An Analysis of Policyholder Defenses to An Insurer's Rescission Claim

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In a recent Summary Order in *Cont'l Cas. Co. v. Boughton*, Case No. 16-2384 (June 5, 2017), the United States Court of Appeals for the Second Circuit upheld a judgment issued by the United States District Court for the Southern District of New York permitting Continental Casualty Co. ("Continental") to rescind a policy issued to Marshall Granger & Co. LLP. Continental's declaratory judgment action against Marshall Granger and its owners sought rescission on the ground that Marshall Granger procured the policy through material misrepresentations. According to court documents, one of the owners of this certified public accounting firm applied for insurance as he and a fellow former executive were engaged in a $2 million securities fraud scheme against their clients. Continental filed the declaratory judgment action when details of the Ponzi scheme emerged. The district judge ruled that Marshall Granger made material representations as a matter of law because the accounting firm's insurance application, which was filled out and signed by its owner/manager, answered "No" to a series of questions related to whether any past or present personnel was aware of any "act, omission, circumstance or fee dispute which might be expected to be the basis of a claim".

The Defendants argued that Continental had waived its right to seek rescission of the Policy because, after learning of sufficient facts to justify rescission, it both unreasonably delayed in seeking rescission and engaged in acts that ratified the Policy. The District Court granted Continental summary judgment as to the issue of ratification, but held there was a question of fact as to whether Continental unreasonably delayed before pursuing its rescission claim. After trial, a jury determined that Continental's delay in filing its rescission lawsuit was reasonable. Boughton and Northstar (assignees of former Marshall Granger executive), as intervenors, appealed the judgment and argued on appeal that, notwithstanding the material misrepresentations, Continental was foreclosed from seeking rescission under New York law because it: (1) "ratified" the insurance Policy; and (2) unreasonably delayed in seeking rescission of the Policy.

In New York, an insurer may not rescind a policy if, after having the requisite knowledge of the insured's fraud, it commits an act that affirms the policy. *Id*. at *2. The Second Circuit, in affirming the District Court's grant of summary judgment to Continental, held that ministerial changes to the policy, such as amending the policy to change the insured's name and address, cannot serve to ratify an insurance policy. *Id*. at *3. In contrast, the Court stated that an insurer's acceptance of premiums after acquiring rescission-justifying knowledge ratified the policy. *Id*. (*See U.S. Life Ins. Co. in N.Y.C. v. Blumenfeld*, 92 A.D.3d 487 (1st Dept. 2012).

The Defendants further argued that Continental had ratified the policy by agreeing to pay litigation costs in defending the various investigations of Marshall Granger. The Second Circuit held that the District Court had properly rejected this ratification argument because Continental was legally compelled to make the defense payment. *Id*. at *4. It stated that New York law requires that when an insurer agrees to pay an insured's defense costs, the insurer must continue performing that obligation until a court

enters a judgment granting rescission of the policy. Thus, the Second Circuit held that since New York law required Continental to pay these defense costs (either before or after seeking rescission), such payment did not "ratify" the policy. *Id*. at *5.

The final ratification argument raised by the Defendants was that Continental's act of offering "extended reporting coverage" to the insured when it decided that it would not renew the policy constituted ratification. The Second Circuit held that this act does not constitute ratification because New York law required Continental to offer this coverage upon the expiration of its claims made policy. *Id*.

Importantly, the Second Circuit discussed the distinction between a notice of non-renewal and a notice of cancellation of the policy. It stated a notice of cancellation of the policy may be deemed to ratify the policy through the date of the cancellation because cancellation is evidence of an understanding that the policy is currently valid, whereas a notice of non-renewal is a declination to enter into a new insurance contract upon the expiration of the old policy. *Id*. at * 6. The Court further noted that when Continental issued its notice of non-renewal it was still considering whether to seek rescission, and explicitly reserved its right to do so.

The intervenors' appeal as respects the jury determination that Continental did not unreasonably delay in seeking rescission focused on the District Court's jury instructions, which appellants' alleged were erroneous regarding the circumstances in which an insurer loses the right to rescind by failing to promptly seek rescission. The Second Circuit found no prejudicial errors in the District Judge's jury instructions, and stated that the intervenors' argument amounted to "splitting hairs" as the instructions contained similar language to that proposed by the intervenors.

Although the Second Circuit was not tasked with deciding whether Continental's delay in filing its rescission action was unreasonable, the District Court's decision provides a succinct narrative of the relevant case law regarding this issue which can be used as a guideline when evaluating whether an insurer's delay in seeking a rescission could be deemed unreasonable. *See Cont'l Cas. Co. v. Marshall Granger & Co., LLP*, 6 F.Supp. 3d 380, 393-397 (S.D.N.Y. 2014). Specifically, the District Court stated in its underlying decision that New York law requires a party seeking rescission of a contract to act without unreasonable delay upon learning of the grounds for rescission. *Ballow Brasted O'Brien & Rusin P.C. Logan*, 435 F.3d 235, 239-240 (2d Cir. 2006). An insurer who fails to rescind a policy promptly after learning of sufficient facts to justify rescission will be deemed to have forfeited the right to rescind. *See e.g., Blumenfeld, supra*. However, an insurer is entitled to a reasonable period of time in which to investigate the potential basis for rescission. *Chi. Ins. Co. v. Kreitzer & Vogelman (Kreitzer & Vogelman III)*, 265 F.Supp. 2d 335, 344 (S.D.N.Y. 2003). The District Court also made clear that there is no bright-line rule as to when the length of a rescission investigation becomes unreasonable, or how long the insurer is entitled to consider whether or not to pursue rescission after completing its investigation. *Cont'l Cas. Co. v. Marshall Granger & Co., LLP*, 6 F.Supp. 3d 380, 396 (S.D.N.Y. 2014) (internal citations omitted).

Importantly, the District Court responded to Defendants' argument that Continental had enough information at the time it issued the denial of coverage letter to the insureds, which cited to the allegations made in the SEC Action, to rescind the policy. The Court stated that "[t]his argument misses the mark" because Continental's letter referenced *allegations* levied by the SEC against the insured, and that it was reasonable for Continental to communicate its current position regarding coverage in a letter to its insured while continuing to investigate the rescission issue. *Id*. at 395. The District Court further stated that it "does not accept Defendants' premise that merely because Continental believed it had

sufficient information to reach a preliminary conclusion with respect to coverage under the Policy, it must have also had sufficient information to conclude that the contract should be rescinded." *Id. (See Republic Ins. Co. v. Masters, Mates & Pilots*, 77 F.3d 48, 53 (2d Cir. 1996)). Rather, the District Court held that "a final decision to rescind the Policy cannot be made without strong evidence that such a remedy is necessary and appropriate because rescission is a far more drastic step than disclaiming coverage. *Id. (See Krumme v. WestPoint Stevens Inc.*, 238 F.3d 133, 143 (2d Cir. 2000)).

Although the Second Circuit affirmed the judgment permitting the insurer to rescind its policy, it is crucial for insurers to be cognizant that their actions, after having the requisite knowledge of a basis to seek rescission, could ratify the policy and that an insurer's unreasonable delay in seeking a rescission could be deemed to have forfeited its right to do so. Further, as evidenced by the District Court's decision, an insurer should not delay the issuance of a coverage position letter while it investigates whether rescission is called for.