

MISREPRESENTATIONS IN THE FINANCIAL INSTITUTION BOND APPLICATION

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I. INTRODUCTION

The purpose of this article is to highlight issues that Financial Institution Bond (the “Bond”) insurers should consider when they discover misrepresentations or omissions in the insured’s application for the Bond. The remedy of rescission, within statutory and common law parameters, is thus examined, with emphasis on decisions involving fidelity bonds. However, because there is not a plethora of rescission cases involving fidelity bonds, similar cases in other insurance contexts are also examined.¹

This article provides general background information on the law of rescission,² examines pertinent provisions of the Bond, and overviews state statutes and case law that define the elements of rescission and the proof requirements thereof.³ Special consideration is given to unique issues related to rescission that have been imposed by statutes and case law,⁴ including

1. Several articles have been written about this subject, many examining rescission statutes, and more broadly considering other types of insurance coverages. *See* Annotation, *Obligee’s Concealment or Misrepresentation Concerning Previous Defalcations as Affecting Liability on Fidelity Bond or Contract*, 4 A.L.R.3d 1197 (1965); Joseph H. Powers, *Pulling the Plug on Fidelity, Crime and All Risk Coverage: The Availability of Rescission As a Remedy or Defense*, (unpublished paper presented at the Fidelity & Surety Law Committee Meeting of the American Bar Association Annual Meeting in August 1996, in Tampa, Florida); Robert Briganti, *Duty of the Insured to Disclose Facts to the Surety Materially Affecting the Risk*, (unpublished paper presented at the Fidelity & Surety Law Committee meeting of the American Bar Association Annual Meeting, 1982). Another article of note is: Geoffrey S. Ruce and Dennis J. Bartlett, *The Insured’s Misstatements, Mistakes and Omission in the Application for Fidelity Insurance: The Insurer’s Rights, Options and Dilemma* (unpublished paper available from authors).

2. *See* discussion at Section II, *infra*.

3. *See* discussion at Section III, *infra*.

4. *See* discussion at Section IV, *infra*.

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the availability of rescission when the Federal Deposit Insurance Corporation is the claimant, attachment of the application to the policy, and ambiguous questions in the application.

II. GENERAL BACKGROUND

An insurance contract requires utmost good faith and is, therefore, a contract *uberrima fides*. While both parties are expected to deal with each other fairly, openly and honestly, the Bond insurer may discover during the course of its investigation of a claim that a misrepresentation or omission was made in the Bond application. At that point, the insurer has a couple of options if it decides to rescind the Bond. First, it can seek a declaratory judgment that there is no liability under the Bond in view of the misrepresentation or omission. Second, the insurer can disclaim coverage, wait for the insurer to commence an action, if it so chooses, and then raise the affirmative defense of misrepresentation.⁵ Regardless of the particular avenue selected by the insurer, the common remedy sought is rescission.

The general law of contracts provides the underpinnings of the law governing rescission. More specifically, the RESTATEMENT (SECOND) OF CONTRACTS provides:

When a Misrepresentation Makes a Contract Voidable

- (1) If a party's misrepresentation of assent is induced by either a fraudulent or a material misrepresentation by the other party upon which the recipient is justified in relying, the contract is voidable by the recipient.⁶

The principles set forth in the Restatement are reflective of the precept recognized in the common law of contracts that a contract is voidable where a party to a contract was induced to enter the contract by false representations made by the other contracting party.⁷

The Bond insurer that chooses the remedy of rescission must view the policy as avoided from inception or, in other words, *void ab initio*.⁸ That is because to rescind is "to declare [the policy] void in its inception and to put an end to it as though it never were."⁹ In other words, to rescind an insur-

5. See, e.g., Robert J. Brennan and Jane M. Hanson, *Misrepresentation in the Application as the Basis for Rescission of a Property Insurance Policy*, 21 TORT & INS. L.J. 451 (Spring 1986).

6. RESTATEMENT (SECOND) OF CONTRACTS § 1641(1) (1981).

7. See, e.g., *Northern Assur. Co. v. Lark*, 845 F. Supp. 1301 (S.D. Ind. 1993), *aff'd* 17 F.3d 1956 (7th Cir. 1994); *Curtis v. Am. Comm. Mut. Ins. Co.*, 610 N.E.2d 871 (Ind. Ct. App. 1993); *Powers, supra*, note 1 at A-1.

8. See generally Brennan and Hanson, *supra* n.5, at 451; Powers, *supra* n.1, at A-1.

9. BLACK'S LAW DICTIONARY, at 679 (5th ed. 1983).

ance policy is “not merely to terminate it and release parties from further obligations to each other but to abrogate it from the beginning and restore parties to relative positions which they would have occupied had no contract ever been made.”¹⁰

Since a Bond that is rescinded is treated as *void ab initio*, the practical result is that the insured will have had no policy in place vis-a-vis losses discovered during the policy period of the rescinded Bond. The insured is “bare” of Bond coverage for that time frame. Consequently, the insured potentially has a great deal of exposure with respect to the types of transactions for which the Bond provides coverage. Also, the Insured that is “bare” on the Bond most likely will not have complied with regulatory measures that require banks to have Bond coverage in place. The net effect is that the remedy of rescission puts insureds in a precarious position. As the following illustrates, legislative measures, as enacted by most jurisdictions and construed by numerous court, set parameters on rescission and provide some degree of protection for insureds by articulating proof standards.

III. CONTRACTUAL, STATUTORY AND COMMON LAW PROVISIONS THAT GOVERN RESCISSION OF THE BOND

In considering whether to rescind the Bond, the Bond insurer should first review pertinent provisions of the Bond itself. In addition to reviewing the policy, the Bond insurer must examine the statutory provisions of the governing jurisdiction. Finally, the Bond insurer should examine decisional law interpreting rescission under the Bond, in general, as well as decisional law that addresses the interpretation of, and application of, the governing statute, in particular. The following discussion examines each of these sources of authority.

A. Provisions of the Bond

A bond carrier that is considering rescission should first review the terms of the Bond, as well as any riders thereto. In addition to reviewing the wording of the general agreement of the Bond concerning the insured’s representations, insurers also should identify any contractual provision that has an impact on the state’s rescission statute.

1. The wording of the bond.

Insurers should be cognizant of the provisions of the Bond that make it clear that statements made in the Bond application are representations — not warranties. More specifically, General Agreement (D), REPRESENTATION OF THE INSURED, of the Bond states the following:

10. *Id.*

The insured represents that the information furnished in the application for this bond is complete, true and correct. Such application constitutes part of the this bond.

Any misrepresentation, omission, concealment or any incorrect statement of material fact, in the application or otherwise, shall be grounds for rescission of this bond.

This general agreement is important because the fundamental differences between representations and warranties and the concomitant rights of insurers when faced with representations or warranties are integral parts of any rescission analysis.

In particular, at one point, insureds' statements were considered to be warranties. Warranties are statements made by the insured upon the literal truth of which the validity of the contract depends.¹¹ Since warranties were considered to be part of the contract and had to be literally true, any misstatement of fact contained in the warranty could void coverage.¹²

Representations, on the other hand, only have to be substantially true, and, therefore, are markedly different from warranties.¹³ As noted by one commentator:

A representation, unlike a warranty, is not part of the insurance contract but is collateral to it. If a representation is not material to the risk, its falsity does not avoid the contract. On the other hand, the materiality of a warranty to the risk insured against is irrelevant; if the fact is not as warranted, the insurer may deny coverage. In case of doubt, courts normally construe a statement in an insurance contract as a representation rather than a warranty.¹⁴

When statements made by insureds in the Bond application were considered to be warranties, a policy could be defeated "on the basis of what may have been an innocent misstatement of an inconsequential fact contained in the warranty."¹⁵ This led to a harsh result. Now, since statements made by insureds in the Bond application are considered to be representations — not warranties — the harsh result is avoided.

2. Terms of the contract that alter statutory requirements.

Since an insurer may contractually limit its right to rescind the Bond, as an initial step, the insurer should know whether it has done so and on what terms. For example, the parties may have agreed that rescission of the Bond

11. 45 C.J.S. INSURANCE § 488.

12. See *Briganti*, *supra* n.1, at 2-3.

13. 45 C.J.S. INSURANCE § 488.

