

ALERT

Failure to Disclose Counterfeiting Scheme Entitles Insurer to Rescission

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Applying California Law, the United States District Court for the Southern District of California has held that an insured's failure to disclose its long-running counterfeiting scheme on a renewal application entitled the insurer to rescission. *Upper Deck Co. v. Endurance Am. Specialty Ins. Co.*, 2011 WL 6396413 (S.D. Cal. Dec. 15, 2011). The court also held that the insured's admittedly willful and intentional conduct in connection with the scheme implicated the fortuity doctrine with respect to the resulting claim.

The insured is a distributor of sports memorabilia and trading cards, which had the exclusive right to distribute a particular brand of cards in the United States. In August 2007, at the direction of the chief executive officer, the insured obtained 600,000 counterfeit cards, which it provided to a sub-distributor owned by the insured for distribution. In October 2008, the owner of the brand seized the counterfeit cards from the sub-distributor, brought suit for trademark infringement against the sub-distributor and obtained a preliminary injunction restraining the sub-distributor and "all parties acting in concert with [the sub-distributor]" from engaging in any counterfeiting-related activities with respect to the brand owner's products. On October 30, 2008, after learning that the insured was the source of the counterfeit cards, the brand owner served the insured with a copy of the complaint against the sub-distributor and demanded that it comply with the preliminary injunction. On December 11, 2008, the brand owner filed an amended complaint, adding the insured as a defendant to the trademark suit.

Meanwhile, the insured completed an application to renew its claims-made and reported professional liability coverage with the insurer for the period of December 10, 2008 to December 10, 2009. Four

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questions on the application required the insured to identify whether the insured was aware of any alleged deficiencies, errors or omissions in its work that had not previously been reported to the insurer. The insured did not respond to these questions and, instead, drew a line through them. The insurer subsequently issued the renewal policy, and the insured tendered the amended complaint for coverage. Thereafter, coverage litigation ensued, and the insurer moved for summary judgment.

As an initial matter, the court noted that the insured in the underlying infringement case stipulated that its conduct with respect to the counterfeiting scheme had been intentional and willful and that it did so to limit the potentially damaging evidence that could be presented to the jury. Here, however, in an effort to preserve coverage, the insured sought to characterize its conduct as “negligent.” Pointing out that the insured benefited from the position it took in the underlying litigation and that, in any event, the record evidence did not support a finding that the scheme was the result of “neglect or inadvertence,” the court ruled that insured was judicially estopped from challenging the stipulation in this case.

Turning to the claim for rescission, the court recognized that rescission is a statutory remedy to which an insurer is entitled in the event of a material misrepresentation, whether intentional or unintentional. The court also noted that the test for materiality is “subjective in the sense that [it requires an assessment of] the effect truthful answers would have had on [the particular insurer], not on some ‘average reasonable insurer.’” Nonetheless, according to the court, materiality can be “determined as a matter of law where no reasonable person can disagree as to the materiality of the misrepresentation.”

Here, the court determined that the insured’s failure to disclose on the application the counterfeiting scheme, including the action filed against the sub-distributor and the injunction that extended to its conduct in acting in concert with the sub-distributor, constituted a misrepresentation. In making this determination, the court rejected the insured’s argument that crossing out the relevant questions on the renewal application “somehow excuse[d] [its] concealment [of the scheme]” or otherwise “impact[ed] [its] duty to disclose material information relevant to the assessment of the risk.” As to this last point, the court further concluded that no reasonable person could dispute that had the insured disclosed “the long-running to scheme to willfully violate the intellectual property rights of [the brand owner, the insurer] would not have issued the [policy].”

In addition to concluding that these circumstances entitled the insurer to rescind the policy, the court found that the fortuity doctrine barred coverage for the infringement suit. In that regard, the court explained that the doctrine, which is codified by statute in California, is grounded in the notion that insurance is limited to “contingent or unknown risks of harm” and provides that “no man can take advantage of his own wrong.” According to the court, because the harm suffered by the brand owner is the product of the insured’s intentional, willful and purposeful conduct, the fortuity doctrine and public policy preclude shifting the financial responsibility and the burden of the loss to the insurer.