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ALERT

Insurer Cannot Rescind Policies Even Though Insured's CEO Lied on Renewal Application

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The United States District Court for the Eastern District of Kentucky, applying Kentucky law, has held that an insurer cannot rescind policies after learning of losses sustained as a result of the insured bank's CEO's embezzlement of funds totaling over $2 million. The court held that the CEO's misrepresentation in the policies' renewal application, which represented that no director or officer of the insured knew of any act, error, or omission that might give rise to a claim under the policies, could not be imputed to the insured. *Bancinsure, Inc. v. U.K. Bancorporation Inc./United Kentucky Bank of Pendleton County, Inc.*, 2011 WL 5570704 (E.D. Ky. Nov. 16, 2011).

The insured bank's CEO, who had been embezzling funds from the bank since 2003, was given exclusive authority on behalf of the bank to complete any applications or other documents necessary to obtain a renewal of the policies issued by the insurer. In completing the renewal application, the CEO answered "no" to the question whether any director or officer of the insured bank had knowledge of any act, error or omission that might give rise to a claim under the policies. The insurer renewed the policies based on the renewal application. When the CEO's embezzlement was discovered shortly thereafter, the insurer rescinded the policies based on the intentional misrepresentation in the renewal application. The insurer then sought a declaratory judgment confirming its rescission of the policies.

In concluding that the policies could not be rescinded, the court held that the CEO's knowledge of her embezzlement was not imputed to the insured bank. The court explained that the CEO's fraud would have been revealed had she answered honestly on the renewal application, and thus held that the adverse interest exception–which provides that the knowledge of an agent is not imputed to the

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principal when it is clear that the agent would not communicate the fact in controversy to the principal–was applicable. The court reasoned that none of the exceptions to the adverse interest exception applied because the CEO was not the sole actor of the bank, the CEO was not acting for the bank when she lied on the renewal application and the bank did not benefit from the CEO's actions. In reaching these conclusions, the court explained that even though the CEO had the "sole" authority to fill out the renewal application, she only had the authority to do so honestly and truthfully. Because the CEO intentionally lied on the application, the court determined that she was acting outside of her scope of authority and, therefore, was not acting as the representative of the bank. The court further explained that, even though the CEO generally was acting for the bank in filling out the application, she was acting on her own behalf when she lied on the renewal application, as it allowed her to continue embezzling funds from the bank. The court also rejected the insurer's argument that the CEO's misrepresentation benefitted the bank by allowing the bank to procure insurance coverage. The court noted that the CEO's misrepresentation caused the insurer to seek rescission and resulted in a greater loss to the bank because it allowed the fraud to go unnoticed for a longer period of time.

Lastly, the court noted that it would be unjust to allow the insurer to rescind the policies based on the CEO's misrepresentation in the renewal application. The court explained that one of the policies, a financial institution bond policy, was specifically designed to cover losses caused by an officer's or director's dishonest or fraudulent acts, and that there could be no question that the CEO's knowledge would not be imputed to the bank had any other officer or director filled out the application.