14. See Brennan and Hanson, *supra* n.5, at 458.

15. See *Briganti*, *supra* n.1, at 3.

is limited to those instances where material misrepresentations were made intentionally. In states where the statute permits rescission based on innocent misrepresentations that are material, a contractual provision in the Bond that provides that the insurer has to show intent will usurp the statutory provision, thereby significantly altering the proof requirements of rescission.¹⁶

State Farm Fire & Casualty Co.,¹⁷ a case involving homeowner's insurance, warrants examination. In that decision, the insurer issued a homeowner's insurance policy to the insured that contained a provision that stated: "If you or any other insured under this policy has intentionally concealed or misrepresented any material fact or circumstance relating to this insurance, whether before or after a loss, this policy is void as to you and any other insured."¹⁸

In the application, the insured answered "no" when asked if he had any losses (fire, crime, wind, etc.), insured or not, in the past five years and when asked if any insurer or agency canceled or refused to issue or renew similar insurance to the applicant or any household member within the past three years. The facts showed that a little more than two years before the application was filed, a fire destroyed a mobile home owned by the insured and his wife. Also, the insured's homeowner's coverage with a previous carrier had been canceled due to nonpayment of premium, and another carrier had refused to issue homeowner's insurance to him.

The insured's home burned and plaintiff insurer filed an action for declaratory judgment to relieve it of the obligation to pay for the fire loss, alleging that the policy should be rescinded because of omissions, concealments or misrepresentations in the application. The jury returned a verdict in favor of the insureds, and the insurer filed a motion for judgment notwithstanding the verdict and, alternatively, a new trial. The district court denied the motion and an appeal was taken by the insurer.

In its affirmance of the lower court's ruling, the court agreed that by setting a standard for judging the Oliver's misrepresentations and concealments that required intent, the insurer waived its defenses of innocent misrepresentation under Alabama's rescission statute.¹⁹

16. See, e.g., *State Farm Fire & Cas. Co. v. Oliver*, 854 F.2d 416 (11th Cir. 1988).

17. *State Farm Fire & Cas. Co. v. Oliver*, 854 F.2d 416 (11th Cir. 1988).

18. *Id.* at 418.

19. *Id.* at 420. Alabama Code Section 27-14-7 provided as follows:

All statements and descriptions in any application for an insurance policy or annuity contract, or in negotiations therefor, by, or in behalf of, the insured or annuitant shall be deemed to be representations and not warranties. Misrepresentations, omissions, concealment of facts and incorrect statements shall not prevent recovery under the

State Farm Fire & Casualty Co. shows that where the insurance policy sets standards for judging misrepresentations and concealments that are more favorable to the insured than the standards prescribed by that jurisdiction's statute, the terms of the contract will govern. Accordingly, insurers weighing the rescission issue should carefully review all provisions of Bond and riders thereto, taking care to ascertain if policy provisions impose greater proof requirements than the applicable state statute.

B. Common Law Provisions

In a few states, only common law principles guide the insurer that is trying to determine whether there are sufficient bases for rescission. The states in which the law of rescission is governed purely by common law are Colorado, Connecticut, Iowa, New Mexico, Pennsylvania, Rhode Island and South Carolina.

An example of how common law addresses the law of rescission under a fidelity bond in a state that does not have a governing statute is found in *Fidelity Federal Savings & Loan Association v. Felicetti*.²⁰ In that case, the court granted plaintiff's motion for reconsideration of the court's earlier order granting summary judgment in favor of the insurer. Construing Pennsylvania law, the court stated:

In order to rescind a bond for misrepresentation, the insured must establish three elements: (1) that the declaration by the insured was false; (2) that the false declaration was material to the risk insured; and (3) that the insured knew it to be false....²¹

The court in *Felicetti*, relying largely on *Fidelity & Deposit Co. v. Hudson United Bank*,²² determined that its earlier decision addressed only the first and third elements and did not have evidence to support the second element.²³ Thus, the court concluded that its earlier conclusion as to the materiality of the misrepresentation on the bond application was in error.²⁴

policy or contract unless either: (1) Fraudulent; (2) Material either to the acceptant of the risk or to the hazard assumed by the insurer; or (3) The insurer in good faith would either not have issued the policy or contract, or would not have issued a policy or contract at the premium rate as applied for, or would not have issued a policy or contract in as large an amount or would not have provided coverage with respect to the hazard resulting in the loss if the true facts had been made known to the insurer as required either by the application for the policy or contract or otherwise.

20. 813 F. Supp. 332 (E.D. Penn. 1993).

21. *Id.* at 335.

22. 653 F.2d 766 (3d Cir. 1981); *see* case discussion in Section II.C.4., *infra*.

23. *Fidelity Fed. Sav. & Loan v. Felicetti*, 813 F. Supp. at 335.

24. *Id.*

Felicetti shows that the common law analytical framework for determining the propriety of rescission requires the insurer to establish certain elements in order to void the policy, and that materiality is an integral part of the rescission inquiry. The common law approach used in *Felicetti*, as shown below, is akin to the legislative rescission framework.

C. Statutory Provisions

In most states, legislation controls the law of rescission.²⁵ Among those states with legislation, some have legislation that only pertains to rescission of certain lines of insurance, including life, automobile and health.²⁶ In the latter instance, however, courts will examine these more narrowly-drawn statutes when considering rescission of other policies of insurance.

Parsing through the statutes of various states, it becomes clear that certain basic elements are required to be shown by an insurer in order to be able to exercise the right of rescission. Although there is a myriad of statutes governing the right to rescind, and the statutes contain different formulations of the elements needed to prove rescission, those statutes share a common thread in that they require, at a minimum, a misrepresentation or omission to be “material.”²⁷ In short, a misrepresentation is material if it is relevant to the assumption of the risk, and it generally is determined by considering if the undisclosed information would have influenced the insurer in assessing the risk.²⁸

In addition to materiality, some states require a causal relation. That is, they require that the matter misrepresented actually contribute to the loss or

25. Ala. Code Section 27-14-7 (1986); Alaska Code Section 21.42.110 (1995); Ariz. Rev. Stat. Ann. Section 20-1109 (1990); Cal. Ins. Code Section 330-361 (West 1993); Del. Code Ann. tit. 18 Section 2711 (1989); D.C. Code Ann. tit. 35 Section 414 (1993); Fla. Stat. Ch. 627.409 (1984); Ga. Code Ann. Section 3302407 (1990); Haw. Rev. Stat. Section 431:10-209 (1993); Ky. Rev. Stat. Ann. Section 304.14-110 (1988); La. Rev. Stat. Ann. Section 22:619(A) (1994); Me. Rev. Stat. Ann. tit. 24A Section 2411 (1990); Mass. Gen. Laws Ann. ch. 175 Section 186 (1987); Minn. Stat. Section 60A:08(1986); Mont. Code Ann. Section 33-15-403 (1993); Neb. Rev. Stat. Section 44-358 (1993); Nev. Rev. Stat. Section 687B.110 (1993); N.H. Rev. Stat. Ann. Section 415.9 (1991); N.J. Rev. Stat. Section 24-3 (1994); N.Y. Ins. Law Section 3105 (1985); N.C. Gen. Stat. Section 58-3-10 (1994); N.D. Cent. Code Section 26-1-29-13 (1989); Okla. Stat. tit. 36 Section 3609 (1990); Or. Rev. Stat. Section 742.013 (1989); 26 L. Puerto Rico A. Section 1110; S.D. Codified Laws Ann. Section 58-11-44 (1990); Tenn. Code Ann. Section 56-7-103 (1994); Tex. Ins. Code Ann. arts. 3.44(3), 21.35 (1981); Utah Code Ann. Section 31A-21-105 (1994); Vt. Stat. Ann. tit. 8 Section 3736 (1984); Va. Code Ann. Section 38.2-309 (1994); Wash. Rev. Code Ann. Section 48.18.090 (1984).

26. Ark. Code Ann. tit. 23 Section 79-107 (1992); Ind. Code tit. 27 Section 8-5-5 (1994); Md. Code Ann. Ins. Art. 48A Section 374 (1957); Mich. Comp. Laws Section 500.2218 (1993); Miss. Code Ann. Section 83-9-11(c) (1992); Mo. Rev. Stat. Section 376.800 (1991); Ohio Rev. Code Ann. Section 3923.14(1989); Vt. Stat. Ann. tit. 8 Section 3736 (1984).

27. See *supra*, notes 25 and 26, and accompanying text.

28. See generally Brennan and Hanson, *supra* note 5, at 453; Powers, *supra* note 1, at A-7.

event on which the claim is made. Further, some states require proof of reliance — proof that the insurer relied on the misrepresentation to its detriment. Finally, scienter requirements are set forth in some statutes.

All three of these elements (materiality, causation and reliance) are discussed at length in this section. Throughout the discussion, cases decided under the Bond are given heightened scrutiny.

