JUDICIAL RESCISSION OF FIDELITY COVERAGE

David J. Krebs and Diane L. Matthews

Rescission is a drastic remedy which voids an insurance policy ab initio, often leaving the insured without coverage for a loss which has already occurred. As a result, courts are understandably reluctant to grant such a remedy.[1] Thus, an insurer seeking to rescind a policy should be well-armed with convincing evidence and be prepared for a hard fight if it wishes to have any chance of success. In such situations, however, an action to rescind part or all of the policy can be a very powerful defense to an attempt by the insured to foist an undisclosed risk onto the insurer. This remedy will be discussed in detail in this article.

I. Grounds for Rescission

In essence, rescission amounts to an "unmaking" of the contract on the grounds that one party's consent to the contract was fraudulently induced. Possible grounds for rescission of fidelity coverage include misrepresentation, fraud, concealment, breach of warranty, and mistake. Of these, misrepresentations in the application or in negotiations for coverage are most often seen by the courts, and comprise the bulk of the case law on this subject.

A. MISREPRESENTATIONS

Courts recognize that insurers try to assess and quantify a risk before assuming it, and that a fidelity insurer will try to discover all pertinent facts regarding the honesty of the employees who are to be covered before deciding whether to accept the risk, and if so, on what terms. Concealing, falsifying or even carelessly omitting information will affect the insurer's assessment of the risk, which determines not only the level of premiums but also whether the insurer will accept the risk at all.[2] In deciding rescission cases, it is clear that not every misrepresentation will vitiate a policy. Judges look closely at whether the misrepresentation was material to the decision to accept the risk and; statutory law is similar.

---

[1] 2 COUCH ON INS. 3D § 31:70 (West 1995); *see also* FDIC v. Moskowitz, 946 F. Supp. 322, (D.N.J. 1996).

[2] 7 COUCH ON INS. 3D § 100:1 (West 1997).

David J. Krebs is a partner and Diane L. Matthews is a senior attorney with the firm of Krebs, Farley & Pelleteri, LLC in New Orleans, Louisiana.

© The Fidelity Law Association

1. Materiality of the Misrepresentations

a. Factors Material in Connection With the Issuance of a Fidelity Bond. The majority of states now have specific statutes regulating the rescission of policies because of misrepresentations made either in the application or in negotiations for coverage. A factor common to these statutes is the materiality of the misrepresentations. Under these statutes, to avoid coverage, the misrepresentation must be material to the acceptance of the risk or the hazard assumed.[3]

"A misrepresentation is 'material' if it concerns a fact, 'the knowledge or ignorance of which would naturally influence the judgment of the underwriter in making the contract at all, or in estimating the degree and character of the risk, or in fixing the rate of the premium.'"[4] Although this normally is a question for the jury to decide, if the facts are not in dispute, certain misrepresentations increase the risk of loss as a mater of law.[5]

The court in *FDIC v. Underwriters of Lloyd's of London*,[6] held that the underwriters of a financial institution bond were entitled to rescission under Massachusetts law given the material misrepresentations made by the Heritage Bank in its application for coverage. The court found compelling the fact that the bank answered "none" on its bond application to the question of whether the bank was aware of any irregularities in its operations over the past three years, when the evidence supported the fact that the bank was well aware of egregious misconduct by two loan officers whom the bank had discharged. Prior to their discharge, these officers had approved credit extensions of thousands of dollars in excess of their lending authority, camouflaged other "straw" loans to avoid lending limits, and

