

Appellate Court Holds Insurer Must Advance Defense Costs Despite Rescission of Policies

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A New York appellate court has held that an insurer that issued D&O and fiduciary liability policies to Tyco International Ltd. must advance defense costs to former CEO Dennis Kozlowski even though the insurer had rescinded the policies based on material misrepresentations and omissions made to the insurer in the application process. *Fed. Ins. Co. v. Tyco Int'l Ltd.*, 2005 WL 646497 (N.Y. App. Div. Mar. 22, 2005).

The insurer issued a series of D&O and fiduciary liability policies to Tyco from March 15, 1999, through March 15, 2003. The fiduciary policy required the insurer to defend the insureds in covered litigation. The D&O policy required the insurer to advance defense expenses for covered claims. Both policies contained a personal profit exclusion that excluded coverage for loss "based upon, arising from, or in consequence of such [insured] having gained in fact any personal profit, remuneration or advantage to which such [insured] was not entitled."

Various Tyco officers and directors were named as defendants in lawsuits alleging liability for misstatements about the company's finances, misrepresentations in SEC filings and misappropriation of hundreds of millions of dollars. Kozlowski sought coverage for the civil litigation as well as a criminal indictment. The insurer rescinded the policy and filed a declaratory judgment action against Kozlowski, Tyco and 14 other defendants. Kozlowski counterclaimed, seeking a declaration that the insurer had a duty to defend and advance defense costs.

The appellate court agreed with Kozlowski. On the merits, the court noted that the severability provision in the policy required the insurer to "show that Kozlowski participated, directly or indirectly, in misrepresenting facts to induce [the insurer] to issue the policy." It held that the insurer had not yet met that burden.

Apart from the merits, the court explained that the insurer had waited until two years after the policy in question had gone into effect, and after the claims had been made, to seek to rescind the policies. According to the court, "[i]n such circumstances, a rescission by notice cannot, without legal sanction, have retroactive effect and serve to suspend, even temporarily, obligations that—absent a basis for rescission—have accrued under the policy." Thus, the insurer's rescission by notice could only have prospective effect. The court explained that if the insurer prevailed in the judicial action to rescind the policy, then "its obligation to defend Kozlowski is vitiated and the policy will be rendered void from its inception."

With respect to the personal profit exclusion, the appellate court noted that the duty to defend is broader than the duty to indemnify. It found that the allegations in the underlying litigation "do not solely and entirely fall within the personal profit exclusion" and that, as a result, the insurer was required to pay defense costs, "subject to recoupment when Kozlowski's liabilities, if any, are determined."

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