1. Materiality.

In determining what is materiality and how to prove it, insurers should look to the provisions of the applicable rescission statute. The statutes in many states require that the misrepresentations, omissions, concealment of facts and incorrect statements be “material either to the acceptance of the risk or to the hazard assumed” by the insured. Further, statutes in many states contain the following provision, which essentially explains that materiality is shown when:

The insurer in good faith would either not have issued the policy or contract, or would not have issued a policy or contract at the premium rate as applied for, or would not have issued a policy or contract in as large an amount or would not have provided coverage with respect to the hazard resulting in the loss if the true facts had been made known to the insurer as required either by the application for the policy or contract or otherwise.²⁹

The court’s exposition of the materiality issue in *St. Paul Fire & Marine Insurance Co. v. Boston Housing Authority*,³⁰ a case involving a Massachusetts statute that contains the above materiality wording, is instructive. In *Boston Housing Authority*, the insurer sought a declaration of its rights and obligations under two public employees’ blanket bonds. The motion judge denied the insured’s motion for partial summary judgment and granted the insurer’s motion for total summary judgment, thereby giving rise to the appeal by the insured.

A renewal application completed by the insured contained the following sequence of questions and answers:

Q: Audits: By whom:

A: C.P.A. [✓]...BIANNUAL [sic] AUDIT REQUIRED[,] ARTHUR YOUNG & CO. MOST RECENT AUDITOR....

Q: When was last audit made?

A: 3/31 1980....

29. These indicia of materiality are reflected in case law. See, e.g., *Greves v. Ohio State Life Ins. Co.*, 821 P.2d 757 (Ariz. Ct. App. 1991).

30. 514 N.W.2d 363 (Mass. App. Ct. 1987).

Q: Will bank statements be reconciled monthly by someone not authorized to deposit or withdraw?

A: Yes. [✓]

Q: Who will reconcile?

A: Finance—Accounting Dept.³¹

The latter two questions and answers were at issue in the case.

James Deas worked in the insured's finance and accounting department as custodian of manual payroll checks. Deas was authorized to issue payroll checks. He was specifically assigned to reconcile certain accounts (not including the payroll account) and was authorized to reconcile any account other than the payroll account. James Kalil, who was on the insured's accounting staff, was responsible for seeing that reconciliations were done, and that each account was reconciled by an accountant not responsible for the records of the account.

During the time that Deas was payroll supervisor (September 1982 until September 1984), he was embezzling funds by writing checks to himself on the manual payroll stock of checks. Deas then endorsed and deposited the checks into his personal bank account. During this time frame, no other accountant reconciled the payroll account.

In its management letter for the two year period ending March 31, 1982, the insured's outside auditor (referring to cash disbursements) noted that the individual responsible for check sequence, who had access to blank checks, also performed the bank reconciliation. Also, in its evaluation for the two year period ending March 31, 1984, the insured's outside auditor noted a segregation of duties problem regarding the payroll account specifically.

Sarah Stratman was the insured's director of finance and accounting. For about two years, she was aware that Kalil was not enforcing the segregation of duties policy. In September 1982, Stratman sent a memorandum to all program accountants in her department. The memorandum assigned the responsibilities for bank reconciliations of a number of specific accounts. Stratman also frequently reminded Kalil of his responsibility with respect to bank statement reconciliations.

Deas was arrested for embezzling over \$350,000 from the insured after a bank contacted Stratman about payroll checks being deposited in Deas' personal account with that bank. The insurer denied coverage for the insured's claim and litigation ensued.

31. *Id.* at 365.

The *Boston Housing Authority* court first looked to the Massachusetts rescission statute, which states:

No oral or written misrepresentation or warranty made in the negotiation of a policy of insurance by the insured or in his behalf shall be deemed material or defeat or avoid the policy or prevent its attaching unless such misrepresentation or warranty is made with actual intent to deceive, or unless the matter misrepresented or made a warranty increased the risk of loss.³²

Noting that there was no significant contention by the insurer that the insured answered the questions in the renewal application concerning reconciliation of bank statements monthly with actual intent to deceive, the court went on to consider whether the representations made by the insured, in view of the provisions of the state's rescission statute, increased the risk of loss.

The court held that "the violations of the promissory representations, as a matter of law, increased the risk of loss (and, indeed, resulted in the loss incurred)..."³³ Further, holding that the motion judge properly granted summary judgment in favor of the insurer, the court stated:

Enough facts are undisputed on this record to make it plain that BHA was not in substantial compliance with its representation that bank statements 'will be reconciled monthly by someone not authorized to deposit or withdraw.' The violations were shown to have continued for a substantial period, and not to have been merely inadvertent, temporary violations.... BHA's director of finance and accounting, with broad duties, knew that independent reconciliations by a person other than Deas (of the bank statements of accounts for which Deas had responsibility) were not being conducted for a considerable period.... Although BHA established a policy of complying with the representations, there was abundant indication that BHA's director of finance and accounting knew the policy was not being enforced by employees of BHA having the duty to enforce, and that she tolerated the lack of enforcement, in part, to build up proof of the ineffectiveness of another employee having that duty.³⁴

The *Boston Housing Authority* court's finding that the matters misrepresented increased the risk of loss meant, *a fortiori*, that the matters misrepresented were material. This conclusion is supported by the statute, which provides that no misrepresentation or warranty made in the negotiation of an insurance policy would be deemed material or defeat the policy unless it was made with actual intent to deceive or the matter misrepresented increased the risk of loss. It also is supported on other grounds. Specifically, in its recitation of the facts, which the court treated as virtually

32. *Id.* (citing Mass. Gen. Laws Ann. ch. 175 Section 186).

33. *Id.* at 368.

34. *Id.* at 368-69. (citations omitted).

undisputed, the court noted that an underwriter for the insurer stated in an affidavit that failure to segregate accounting functions significantly increases the risk of fidelity losses. The court stated that “[t]he increase of risk, of course, was illustrated by the circumstances of Deas’ embezzlement.”³⁵

Boston Housing Authority serves as a good example of a decision involving a blanket bond in which the court followed the statute governing the right to rescind and found that the matters misrepresented increased the risk of loss. Such a finding necessarily meant that there was a showing of materiality, the key element needed to prove rescission.

In addition to considering the wording in many rescission statutes that relate to materiality, insurers considering rescission also should be cognizant of the three tests of materiality that have been developed by the courts. Those tests are the industry wide test, the reasonable and prudent insurer test and the subjective viewpoint of the insurer test.³⁶ The court in *Merchants Fire Assurance Corp. v. Lattimore*³⁷ discussed these tests as follows:

There are three tests which the courts employ to determine the materiality of undisclosed facts. The test most frequently applied is whether a fact is regarded as material by all similar insurers. A second test is what a reasonable and prudent insurer would regard as material. (Citations omitted). The third test is whether the particular individual insurer regarded the undisclosed facts as material to the contract. This test looks only to the evidence concerning the attitude or practice of the insurance company involved in the suit.³⁸

The net effect of the wording of many of the rescission statutes, as well as the holdings of, and commentary in, case law, is that an insurer may be able to prove materiality, the underpinning of a rescission analysis, by showing: (1) that the misrepresentation or omission increased the risk or loss or the hazard assumed; (2) that it would not have issued the policy; (3) that it would not have issued the policy at the same premium; (4) that it would not have issued the policy for the same limit of liability; or (5) that it would not have covered the particular hazard that caused the loss.

2. Causation.

A small number of state statutes limit an insurer’s right to rescind by requiring an insurer to prove a nexus between the event or hazard that caused the loss and the matter misrepresented.³⁹ The statutes require that the matter misrepresented actually “contributed” to the loss, event or hazard on

35. *Id.* at 366.

36. See Brennan and Hanson, *supra* note 5, at 754; Race and Bartlett, *supra* note 1, at 4; Briganti, *supra* note 1, at 2.

37. 263 F. 2d 232 (9th Cir. 1959).

38. *Id.* at 241.

39. See Ark. Code Ann. tit. Section 23-79-107(c) (1992); Mo. Rev. Stat. Section 376.800 (1991); Neb. Rev. Stat. Section 44-358 (1993); Utah Code Ann. Section 31A-21-105(2)(b) (1996).

which the claim is based. One commentator reasoned that the causal relation requirement exists in some jurisdictions because:

[T]he insurance company should not be allowed to avoid liability because rescission is too severe a penalty even for intentional fraud, as rescission would strip the insured of coverage on which he has relied.