---

[3]*See, e.g.*, ALA. CODE § 27-14-7 (2000); ALASKA STAT. § 21.42.110 (Michie 2000); ARIZ. REV. STAT. ANN. § 20-1109 (West 2000); CAL. INS. CODE § 359 (West 2000); DEL. CODE ANN. tit. 18 § 2711 (2000); FLA. STAT. ANN. § 627.409 (West 2000); GA. CODE ANN. § 33-34-7 (2000); HAW. REV. STAT. ANN. § 431:10-209 (Michie 2000); IDAHO CODE § 41-1811 (Michie 2000); 215 ILL. COMP. STAT. ANN. § 5/154 (West 2000); IND. CODE ANN. § 27-8-5-5 (West 2000); KY. REV. STAT. ANN. § 304.14-110 (Michie 2000); LA. REV. STAT. ANN. § 22:619 (West 2000); ME. REV. STAT. ANN. tit. 24-A § 2411 (West 2000); MASS. GEN. LAWS ANN. CH. 175 § 186 (West 2000); MISS. CODE ANN. § 83-9-11 (2000); MONT. CODE ANN. § 33-15-403 (2000); NEB. REV. STAT. ANN. § 44-358 (Michie 2000); NEV. REV. STAT. ANN. § 687B.110 (Michie 1999); N.H. REV. STAT. ANN. § 415:9 (2000); N.M. STAT. ANN. § 59A-18-11 (Michie 2000); N.Y. INS. LAWS § 3105 (Gould 2000); N.C. GEN. STAT § 58-3-10 (2000); N.D. CENT. CODE § 26.1-29-25 (2000); OHIO REV. CODE ANN. § 3911.03 (West 2001); OKLA. STAT. ANN. tit. 36 § 3609 (West 2000); OR. REV. STAT. ANN. § 742.013 (1999); 40 PA. CONS. STAT. ANN. § 757 (West 2000); S.C. CODE ANN. § 38-71-40 (Law. Co-op. 2000); S.D. CODIFIED LAWS § 58-11-44 (Michie 2000); TENN. CODE ANN. § 56-7-103 (2000); TEX. INS. CODE ANN. art. 21.17 (Vernon 1999); UTAH CODE ANN. § 31A-21-105 (2000); VA. CODE ANN. § 38.2-309 (Michie 2000); WASH. REV. CODE ANN. § 48.18.090 (West 2000); W. VA. CODE § 33-6-7 (2000); WIS. STAT. ANN. § 631.11 (West 2001); WYO. STAT. ANN. § 26-15-109 (Michie 2000).

[4]FDIC v. Underwriters of Lloyd's of London, 3 F. Supp. 2d 120, 140 (D. Mass. 1998).

[5]*Id.* at 141.

[6]*Id.* at 148.

© The Fidelity Law Association

flagrantly violated loan underwriting procedures. Moreover, the evidence adduced at trial established that the bank, having become suspicious of the lifestyle of these officers, had hired a law firm to investigate them. Finally, months before the bond application was completed, an FDIC examiner filed a Report of Apparent Crime on one of the officers.[7] The court glibly concluded that to answer "none" to the question was "analogous to submitting an application for fire insurance without telling the carrier that the kitchen [was] already in flames."[8]

Another interesting fact withheld from the London underwriters was an arrangement between the bank and St. Paul, its prior financial institution bond carrier. Two weeks after the London Underwriters' application was completed, St. Paul elected not to renew coverage. Rather than issuing a ninety day notice of cancellation which the bank would have to disclose, St. Paul agreed to accept a signed release from the bank extinguishing any liability of St. Paul as of the date of the release. Thus, at the expiration of the St. Paul coverage, the bank could seek coverage from another underwriter without having a "cancellation black mark" on its record. Indeed, when the bank was asked in the London Underwriter's application whether any policy had been canceled or renewal refused, it answered "no." It was argued by the bank that, at the time it completed the application, St. Paul had not made a final renewal decision. The court found that, although this response alone might not have been sufficient to support rescission, when viewed in combination with the bank's other acts of concealment, it was further evidence that the bank was doing everything it could to keep Lloyd's from discovering the full extent of the risk it was being asked to cover.[9] Accordingly, the court held that "[t]hese misrepresentations were material in that they misled defendants as to the nature of the risk being undertaken, and thereby heightened defendants' risk of loss as a matter of law. As a result, defendants are entitled to rescission of the bond."[10]

