OUTSIDE PERSPECTIVES

What To Do When Your D&O Insurance Company Denies Coverage Or Threatens To Rescind The Policy

The current insurance market dominated by headlines regarding accounting fraud, various stock market meltdowns and September 11th only amplifies the need for Directors and Officers liability insurance coverage. The D&O liability insurance marketplace is now regularly front-page news. These reports include accounts of *tripling* of premium, *quintupling* of deductibles and *narrowing* of coverage.

Recently, insurance companies repeatedly have threatened to avoid the D&O policies they sold by rescinding them. The arguments used to attempt to rescind bought-and paid- for insurance policies sound similar to post-loss underwriting.

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As measured by premium volume, the top-three companies together account for almost two-thirds of the market. According to the most recent (2002) report by Tillinghast–Towers Perrin, AIG had a 35% share, Lloyd's a 14% share and Chubb a 13% share. All the remaining sellers have a 5% or lower share. So much for choice.

Due to the size and complex nature of many D&O claims, assertion of a D&O claim frequently leads to coverage disputes. Insurance companies are familiar with the types of issues that arise when a D&O claim is submitted, but policyholders generally are not. Some problems can be avoided with planning and proper advocacy.

D&O Insurance Should Not Require That Premiums Be Paid Twice

A number of insurance companies are capitalizing on public sentiment and using the opportunity to avoid or "rescind" the policies that already for which premiums already have been paid. In effect, policyholders may be asked to pay a second time for insurance, or face the threat of rescission.

In a different time, other obligations loomed larger. Although Chubb has more recently sought to undue the policies it sold through rescission, it also has advertised its "moral obligation" in claims handling:

> While an insurance policy is a legal contract that expresses our minimum responsibility, there are many occasions when equity demands that we recognize a moral obligation beyond the strictly legal terms - and this is always a consideration in our settlements.

Hendon Chubb (1874-1960). Would directors faced with a rescission argument agree?

1. Post-Loss Underwriting Is An Age-Old Game That Destroys Insurance

The rescission ploy currently working its magic in the D&O liability insurance area is the newest after-the-fact underwriting. It certainly is not the first. Insurance companies have been presumed to know the business of the companies they insure at least since 1780.

The rule that an insurance company is presumed to know the business of its policyholder was originally announced by Lord Mansfield, the father of insurance law:

> [e]very under-writer is presumed to be acquainted with the practice of the trade he insures, and that whether it is recently established, or not. If he does not know it, he ought to inform himself. It is no matter if the usage has only been for a year.

Noble v. Kennoway, 2 Doug. 511 (K.B. 1780)

(Mansfield, C.J.) The courts in United States followed Lord Mansfield's lead fifty years later.

> a knowledge ... of the course and incidents of the trade on which they insure, and of the established import of the terms used in their contract, must necessarily be imputed to underwriters.

Buck & Hedrick v. Chesapeake Ins. Co., 26 U.S. (1 Pet.) 151 (1828).

Much more recently, post-loss underwriting made its way into popular culture. A superb definition of post-loss underwriting (also known as "post-claim underwriting") was provided by John Grisham:

> Everett Lufkin, Vice President of Claims . . . finally admits it's company policy to do what is known as "postclaim underwriting," an odious but not illegal practice. When a claim is filed by an insured, the initial handler orders all medical records for the preceding five years. In our case, Great Benefit obtained records from the Black family physician who had treated Donny Ray for a nasty flu five years earlier. Dot did not list the flu on the application. The flu had nothing to do with the leukemia, but Great Benefit based one of its early denials on the fact that the flu was a preexisting condition.

John Grisham, *The Rainmaker* at 295 (1st ed. Doubleday) (1995). The parallels to the current atmosphere in the D&O liability area are striking.

2. Rescission Arguments Can Be Defeated

Policyholders who receive a notice that their D&O liability insurance company seeks to rescind their policy based upon supposed misrepresentations in the application can fight. The requirements for an insurance company to rescind the policy are very significant and a policyholder should insist on strict compliance.

Rescission arguments usually will be determined by state law. Many states have statutes governing the effects of a misrepresentation in an insurance application. *See, e.g.*, Del. Code Ann. tit. 18, § 2711; N.Y. Ins. Law § 149.

When an insurance company knows of facts supporting an argument to rescind a policy it must act. The insurance company must notify the policyholder of its intent to rescind and return premium to other value received. *Mt. Hawley Ins. Co. v. Federal Sav. & Loan Ins. Corp.*, 695 F. Supp. 469 (C.D. Cal. 1987); *SEC v. Credit Bancorp, Ltd.*, 147 F. Supp. 2d 238 (S.D.N.Y. 2001) (failure to act regarding insurance policy acquired through fraud ratified policy).

Further, the insurance company's questions must be sufficiently clear to alert the policyholder to the information sought by the insurance company. *National Union Fire Ins. Co. v. Seafirst Corp.*, 1986 U.S. Dist. LEXIS 28065 (W.D. Wash. Mar. 18, 19860. Some courts have held that there is "no duty to provide information. . . beyond the questions asked." *Harristown Dev. Corp. v. International Ins. Co.*, 1988 U.S. Dist. LEXIS 12791 (M.D. Pa. Nov. 15, 1988).

Any misrepresentation relied upon to attempt to rescind an insurance policy must be material. *Saint Calle v. Prudential Life ins. Co.*, 815 F. Supp. 679 (S.D.N.Y. 1993). Whether a misrepresentation is material is usually a jury question, and may be inappropriate for disposition on summary judgment.

Given the current hard market for insurance and the geyser of business scandals that have splashed across the front pages of most newspapers, the threat of rescission has become a more popular tactic used by D&O insurance companies. Don't let it happen to you. Force your D&O insurance company to meet the stringent requirements before it can argue to rescind your policy.

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