Furthermore, in cases where the loss has already occurred, the insured will be unable to secure other coverage and innocent beneficiaries may suffer the ultimate loss. As between them and the insurance company, causal relation states arbitrarily assign the risk of misrepresentation to the latter.⁴⁰

Cases in which the causal relation requirement is discussed, albeit under circumstances involving policies other than fidelity bonds, are instructive. An opinion in which the causal relation requirement is analyzed in the context of hospital insurance policies is *White v. American Republic Insurance Co.*⁴¹ In *White*, the insured was hospitalized several times in connection with injuries sustained from being kicked by a horse. The insured brought an action against the insurer to recover benefits under two hospital insurance policies. Judgment was entered in a court-tried case in favor of the insured.

In the action, the insurer counterclaimed. It sought, *inter alia*, rescission of the policies. The insurer contended that the insured had numerous other insurance policies that he did not disclose in his applications, and that such misrepresentations were material and voided the risk.

The jurisdiction's rescission statute provided that no misrepresentation made in obtaining insurance would be deemed material or render the policy void unless the matter misrepresented "shall have actually contributed to the contingency or event on which any claim thereunder is to become due and payable"⁴² The court determined that the language of the statute prevented the insurer from voiding the policies "because plaintiff's misrepresentations admittedly had no relationship to the claims he ultimately made."⁴³ The court explained that the insurer had to prove that the insured's misrepresentations regarding other insurance coverage actually contributed to the event on which the claim became due and payable -- the treatment of the insured for injuries sustained from a horse kick.⁴⁴

40. Kathryn H. Vratil and Stacy M. Andreas, *The Misrepresentation Defense in Causal Relation States: A Primer*, 26 TORT & INS. L.J. 832, 834 (Summer 1991).

41. 799 S.W.2d 183 (Mo. Ct. App. 1990).

42. *Id.* at 188 (citing Mo. Rev. Stat. Section 376.800).

43. *Id.* at 190.

44. *Id.*

Another decision in which the causal relation requirement is the focal point of the court's rescission analysis is *Derickson v. Fidelity Life Association*.⁴⁵ In *Derickson*, the plaintiff appealed from the district court's grant of summary judgment for the defendant life insurance company. The insurer had issued a policy on the life of Christopher Derickson in December 1992. Derickson died a few months later in a one-car accident. Derickson's car crossed the center line and hit a metal railing and two parked cars as he was driving from the hospital after the birth of his first child. He had been awake for thirty-six hours. A witness to the accident stated that Derickson was not speeding or driving recklessly at the time of the accident.

The application asked if Derickson's driver's license had been suspended or revoked in the past three years. Derickson checked the "no" box. The insured's investigation revealed that Derickson's driver's license had been suspended nine times and revoked four times in the three years preceding the date of the application. Also, Derickson's license was revoked at the time of the accident. The insurer denied coverage, returned the paid premium, and maintained that it would not have issued the policy had it known of Derickson's poor driving record.

The *Derickson* court stated that Missouri law required the matter misrepresented in an application for life insurance to have "actually contributed" to the insured's cause of death to be deemed material and, therefore, render the policy void.⁴⁶ The court reversed, finding that the causation issue should have been left to a jury, and that "a jury could find that the matter Christopher misrepresented -- his reckless or negligent driving record -- did not contribute to the accident...."⁴⁷

These cases illustrate statutes, and judicial interpretations of statutes, that require a connection between the matter misrepresented and the hazard or event upon which the claim is based. Hence, if an insurer is considering rescission in a jurisdiction that requires a showing of causation, the insurer's right of rescission is more narrowly-defined.

3. *Reliance.*

A couple of jurisdictions, by statute, require the insurer to prove its reliance on the misrepresentation, thereby interjecting another limitation on the insurer's right to rescind.⁴⁸ A number of cases require proof of reliance

45. 77 F.3d 263 (8th Cir. 1996).

46. *Id.* at 264.

47. *Id.* at 265.

48. Or. Rev. Stat. Section 742.013 (1995); Utah Code Ann. Section 31A-21-105 (1996).

as a separate element of rescission.⁴⁹ On the other hand, however, some courts have found it unnecessary to prove reliance as a separate element, viewing it as duplicative if materiality is proven.⁵⁰

As with the discussion of causation, it is instructive to examine cases involving policies other than the fidelity bond in which rescission is at issue. The juxtaposition of *Zimmerman v. Continental Casualty Co.*⁵¹ against *Shapiro v. American Home Assurance Co.*⁵² demonstrates the split in authority over whether reliance has to be proven as a separate element of rescission.

In *Zimmerman*, plaintiff recovered judgment in the amount of \$2,000 under an accident insurance policy covering disability and health benefits after her husband died when hit by a train engine. The policy excluded suicide or attempted suicide.

The defendant insurer alleged that there was fraud and misrepresentation by the insured in the application. It further alleged that it relied on the truthfulness of the answers, that it was deceived by the answers to its injury, and that had truthful answers been given, it would not have issued the accident insurance policy.

The facts revealed that when asked in the application if he had been treated for, or had any of a number of, enumerated conditions, including any disorder of the mental or nervous system, the applicant indicated that he had a minor case of ulcers that apparently was under control. The applicant gave a “no” answer when asked if, to the best of his knowledge and belief, he had received medical or surgical advice or treatment or been hospitalized during the past five years (other than as previously stated) and when asked if he had any physical impairment, deformity or disease (other than as previously stated). The facts showed that the applicant had been hospitalized twice during the time frame in question, once after a suicide attempt in a jail and again after threatening his wife’s life and his own life after he had been drinking. The applicant’s condition in the hospital had been diagnosed as psychoneurotic disorder, depressive reaction.

The pertinent statute provided that no misrepresentation or warranty made in the negotiation of an insurance policy would be deemed material or

49. See, e.g., *Albany Ins. Co. v. Anh Thi Kieyu*, 927 F.2d 882 (5th Cir.1991), cert. denied, 502 U.S. 901 (1991); *Zimmerman v. Cont. Cas. Co.*, 150 N.W.2d 268 (Neb. 1967); *John Hancock Mut. Life Ins. Co. v. Weisman*, 27 F.3d 500 (10th Cir. 1994); *Northern Life Ins. Co. v. Ippolito Real Estate Partnership*, 601 N.E.2d 773 (Ill.Ct. App. 1992).

50. See, e.g., *Shapiro v. American Home Assur. Co.*, 584 F. Supp. 1245 (D. Mass. 1984); *National Union Fire Ins. Co. of Pittsburgh, Pa. v. Sahlen*, 999 F.2d 1533 (11th Cir. 1993); *Pinette v. Assurance Co.*, 52 F.3d 407 (2d Cir. 1995).

51. *Zimmerman v. Continental Cas. Co.*, 150 N.W.2d at 268.

52. *Shapiro v. American Home Assur. Co.*, 999 F.2d at 1532.

defeat the policy unless the misrepresentation or warranty deceived the company to its injury, existed at the time of the loss and contributed to the loss.⁵³ The *Zimmerman* court identified the statutory requirement that the company be “deceived to its injury” and judicial interpretations of that statutory requirement as the critical inquiry in the case.

Reversing and remanding, the Supreme Court of Nebraska decided that the jury was entitled to consider, among other things, whether the insureds’ misrepresentations or false statements were made knowingly with intent to deceive and whether the company was thereby deceived to its injury.⁵⁴ Thus, the *Zimmerman* court made it clear that the insurer’s efforts to defeat the policy had to include the statutorily-required, separate proof that the insurer, deceived by the misrepresentations to its injury, relied on the misrepresentations.

A different approach to the reliance issue was advanced in *Shapiro*. In that case, former directors and officers of Giant Stores sought a declaration that they were covered under a directors’ and officers’ liability policy. The defendant insurer moved for summary judgment, contending that the policy was voidable because the application contained misrepresentations made by plaintiff Shapiro, the former president of Giant Stores.

Shapiro falsely stated in the application for insurance that he did not know of any act, error or omission by Giant officials that might give rise to a claim. Shapiro also submitted to the insurer a financial statement that grossly overstated Giant’s earnings.

