wiley

ALERT

Dishonesty Exclusion Triggered By Criminal Convictions But Factual Dispute Over Potential Waiver Precludes Summary Judgment on Rescission

October 21, 2011

A federal district court, applying Ohio law, has held that an excess insurer potentially waived its right to rescind a policy issued to a company that purchased accounts receivable from health care providers, but the policy's dishonesty exclusion barred coverage for the company's directors and officers due to their criminal convictions. *Unencumbered Assets Trust v. Great American*, 2011 WL 4348128 (S.D. Ohio Sept. 16, 2011). The court also held that the dishonesty exclusion applied to the company because the directors' and officers' dishonest conduct was imputed to the company.

In November 2002, the company declared bankruptcy amid reports the company had issued false financial statements. In March 2003, the company exercised an option to purchase tail coverage under the policies issued by its primary and excess insurers. The company and its directors and officers subsequently faced civil and criminal proceedings. The primary carrier tendered its limit, and the insureds requested advancement of defense expenses under the excess carrier's policy, which the excess carrier then sought to rescind. Four of the company's directors and officers were convicted of financial crimes, and on appeal, the convictions were affirmed in part. The convicted directors and officers and a litigation trust established on behalf of the insolvent company filed suit against the excess carrier, and all of the parties cross-moved for summary judgment regarding coverage under the excess policy.

Practice Areas

E&O for Lawyers, Accountants and Other Professionals

D&O and Financial Institution Liability

Professional Liability Defense

Insurance

The court held that the company's CEO had made material misrepresentations about the company's financial condition in the application for the primary policy. The court further held that those misrepresentations were specifically incorporated into the excess policy and therefore constituted warranties that would void the excess policy *ab initio*. In addition, the court held that the excess policy explicitly imputed misstatements about material facts known by the applicant to other insureds, potentially rendering the policy void as to all insureds. The court, however, denied summary judgment to the excess carrier as to rescission, finding a disputed issue of fact as to whether the excess carrier had waived its right to rescind the excess policy because it knew about the company's falsified financial statements when it accepted the payment for tail coverage.

The court then examined whether coverage was barred by the dishonesty exclusion, which provided that "[t]he insurer shall not be liable to make any payment for Loss in connection with any Claim . . . against any Insured . . . brought about or contributed to by any deliberately fraudulent or deliberately dishonest act or omission or any purposeful violation of any statute or regulation by such Insured if a judgment or other final adjudication adverse to such Insured establishes such a deliberately fraudulent or deliberately dishonest act, omission, or purposeful violation." The court concluded that the plain language of the exclusion barred coverage for the directors and officers who were convicted. In so holding, the court noted that the exclusion did not refer to exhaustion of appellate review, so it was irrelevant that the CEO still had time to appeal his conviction to the Supreme Court. Finally, the court applied agency law principles to conclude that the directors' and officers' fraudulent conduct should be imputed to the company and the litigation trust, which stood in the insolvent company's shoes. The court therefore granted summary judgment to the excess carrier as to the applicability of the dishonesty exclusion to the company and the convicted directors and officers, while noting that discovery would proceed on claims for coverage by the outside directors and officers and the wife of the CEO, none of whom was convicted in criminal proceedings.