Rescission also was granted to the insurer in *FDIC v. Moskowitz.*[11] The court found that United Savings Bank's representation in its bond application to Fidelity & Deposit Company of Maryland that it had not been criticized by regulators was a material misrepresentation in light of certain Supervisory Directives which were then in place. The court held that "simple logic contributes to the conclusion that the question is material. Evidence that bank regulators had criticized a bank's operations would be relevant to the determination of whether to issue fidelity insurance to the bank; an affirmative response to [the] question . . . would have triggered an investigation by F&D[12] as to why such criticisms had been leveled at United."[13]

---

[7]*Id.* at 123.
[8]*Id.*
[9]*Id.* at 145.
[10]*Id.*
[11]946 F. Supp. 322 (D.N.J. 1996).
[12]Fidelity & Deposit Company of Maryland will be referred to throughout as "F&D."
[13]*Id.* at 332.

© The Fidelity Law Association

Misrepresentations contained in an application for crime coverage were held material and the court voided coverage in *In re Payroll Express Corp.*[14] Suit was brought by the Chapter 11 trustee of the estate of Payroll Express Corporation[15] against Aetna and a group of London Excess Underwriters,[16] issuers of various dishonesty and crime policies. Barbara and Robert Felzenberg were the sole shareholders of PEC and Robert Felzenberg was its founder, president and chief executive officer. PEC operated a payroll check cashing service whereby customers of PEC transferred funds representing their payroll for a particular period of time into PEC bank accounts. These funds were then used by PEC to handle the on-site distribution of cash in exchange for endorsed payroll checks. Funds representing uncashed checks were to be returned to customers.

The Felzenbergs began diverting customer funds for their own benefit and for the benefit of other companies which they controlled as early as the mid-1980's. Initially, their dishonesty involved their failure to return unused funds. Later, they engaged in a massive check-kiting scheme. PEC suffered millions of dollars in losses as a result.

LEU issued three policies, one primary and two excess. In response to question 10 of the application for the policies, which inquired as to whether PEC had suffered a loss during the last five years, Robert Felzenberg answered yes and explained that a burglar had stolen $1.5 million from a safe in 1988. In truth, however, PEC had suffered seventeen other theft and robbery losses, totaling over $3 million during the five years preceding the date of the application. Under New Jersey law, the court noted that a misrepresentation by an insured voids its rights under the policy, "if it is untruthful, material to the particular risk assumed by the insurer, and reasonably relied upon by the insurer issuing the policy."[17] The court further found that under New Jersey law, a misrepresentation is material if it is "'reasonably related to the estimation of the risk or assessment of the premium.'"[18] The court reasoned that common sense tells us that an applicant's loss history is material to a reasonable insurance company's decision of whether to insure an applicant and its determination of the premium. The court concluded that reasonable minds would not differ on the materiality of the misrepresentations made in this case and held them material as a matter of law.[19]

The court also found Robert Felzenberg's answer of "none" to question thirty-six of the application, a catch-all question asking for any information which is

---

[14]216 B.R. 344 (S.D.N.Y.), *aff'd*, 186 F.3d 196 (2nd Cir. 1999).
[15]Hereinafter referred to as PEC.
[16]Hereinafter referred to as LEU.
[17]*Id.* at 355 n.6 (citing FDIC v. Moskowitz, 946 F. Supp. 322, 329 (D.N.J. 1996)).
[18]*Id.* at 357 (quoting Massachusetts Mutual Life Ins. Co. v. Manzo, 584 A.2d 190 (N.J. 1991)).
[19]*Id.* at 357-58.