The court granted the insurer’s motion for summary judgment, using the Massachusetts rescission statute as the touchstone for its analysis.⁵⁵ Responding to the argument that the insurer had to prove that it had relied on the misrepresentations, the court stated:

The weight of Massachusetts authority does not consider ‘reliance’ as a separate element which an insurer must prove in order to invalidate an insurance policy.... It is likely that reliance is not treated as an independent requirement because the standard of materiality under Massachusetts common and statutory law is such that any statement that is shown to be material is one so central to the risk being insured that the insurer would be expected to take it into consideration in making the underwriting decision. Indeed, in doing so the insurer would be serving not only its own interest but also the public interest in controlling costs to the insurance system that would result from misrepresented risks. Materiality has long been defined as something ‘the knowledge or ignorance of which would naturally influence the judgment of

53. *Id.* at 271 (citing Neb. Rev. Stat. Section 44-358).

54. *Id.* at 272.

55. *Shapiro v. Am. Home Assurance Co.*, 584 F. Supp. at 1249, 1253.

the underwriter in making the contract at all, or in fixing the rate of the premium.' ... The statute states no added requirement of proof of reliance, and the Massachusetts courts have imposed none.⁵⁶

Neither *Zimmerman* nor *Shapiro* involved attempts at rescission under the Bond or other types of fidelity bonds. Nevertheless, courts and insurers considering rescission under the Bond should find these cases helpful in demonstrating how reliance alternatively is considered by courts and in demonstrating how the process of ferreting out the elements of rescission is a jurisdiction-specific inquiry that can yield varied results.

4. *Scienter Requirements.*

Many cases and rescission statutes provide that a fraudulent misrepresentation or concealment of a material fact is grounds for rescission.⁵⁷ Some states also require that any misrepresentation be made intentionally or in bad faith.⁵⁸ *Fidelity & Deposit Co. of Maryland v. Hudson United Bank*,⁵⁹ a decision involving a fidelity bond issued to a bank, and *Sun Insurance Co. v. Hercules Securities Unlimited, Inc.*,⁶⁰ a decision involving indemnity policies, are illustrative of the latter.

The Court of Appeals in *Hudson United Bank* construed New Jersey law in an appeal from an order of the district court granting a judgment of rescission in favor of the insurer. A chronology of the facts of the case follows.

In July 1975, the insured, on the recommendation to the board of directors of Mr. Potter, a senior loan officer, made loans totaling \$700,000 to companies owned and controlled by Mr. Mullens. In January 1976, Mr. Robertson was appointed president of the bank. Soon thereafter, some senior loan officers told Robertson that they questioned Potter's competence. Robertson reviewed loan files and determined that Potter in fact was incompetent. He found that there was poor loan documentation, that there was incorrect totaling on certain financial statements, and a \$600,000 loan to one of Mullens' companies should not have been granted. Robertson thought

56. *Id.* at 1250 (citations omitted).

57. *See supra*, notes 25 and 26 for the statutes referenced in the following states: Arizona; Arkansas; Delaware; Washington, D.C.; Florida; Georgia; Hawaii; Idaho; Illinois; Kentucky; Louisiana; Maine; Maryland; Massachusetts; Minnesota; Montana; North Carolina; North Dakota; Nebraska; Nevada; New Hampshire; New Jersey; Oregon; South Dakota; Tennessee; Utah; and Washington; *see, e.g., Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Sahlen*, 999 F.2d at 1532; *Cova v. Am. Family Mutual Ins. Co.*, 880 S.W.2d 928 (Mo. Ct. App. 1994); *Carroll v. Jackson Nat'l Life Ins. Co.*, S.E.2d 777 (S.C. 1992); *see generally Powers, supra* note 1, at A-11.

58. *See, e.g., Cova v. Am. Family Mut. Ins. Co.*, 880 S.W.2d at 928; *Bishop v. Farm Bureau Life Ins. Co.*, 421 N.W.2d 423 (Neb. 1988); *Perault v. Time Ins. Co.*, 633 So.2d 263 (La. Ct. App. 1993), *cert. denied*, 634 So.2d 833 (La. 1994); *Martell v. Universal Underwriters Life Ins. Co.*, 564 A.2d 584 (Vt. 1989).

59. *Fidelity & Deposit Co. v. Hudson United Bank*, 653 F.2d at 766.

60. 605 N.Y.S.2d 767 (N.Y. App. Div. 1993).

that the loan was not a bad risk since it was collateralized by a \$300,000 certificate of deposit and what appeared to be valuable mortgages.

Robertson commenced a more extensive investigation. He learned that there was a warrant out for Mullens' arrest for issuing bad checks, that Mullens' references did not think highly of him, that Mullens was being investigated in a multimillion dollar fraud scheme, that several judgments and liens were pending against Mullens, and that the firm that purportedly certified his company's financial statements did not exist. Robertson also discovered that Potter and another loan officer had violated general banking practice by allowing some corporate checks to be cashed by the individual authorized to sign checks for the corporation.

As part of the process of receiving bids for insurance coverage, the bank completed and returned an application for coverage with the plaintiff insurer in January 1976. On March 12, 1976, the bank's comptroller in charge of obtaining insurance advised the insurer of a "possible pending fraud claim" that had been reported to the bank's then current carrier. Plaintiff insurer wrote the bank a letter confirming that it was advised of a possible pending fraud, and that the bank's current carrier had been notified. In the letter, plaintiff insurer stated that since the premiums quoted were based on a no loss experience, it wanted to receive a letter from the bank regarding the possible fraud and the facts surrounding it. Although plaintiff insurer never received a reply, it issued a policy effective March 2, 1976.

The bank filed a proof of loss with plaintiff insurer and its previous carrier for the Mullens loans. On January 31, 1977, plaintiff insurer advised the bank that it was canceling the bond effective April 2, 1977, explaining that the basis for the cancellation was that the bank had notified its previous carrier of a potential loss prior to the effective date of the policy. The bank requested and received an extension. It then purchased from plaintiff insurer an additional twelve month rider, which was an option provided in the original bond.

During 1977, the bank discovered many additional losses unrelated to Mullens. Some of them also involved Potter. The bank filed proofs of loss for these matters. On January 13, 1978, the insurer tried to rescind the bond and tendered premium payments to the bank. The bank refused the tender and the insurer filed the instant action.

The district court, holding that the insurer was entitled to rescind, concluded that under New Jersey law the doctrine of equitable fraud controlled. The trial court found that the insurer did not have to prove that the bank intended to conceal information or to submit false answers in its application for insurance because the insurer could rescind the bond if the bank had made innocent misrepresentations of material facts.

The reviewing court addressed the issue of equitable fraud, explaining that in New Jersey the concept of equitable fraud developed mainly in response to attempts by life insurance companies to avoid coverage after an insured's death. The doctrine, the court explained, allowed the insurer to rescind in equity on the basis of an innocent misrepresentation of material facts when it could not prove "legal fraud."

The *Hudson United Bank* court stated that in New Jersey the doctrine of equitable fraud was strictly applied to objective questions. On the other hand, stated the court, there was no misrepresentation and, consequently, no equitable fraud in New Jersey when a negative answer was a correct statement of the applicant's knowledge and belief.⁶¹

The insurer's application contained a chart entitled "Six-year loss information," which sought information about, among other things, date of loss, amount of loss, amount of loss pending and type of loss. The bank's response to the information sought in the chart was "NO LOSSES PAID BY INSURANCE CARRIER DURING THE PAST SIX YEARS." The insurer's application also contained a statement certifying that the officers and directors, to the best of the bank's knowledge and belief, performed their duties honestly while employed by the bank, and that it had not come to the bank's notice that any of the officers or directors were dishonest.

With respect to the certification of employee honesty, the court stated that it requested subjective information.⁶² The court further stated that for subjective questions, the state's law provided that an insurer had to demonstrate that the answer was false and that the insured knew the answer was false.⁶³ The court determined that the district court erred when it decided that the doctrine of equitable fraud should be applied strictly against the bank with respect to the certification.⁶⁴

The district court found that the bank acted under the honest belief that the Mullens losses were not covered by its existing bond, and that there was no evidence of a conscious intention to conceal. The *Hudson United Bank* court decided that the district court's findings in this regard were not clearly erroneous.⁶⁵ Consequently, the court held that the insurer was not entitled to rescind when the doctrine of equitable fraud was appropriately applied to the bank's certification of employee honesty because there was no evidence that the bank knew its response concerning the certification was false.⁶⁶

61. *Fidelity & Deposit Co. v. Hudson United Bank*, 653 F.2d at 771.

62. *Id.* at 773.

63. *Id.*

64. *Id.*

65. *Fidelity & Deposit v. Hudson United Bank*, 653 F.2d at 773.

66. *Id.*

In *Sun Insurance Co.*, three thieves, planning to steal a large sum of money from an armored car company, had their “front man” acquire the defendant armored car company from which they planned to steal. The conspirators stole \$3,700,000, as planned, from the acquired armored car company. The insurer had issued a policy to the acquired armored car company at the behest of the conspirator that served as the “front man.”

