurer's argument that claims for coverage were barred by the "known loss" doctrine to the extent that the losses for which coverage was sought were known to the insureds prior to the policy's inception. The court dismissed this count as well, stating that, at the time the policy was issued, the insureds "could have known, at most, the risk of loss, not the loss itself. Accordingly, the 'known loss doctrine' is

not applicable."

Finally, the court denied the insurer's request to replead the dismissed causes of action, stating that, under New York law, the insured had not demonstrated grounds to warrant repleading.

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