© The Fidelity Law Association

or may become material to the proposed insurance, provided additional grounds to void coverage. Although the court found the question to be broad and to provide little guidance, it rejected the plaintiff's argument that the question was ambiguous. The court held that, given the fact that the Felzenbergs had embezzled continuously for years and that Robert Felzenberg was aware that others who might fall under the proposed policy definition of "employee" had assisted him in his defalcations, it was "beyond cavil that Robert Felzenberg knew or should have known that knowledge of the existence of his scheme . . . would be reasonably related to LEU's calculation of the risk it would bear under the LEU Policies."[20]

Misrepresentations in an application for a commercial crime policy issued through the Federal Crime Insurance Program were at issue in *Nyasco Sports, Inc. v. Director, Federal Emergency Management Agency.*[21] The policy was issued to Nyasco, a corporation engaged in the business of selling athletic shoes. A loss occurred when Nyasco was burglarized. Coverage was denied under 44 C.F.R. § 81.7(d) because the corporation misstated the amount of gross receipts it reasonably anticipated receiving. The court held that the:

> [m]isstatement of gross receipts on an application for federal crime insurance clearly constitutes a material misrepresentation warranting disclaimer of the policy. Since the amount of gross receipts controls the size of the premium which the applicant must pay, misrepresentation of that amount enables an applicant to pay a smaller premium. Since the policy would not have been issued at the lower premium level if the insurer had known the true amount of the applicant's gross receipts, such misrepresentation is material.[22]

b. Proof of Materiality of the Misrepresentations. Of course, in a court of law, a fact is not a fact unless it can be proven by competent evidence. Proof of materiality was at issue in *Fidelity Federal Savings and Loan Association v. Felicetti.*[23] In that case, the savings and loan failed to disclose in its application for coverage certain losses sustained from a particular loan it had made. The court ruled that under Pennsylvania law, a misrepresentation of fact is material if it would have caused the insurer to refuse to issue the policy altogether or to demand higher premiums, and held that this was a material misrepresentation. However, the insured filed a motion for reconsideration, arguing that there was no evidence that the misrepresentation had swayed the underwriting decision. The court found that the insurer, F&D, had failed to include any evidence in the form of an affidavit or otherwise that the misrepresentation regarding the loan loss was material to the risk

[20]*Id.* at 359.
[21]561 F. Supp. 864 (S.D.N.Y. 1983).
[22]*Id.* at 867-68.
[23]813 F. Supp. 332 (E.D. Pa. 1993).

© The Fidelity Law Association

involved. Accordingly, the court granted the insured's motion for reconsideration of its decision finding the misrepresentation material.[24]

2. Intent to Deceive

Some states require, in addition to, or in lieu of materiality, that the misrepresentations be made by the insured with intent to deceive before rescission can be granted.[25] For example, Louisiana Revised Statute Annotated 22:619(A) provides in part that "no oral or written misrepresentation or warranty made in the negotiation of an insurance contract, by the insured or in his behalf, shall be deemed material or defeat or void the contract or prevent it attaching, unless the misrepresentation is made with the intent to deceive." Intent to deceive is determined from "the surrounding circumstances indicating the insured's knowledge of the falsity of the representation made in the application and his recognition of the materiality of his misrepresentations, or to circumstances which create a reasonable assumption that the insured recognized the materiality."[26] Strict proof of fraud, however, is not required to show intent to deceive.[27] As the court noted in *FDIC v. Underwriters of Lloyd's of London,*[28] under the applicable Massachusetts statute, reliance, an element of fraud, need not be shown by the insurer to establish its entitlement to rescission where it can show material misrepresentations have been made.[29]

3. Innocent Misrepresentations

Intent to deceive need not always be shown. For example, the concept of equitable fraud has been applied to fidelity policies in two cases decided under the law of New Jersey. Equitable fraud occurs when there has been a misrepresentation of a material fact although innocently made.[30]

In *FDIC v. Moskowitz,*[31] the court allowed rescission of a bank's financial institution bond after the bank failed to disclose in its application that it has not been

---

[24]*Id.* at 334-35.