The court considered whether the insurer was required to reimburse various defendants who were customers of the armored car company and had their funds on deposit with the company at the time of the theft. The court determined that “because Sun’s policy had been obtained by the conspirators after they had already entered into the conspiracy to commit the theft from Hercules, the theft coverage contained in that policy, as well as the coverage contained in the excess policy, was void ab initio.”⁶⁷ The court granted the plaintiff insurer summary judgment and declared the policies void.

The court stated the rule of law as follows:

A policy of insurance will be voided where it is proved that in applying for the insurance coverage the insured fraudulently concealed a material fact.... The mere nondisclosure of a fact, concerning which the insured has not been asked, will not necessarily void an insurance policy.... However, if fraudulent intent is present, the opposite result will follow. In order to constitute fraud, there must be a willful intent to defraud and not a mere mistake or oversight.⁶⁸

Applying the law to the facts of the case, the court concluded that the insured armored car company, which acted through its agent (the conspirator that served as “front man”), did not just conceal the existence of a plan to steal from the armored car company’s vault, a material fact. Rather, the company concealed a material fact with the actual intent to defraud the insurer.⁶⁹

The *Hudson United Bank* court found that the doctrine of equitable fraud, as applied to a request for subjective information, required a showing of a false statement and a showing that the bank knew the statement was false. The court rejected the insurer’s attempt to rescind since there was no evidence that the bank knew of the falsity of its response to the certification of employee honesty. The *Sun Insurance Co.* court required a specific showing of willful intent to defraud in order for rescission to be permissible, found the requisite intent and allowed the policies to be voided. Although the courts in *Hudson United Bank* and *Sun Ins. Co.* reached different conclusions about the availability of the remedy of rescission, both courts imposed a scienter

67. *Id.* at 768.

68. *Id.* at 771 (citations omitted).

69. *Id.*

requirement and refused to permit insurers to rescind solely on the basis of material, innocent misrepresentations.

Some states, in contrast, do not require a showing of intent to defraud or bad faith. Rather, they allow rescission when innocent misrepresentations are made that are material.⁷⁰ *West American Finance Co. v. Pacific Indemnity Co.*⁷¹ is representative. That case involved three actions brought by the insured against its fidelity bond carriers. Appeals were taken after demurrers were sustained to the amended complaints without leave to amend.

Prior to and at the time of the applications, four majority members of the board of directors of the insured, acting under corporate authority, had been, and at that time were, carrying on fraudulent business transactions that resulted in large financial losses to the insured. Also, those directors appropriated money to different purposes that were dishonest. No disclosure was ever made to the insurer of the directors' activities prior to, or at the time of, issuance of the bonds.

The court decided that the trial court was justified in sustaining the demurrers.⁷² In its affirmance, the court stated:

[T]he mere nondisclosure of the circumstances affecting the situation of the parties which are material for the surety to be acquainted with and are within the knowledge of the person obtaining the surety bond, is undue concealment *even though not wilful* [sic] or intentional or with a view to any advantage to himself. Manifestly, therefore, in the present case, the nondisclosure of the fraudulent practices which were being carried on by the majority members of the boards of directors under their corporate powers at the time of the application for the issuance of these successive fidelity bonds, and which resulted in the enormous losses the corporation now seeks to compel the surety to make good, constituted concealment from the surety of the material facts upon which it was clearly entitled to be informed before it could intelligently decide whether under the existing conditions it would assume the risk to be imposed upon it by the fidelity bonds.⁷³

West American Finance reflects the more relaxed showing required in states where rescission is allowed when there are misrepresentations that are material. In such states, the insurer that does not have to prove intent to deceive has one less hurdle to cross in establishing its right to void the policy *ab initio*.

70. See, e.g., *National Union v. Sahlen*, 999 F.2d at 1533; *Curtis v. Am. Community Mutual Ins. Co.*, 610 N.E.2d at 871; *John Hancock Mu. Life Ins. Co. v. Weisman*, 27 F.3d at 500; *Coots v. United Employers Fed'n*, 865 F. Supp. 596 (E.D. Mo. 1994).

71. 61 P.2d 963 (Cal. Ct. App. 1936).

72. *Id.* at 968

73. *Id.* at 967 (emphasis added).

As the discussion in this section shows, materiality is the core element of proof of rescission. The discussion further shows that states range the gamut in requiring additional elements of proof, and that the other elements that may be required — causation, reliance and scienter — all have nuances that are fleshed out in case law.

IV. UNIQUE ASPECTS OF THE LAW OF RESCISSION

The Bond insurer that is considering rescission should not simply examine the provisions of the Bond that affect rescission and determine the elements of rescission, as defined by statute and case law, that need to be proven in the jurisdiction in question. The Bond insurer also should be cognizant of a few other unique aspects of the law of rescission that could introduce further obstacles to rescission, including issues related to rescission of Bonds issued to failed banks, attachment of the application and ambiguous questions in the application.

A. Failed Banks and the FDIC

A Bond insurer that is considering rescission on a claim pursued by the FDIC as receiver after it has taken over a failed bank does not have a uniform body of case law to guide its decision making. That is because there is a split of opinion between the Sixth Circuit Court of Appeals and the Tenth Circuit Courts of Appeals over the availability of the remedy of rescission when the FDIC is the claimant. The cases giving rise to the split of authority are *Federal Deposit Insurance Corp. v. Aetna Casualty & Surety Co.*⁷⁴ and *FDIC v. Oldenburg*.⁷⁵ A closer examination of these decisions explains the nature and scope of the split in authorities.

In *Federal Deposit Insurance Company v. Aetna Casualty & Surety Co.*, the insurer appealed from a jury verdict that awarded \$5,950,000 to the FDIC in a case involving a bankers' blanket bond issued to the failed United American Bank. On appeal, the insurer argued, among other things, that the district court erred when it held that 12 U.S.C. Section 1823(e) barred Aetna's misrepresentation defense. The reviewing court agreed with the insurer and reversed.

The facts of the case were that the bank was operated and controlled by Jake and C.H. Butcher. Jake Butcher, president, board chairman and the largest shareholder of the failed bank, concealed and misrepresented several loans that were for his or his family's personal benefit. He also forged

74. 947 F.2d 196 (6th Cir. 1991).

75. 34 F.3d 1529 (10th Cir. 1994).

loan documents and misrepresented the existence and value of collateral for the loans.

The bankers' blanket bond application asked whether the bank was under investigation by either state or federal authorities with regard to its banking practices. The bank responded that it was not.

After the FDIC was appointed as receiver, it filed suit against the insurer seeking recovery under the Bond. One of the defenses the insurer asserted was that the Bond was void as a matter of Tennessee law because the bank made material misrepresentations in the application.

The appellate court reviewed the D'Oench doctrine. It stated that *D'Oench, Duhme & Co., Inc. v. Federal Deposit Insurance Corp.* held that there was a "federal policy to protect respondent [FDIC], and the public funds which it administers, against misrepresentations as to the securities or other assets in the portfolios of the banks which respondent insures or to which it makes loans."⁷⁶ The court further explained that the D'Oench doctrine was later codified in 12 U.S.C. Section 1823(e).⁷⁷

The district court found that the application for the bond did not meet Section 1823(e)'s requirements. Specifically, it found that in order to satisfy the section's requirements for an exception the board had to approve the misrepresentations on the application. That is, the board had to have been aware that the agreement contained fraudulent misrepresentations made by the bank, and the board had to have effectively endorsed the misrepresentations in the minutes.⁷⁸

The appellate court found the district court's reliance on *D'Oench* and *Langley v. Federal Deposit Insurance Corp.*⁷⁹ to be misplaced. It stated that the policy articulated by the Langley court was the same as the concern articulated by the *D'Oench* court. That concern was that the function of the FDIC would be largely undermined "if secret oral or side agreements between a bank and the maker of a note were enforced."⁸⁰

76. *FDIC v. Aetna Cas. & Surety Co.*, 947 F.2d at 200 (citations omitted).

77. 12 U.S.C. Section 1823(e) provides: No agreement which tends to diminish or defeat the interest of the Corporation [FDIC] in any asset acquired by it under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement: (1) is in writing, (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution, (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) has been, continuously, from the time of its execution, an official record of the depository institution.

78. *FDIC v. Aetna Casualty & Surety Co.*, 947 F.2d at 201.

79. 484 U.S. 86 (1987).

