

Federal Court Declines to Decide Rescission Issues Until Underlying Shareholder Suits Resolved

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The U.S. District Court for the Northern District of Illinois, applying both federal and Illinois law, dismissed a declaratory judgment action brought by several excess D&O liability insurers, holding that, in order to resolve the insurers' rescission and coverage arguments, it would have to determine factual issues that were in dispute in underlying shareholder actions, and that such fact-finding might impermissibly prejudice the policyholder in the underlying actions. *Travelers Indem. Co. v. Bally Total Fitness Holding Corp.*, 2006 WL 2660930 (N.D. Ill. Sept. 11, 2006). The insurers received leave to replead upon resolution of the underlying litigation.

The insurers issued excess D&O liability insurance policies to the policyholder in 2002. After the policies were renewed, the company announced it was restating its financials due to accounting errors and that it was the subject of a Securities and Exchange Commission (SEC) investigation. The company placed much of the blame for the restatements on the director who signed the excess D&O insurance proposal forms, stating that he created a culture of aggressive accounting and had made false and misleading statements to the SEC. Subsequently, the U.S. Department of Justice launched a criminal investigation of the company, and a variety of shareholder actions ensued.

The company and the defendant directors and officers in the underlying shareholder actions demanded that the excess D&O insurers provide coverage. In response, the insurers filed the present action, claiming that under the Illinois insurance rescission statute, 215 Ill. Comp. Stat. 5/154, the policies were void because the company had misrepresented its finances when applying for the excess D&O liability insurance policies. Alternatively, the insurers argued that certain exclusions in the policies barred coverage. The company and the individual insureds moved to dismiss the declaratory judgment action.

The court first considered and rejected the individual insureds' argument that the rescission claims should be dismissed for failing to meet Federal Rule of Civil Procedure 9(b)'s heightened pleading requirements for "all averments of fraud or mistake." It reasoned that the rule's heightened pleading requirements apply only in cases of "fraud and mistake and nothing else," whereas the Illinois statute allowed rescission in situations involving either fraudulent conduct (misrepresentation with the intent to deceive) or non-fraudulent conduct

(material misrepresentation). The court added that it was unnecessary to decide whether the "intent to deceive" prong of the Illinois statute required heightened pleading since the insurers' allegations, which incorporated the company's public statements acknowledging misrepresentations to the SEC at the time the excess D&O policies incepted, satisfied any such requirement.

Next, the court considered the individual insureds' contention that the severability and "best knowledge" clauses of the excess D&O policies each precluded rescission. The court rejected this argument, reasoning that the existing allegations in the insurers' complaint, such as the company's acknowledgment that the director who signed the excess insurance proposal forms had made false and misleading statements to the SEC, sufficiently pleaded that the same director knew the financial records submitted with the policy application materials contained false statements. The court determined that the director may have violated the "best knowledge" clause and, therefore, that knowledge of the financial misrepresentations could potentially be imputed to the other directors and officers under the severability clauses' exception for "material facts or circumstances known to the person(s) who subscribed to the Proposal Forms."

After resolving these arguments in the insurers' favor, the court nonetheless concluded that crucial factual issues in the underlying shareholder suits were inseparable from the issues in the insurers' action. In doing so, the court observed that the intent and knowledge of the director who submitted the false financial statements to the excess D&O insurers were key disputed factual issues in both the underlying shareholder actions and the coverage action. The court concluded that it was inappropriate for it to decide the insurers' statutory rescission claims because any factual findings in the present case regarding the issues of the director's intent and knowledge might impermissibly prejudice the company and the defendant directors and officers in the underlying shareholder suits. Accordingly, the court dismissed the insurers' declaratory judgment action with leave to replead upon resolution of the underlying shareholder suits.