80. *FDIC v. Aetna Casualty & Surety Co.*, 947 F.2d at 201.

The court held that Section 1823(e) did not apply to the insurer's bankers' blanket bond, stating:

The primary purpose of D'Oench and section 1823(e) is to provide notice to federal bank examiners and not to change conditional promises to pay into absolute obligations. Essentially, we are holding that when the FDIC, in the course of a purchase and assumption transaction, finds a bankers blanket bond, it acquires the bond with knowledge of the recognized defenses available under insurance law.⁸¹

The court in *Federal Deposit Insurance Corp. v. Aetna Casualty & Surety Co.* went on to make it clear that its holding was limited to the bankers' blanket bond, and that its finding did not in any way touch upon the merits of the insurer's misrepresentation defense.⁸²

The following, in synoptic fashion, sets forth the court's rationale for finding that the district court improperly interpreted 12 U.S.C. Section 1823(e) as it related to the insurer's misrepresentation defense:

- (1) There were no secret or unwritten contractual conditions present in the case at hand;⁸³
- (2) The application was contained in the bank's records;⁸⁴
- (3) Even assuming, *arguendo*, that the bankers' blanket bond is an asset within the meaning of the statute, the bankers' blanket bond is not the type of asset that can be instantaneously assessed with respect to likely proceeds in view of its conditional nature (i.e., policy defenses or limitations);⁸⁵
- (4) The insurer was not colluding with officers of the failed bank in an effort to rewrite the terms of the contract;⁸⁶
- (5) The alleged misrepresentations made by the failed bank in the application did not reflect on the sufficiency or adequacy of the consideration given by the failed bank's directors to the Bond's terms;⁸⁷ and

81. *Id.* at 208.

82. *Id.*

83. *Id.* at 201-02.

84. *Id.*

85. *Id.* at 202.

86. *Id.*

87. *Id.*

(6) To hold Section 1823(e) applicable, the court would have to “engraft a holder in due course doctrine onto insurance law” and would be “giving the FDIC the ability to transmute lead into gold.”⁸⁸

The Tenth Circuit Court of Appeals, considering an insurer’s appeal of judgment rendered for the FDIC on two savings and loan blanket bonds, examined 12 U.S.C. Section 1823(e) and reached a result that runs counter to that reached by the court in *Federal Deposit Insurance Corp. v. Aetna Casualty & Surety Co.* The underlying claim in *FDIC v. Oldenburg*⁸⁹ involved real estate known as Park Glen Estates. Defendant Oldenburg was the owner, president and chairman of Investment Mortgage International, Inc. (“IMI”), which provided real estate financing services, and Empire State West (“Empire”), whose primary business was owning and developing Park Glen Estates. IMI’s financial condition began rapidly deteriorating in July 1983 because its expenses far exceeded its earnings.

Oldenburg became the owner of State Savings & Loan Association in October 1983 by purchasing 99.9% of its stock for \$10.5 million in cash. On January 30, 1984, senior employees called James Rossetti, the bank’s president, and told him that Oldenburg or IMI wanted to borrow \$10 million from the bank. Rossetti and Charles Burgardt, the bank’s general counsel, agreed to tell Oldenburg that making such a loan would violate federal banking regulations. Rossetti and Burgardt then met with others to discuss ways that Oldenburg’s loan request could be met. They concluded that the only option was for federal regulators to approve the sale by Oldenburg of something worth \$10 million to the bank.

A day after Oldenburg’s loan request, Rossetti had \$10 million transferred from the bank to IMI. The money was used to prop up IMI, which was on the verge of collapsing.

In late February 1984, Rossetti, Burgardt and IMI’s senior management were advised that no dealings were to take place between the bank and any of Oldenburg’s companies until the Federal Home Loan Bank had more information. Nevertheless, Rossetti, Burgardt and others proceeded with the bank’s purchase of Park Glen Estates for \$55.7 million without obtaining federal approval. (As of March 1984, the property was valued at \$4.1 million and was subject to \$16.5 million in encumbrances.)

Oldenburg, Rossetti, Burgardt and others continued to conceal the Park Glen Estates transaction from federal regulators. When the full scope of the transaction came to light, federal and state regulators issued cease and desist orders to the bank in June 1984. The FSLIC eventually became the bank’s receiver.

88. *Id.* at 207.

89. *FDIC v. Oldenburg*, 34 F.3d at 1552-53.

The FDIC filed suit to recover under the blanket bonds for the losses arising from the Park Glen Estates transaction. The district court entered judgment in favor of the FDIC in the amount of \$3 million under each bond.

On appeal, the insurer argued that the district court erred by concluding, among other things, that the D'Oench doctrine applied to bar the insurer's affirmative defenses, including the affirmative defense of misrepresentation. Specifically, the insurer argued that because the bank made material misrepresentations in its application by stating that it was not aware of any dishonest employees, the insurer was entitled to rescind. The FDIC moved to strike the defense, arguing that it was barred by the D'Oench decision and 12 U.S.C. Section 1823(e). The district court ruled that those authorities barred the insurer from presenting evidence of the misrepresentation defense.

The *Oldenburg* court held that the district court correctly ruled that section 1823(e) applied to the bond at issue and barred the insurer from asserting the misrepresentation defense in an effort to avoid the policy.⁹⁰ The Tenth Circuit found reliance on Section 1823(e) sufficient to support the district court's decision. The court determined that the insurer did not meet its burden of presenting evidence, and did not argue on appeal, that the bond application met the strict requirements of Section 1823(e).⁹¹ The court further determined that the insurer's misrepresentation defense should fail since the Section 1823(e) applied to the bond in the case.⁹²

In analyzing the issue, the court first inquired whether there was an "agreement" pursuant to the terms of the statute. It held that: "the conditioning of payment under a fidelity bond on the truthfulness of assertions in the bond application is an 'agreement' for purposes of section 1823(e) where the bond itself does not predicate payment upon assertions made in the application, does not reference the application or incorporate it by reference, and the bond and application are separate and essentially unrelated documents."⁹³

The court next considered whether the bond in question was an "asset" under the statute. Noting that it was unpersuaded by the majority analysis in *Federal Deposit Insurance Corp. v. Aetna Casualty & Surety Co.*, the court concluded that the bond was an "asset."⁹⁴ It reasoned that Congress used the broad language "any asset" in the statute, that it was convinced that Congress intended those words not to be narrowly interpreted so as to apply

90. *Id.* at 1554.

91. *Id.* at 1551.

92. *Id.*

93. *Id.*

94. *FDIC v. Oldenburg*, 34 F.3d at 1552-53.

to promissory notes or negotiable instruments and not fidelity bonds, and that it did not believe fidelity bonds were so unique that they were beyond the reach of Section 1823(e).⁹⁵

The *Oldenburg* court further stated that the statutory purpose of preventing fraud and collusion would be furthered by including fidelity bonds under section 1823(e)'s requirement that agreements be executed, recorded in the bank's records and approved by the board.⁹⁶ The court thought that if the bond application had to be considered and approved by the board, it was more likely that misrepresentations would be noticed and avoided.⁹⁷

The courts in *Federal Deposit Insurance Corp. v. Aetna Casualty & Surety Co.* and *Federal Deposit Insurance Corp. v. Oldenburg* reached conflicting conclusions about the applicability of section 1823(e) to the blanket bond and, consequently, rendered conflicting holdings on an insurer's ability to rescind the blanket bond when the FDIC is pursuing the claim. Thus, in determining its course of action, the Bond insurer of a failed bank must carefully weigh the facts of its case. It must also examine critically the effect of the D'Oench doctrine, as articulated in legislation and conflicting case law, on the availability of the remedy of rescission.

B. The Application Attachment Requirement

Until recently, Illinois' rescission statute required that the application had to be physically attached to the policy or endorsed on the policy in order for an insurer to rely on the misrepresentations therein to void the policy. More specifically, the predecessor of the current statute provided:

No misrepresentation or false warranty made by the insured or in his behalf, in the negotiation for a policy of insurance, or a breach of a condition of such policy shall defeat or avoid the policy or prevent its attaching unless such misrepresentation, false warranty or condition shall have been stated in the policy or endorsement or rider attached thereto, or in the written application therefor, of which a copy is attached to or endorsed on the policy, and made a part thereof. No such misrepresentation or false warranty shall defeat or avoid the policy unless it shall have been made with actual intent to deceive or materially affects either the acceptance of the risk or the hazard assumed by the company. This section shall not apply to policies of marine or transportation insurance.⁹⁸

In cases involving various kinds of policies where courts interpreted the predecessor statute, courts found that insurers could not rely on any alleged

95. *Id.*

96. *Id.* at 155 4.

97. *Id.*

98. 25 ILCS 5/154.

misrepresentation or omission to void the policy if the application was not actually attached to the policy.⁹⁹ *National Union Fire Insurance Co. v. Continental Illinois Corp.*, a decision involving a directors' and officers' liability policy, is illustrative. *National Union Fire Insurance Co.* involved litigation brought by several insurers against Continental Illinois Corporation ("CIC") and its subsidiary bank seeking to avoid liability under the directors' and officers' liability policies issued by the insurers to CIC. The insurers sought leave to file amended complaints.

CIC completed a Renewal Proposal for Harbor Insurance Company ("Harbor") and a form Renewal Application for National Union Fire Insurance Company ("National Union") a few months later. Both companies issued policies within days of receiving the forms. Neither the Renewal Proposal for Harbor nor the Renewal Application for National Union expressly incorporated any attached Financial Statements as part of the proposal or application, and both forms expressly excluded the form Renewal Proposal from being a part of the proposal or application.

The insurers' proposed Amended Complaints sought to add allegations in an attempt to comply with the attachment provisions of 25 ILCS 5/154. The court decided that unless the insurers could allege in good faith that the documents that contained the alleged misrepresentations, the Form Renewal Proposal and Financial Statement, were physically attached to the policies, they were denied leave to add the paragraphs they sought to add.¹⁰⁰ In support of its position, the court stated:

Insurers' inability to allege and prove such physical attachment ...would be fatal to their attempted reliance on the unattached documents as the basis for rescission.

....

[I]f the Financial Statements were not attached to the National Union Policy, National Union cannot rescind that Policy because of misrepresentations in those documents. And that is true even if the National Union Renewal Application, which apparently was attached to its Policy, incorporated those Financial Statements expressly or because of custom and practice.... Insurers' allegations of incorporation because of custom and practice, rather than physical attachment, are at war with the mandate of the Illinois legislature. Those allegations are indeed irrelevant and futile.¹⁰¹

The *National Union Fire Insurance Co.* court's strict adherence to the dictates of the rescission statute shows how important the issue of attach-

99. See, e.g., *National Union Fire Ins. Co. v. Continental Illinois Corp.*, 658 F. Supp. 781 (N.D. Ill. 1987); *Gibraltar Casualty Co. v. A. Epstein & Sons, Int'l Inc.*, 562 N.E.2d 1039 (Ill. App. Ct. 1990).

100. *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Continental Illinois Corp.*, 658 F.Supp. at 788.

101. *Id.* at 787-88.

ment of the application was for the insurer considering rescission in Illinois. The amendment to Illinois' rescission statute, however, which became effective June 1, 1996, makes attachment an non-issue for Bond insurers considering rescission in Illinois. The revised statute provides the following:

No misrepresentation or false warranty made by the insured or in his behalf in the negotiation for a policy of insurance, or breach of a condition of such policy shall defeat or avoid the policy or prevent its attaching unless such misrepresentation, false warranty or condition shall have been stated in the policy or endorsement or rider attached thereto; or in the written application therefor. No such misrepresentation or false warranty shall defeat or avoid the policy unless it shall have been made with actual intent to deceive or materially affects either acceptance of the risk or the hazard assumed by the company. With respect to a policy of insurance as defined in subsections (a), (b) or (c) of Section 143.3, except life, accident and health, fidelity and surety, and ocean marine policies, a policy or policy renewal shall not be rescinded after the policy has been in effect for one year or one policy term, whichever is less. This Section shall not apply to policies of marine or transportation insurance.¹⁰²

The changes made in the Illinois rescission statute inure to the benefit of Bond insurers for a couple of reasons. First, with respect to all policies of insurance, the new statute does not require the application to be physically attached to the policy. Further, the new statute prohibits rescission after the policy has been in effect for one year or one policy term, whichever is less. Fidelity policies, however, are exempted from this provision. Thus, the physical attachment requirement is no longer a hurdle the insurer considering rescission in Illinois has to satisfy.

C. Questions in the Application

In considering rescission, the Bond insurer should closely examine the wording of the question that gives rise to the material misrepresentation by the insured. The insurer should dispassionately examine whether the question is ambiguous, unclear or capable of varying interpretations and recognize that a court leaning toward disallowing rescission may rely on the question's ambiguity as a reason for preventing rescission altogether or not disposing of the issue on summary judgment.

A case involving a fidelity bond issued to a savings and loan clearly illustrates the latitude afforded courts when presented with an ambiguous question in the application. In *Felicetti*,¹⁰³ the insured savings and loan brought an action against the insurer for declaratory judgment and breach

102. 25 ILCS 5/154 (effective June 1996).

103. *Fidelity Fed. Sav & Loan v. Felicetti*, 813 F. Supp. at 332.

of contract for failure to pay insurance proceeds under a fidelity bond. The court granted summary judgment in favor of the insurer, and the savings and loan filed a motion for reconsideration.

The case involved various breaches of fiduciary duty, as well as fraud and misrepresentation, by the president, vice president and appraisal agent of the savings and loan that caused the savings and loan to sustain losses. The president completed the application. Question 16 required the applicant to list “all losses sustained in the past three years.” The president listed one loss in the amount of \$2,000 of unknown origin.

In its motion for summary judgment, the insurer argued that it was entitled to rescind the bond because the savings and loan, through its president, made misrepresentations of material fact by not listing the losses caused by the president, the vice president and the appraisal agent.

On reconsideration, the savings and loan argued that Question 16 of the application required that the applicant only list those losses that would be covered by the bond — not all losses sustained by the applicant in the previous three years. The savings and loan relied on *Hudson United Bank*,¹⁰⁴ a case in which the insurer sought rescission of a bankers’ blanket bond. In *Hudson United Bank*, the application contained a question concerning prior losses almost identical to the question at issue in *Felicetti*. The *Hudson* court, the court determined that the insured’s construction of the question was reasonable. The insured had construed it to mean that it only had to list information about covered losses that had actually been filed with its insurance carrier.¹⁰⁵

The *Felicetti* court granted the savings and loan’s request for reconsideration and modified its earlier order so as to deny the insurer’s summary judgment motion. It concluded that it was obliged to following the findings of *Hudson United Bank* under the theory of stare decisis.¹⁰⁶ The court further stated that the savings and loan had convinced it that Question 16 was susceptible to different interpretations. Citing the principal that any ambiguities or uncertainties in language are construed strictly against the insurer and in favor of coverage, the court found that the savings and loan’s construction of Question 16 was reasonable.¹⁰⁷ The *Felicetti* court made it clear that the savings and loan had raised an issue of fact regarding the meaning

104. *Fidelity & Deposit Co. v. Hudson United Bank*, 653 F.2d at 766; see also discussion in Section II.C.4.

105. *Fidelity & Deposit Co. v. Hudson United Bank*, 653 F.2d at 772.

106. *Fidelity Fed. Sav. & Loan Ass’n v. Felicetti*, 813 F. Supp. at 335.

107. *Id.*

of Question 16 so as to defeat the summary judgment motion, and that the meaning attributable to the question should go to the jury.¹⁰⁸

Felicetti shows that a question capable of different interpretations provides fodder for the court that is looking to prevent rescission or not dispose of the rescission issue on summary judgment. For the Bond insurer, *Felicetti* serves to reinforce the need to carefully examine the question at issue in the application, inquiring whether it is susceptible of different interpretations. If such a determination is made, the insurer should assess the relative weight of this factor in deciding whether to rescind.

V. CONCLUSION

When faced with misrepresentations in a Bond application, the insurer should look to the provisions of the Bond that are pertinent. It should then determine whether the state in which it is considering rescission has a rescission statute. Most states have such statutes. In the absence of a rescission statute, the insurer should resort to common law to determine what the insurer has to prove in order to be able to rescind. In states where there are rescission statutes, the insurer should look to the state's statute, as well as interpretive judicial opinions, to ascertain the precise elements of rescission.

While statutory provisions and common law principles vary, materiality is a core requirement. To measure materiality, insurers should look to the wording of the state statute, as well as the three tests of materiality found in decisional law. Whether the insurer is required to prove causation, reliance or intent depends on the jurisdiction.

The insurer should keep in mind unique issues that have arisen in the law of rescission such as the split of authorities on the availability of the remedy of rescission when the FDIC is the claimant, the revised statute in Illinois that no longer requires physical attachment of the policy, and the latitude afforded courts when the question in the application is ambiguous.

108. *Id.*