[25]*See, e.g.*, HAW. REV. STAT. ANN. § 431:10-209 (Michie 2000); 215 ILL. COMP. STAT. ANN. § 5/154 (West 2000); LA. REV. STAT. ANN. § 22:619 (West 2000); MASS. GEN. LAWS ANN. CH. 175 § 186 (West 2000); NEB. REV. STAT. ANN. § 44-358 (Michie 2000); N.H. REV. STAT. ANN. § 415:9 (2000); N.D. CENT. CODE § 26.1-29-25 (2000); OHIO REV. CODE ANN. § 3911.03 (West 2001); 40 PA. CONS. STAT. § 757 (West 2000); S.C. CODE ANN. § 38-71-40 (Law. Co-op. 2000); UTAH CODE ANN. § 31A-21-105 (2000); WASH. REV. CODE ANN. § 48.18.090 (West 2000); WIS. STAT. ANN. § 631.11 (West 2001).

[26]Breaux v. Bene, 664 So. 2d 1377, 1380 (La. App. 1st Cir. 1995).

[27]Holt v. Aetna Cas. & Sur. Co., 680 So. 2d 117, 126 (La. Ct. App. 1996).

[28]3 F. Supp. 2d 120 (D. Mass. 1998).

[29]*Id.* at 140.

[30]Formosa v. Equitable Life Assurance Soc'y of the United States, 398 A.2d 1301, 1304 (N.J. Super. Ct. App. Div. 1979).

[31]946 F. Supp. 322 (D. N.J. 1996).

© The Fidelity Law Association

criticized by regulators. The court found this to be a material misrepresentation in light of the Supervisory Directives which were in place, explaining that:

> New Jersey law generally provides that, "a misrepresentation by the insured, whether contained in the policy itself or in the application for insurance, will support a forfeiture of the insured's rights under the policy if it is untruthful, material to the particular risk assumed by the insurer, and reasonably relied upon by the insurer issuing the policy." New Jersey statutory law authorizes an insurer to deny recovery for misrepresentations made on an application for insurance if such misrepresentations 'materially affected either the acceptance of the risk or the hazard assumed by the insurer.' In interpreting that section, the New Jersey Supreme Court has stated that 'to rescind a policy, an insurer need not show that the insured actually intended to deceive.' Rather, '[e]ven an innocent misrepresentation can constitute equitable fraud justifying rescission.'[32]

The court explained that equitable fraud occurs only in response to objective questions, not subjective ones. Objective questions focus on the applicants knowledge, whereas subjective questions focus on his state of mind. As to subjective questions, the insurer must show, "not only that the answer was false but also that the insured knew it was false."[33]

Equitable fraud was also at issue in *Fidelity & Deposit Co. of Maryland v.Hudson United Bank.*[34] Objective information about loss history and a statement by the bank in its application for a fidelity bond that it had no knowledge of employee dishonesty were in question. Noting that the doctrine of equitable fraud has been strictly applied to objective questions, the court found that the bank had truthfully answered the objective questions regarding loss history. [35]

With respect to the subjective question regarding knowledge of dishonesty, New Jersey courts hold that "if a negative answer is a correct statement of (the applicant's) knowledge and belief, it is not a misrepresentation, and thus does not constitute equitable fraud."[36] In those cases, the insurer must demonstrate not only that the answer was false, but also that the insured knew it was false.[37] The court noted the district court's conclusion that there was no evidence establishing a

---

[32]*Id.* at 329 (citations omitted).

[33]*Id.* at 330 (citing Fid. & Dep. Co. of Maryland v. Hudson United Bank, 653 F.2d 766, 773 (3d Cir. 1981)).

[34]653 F.2d 766 (3rd Cir. 1981).

[35]*Id.* at 771-773.

[36]*Id.* at 772 (citing Formosa Equitable Life Assurance Soc'y, 398 A.2d 1301, 1305 (N.J. Super. Ct. App. Div. 1979)).

[37]*Id.* at 772-73.

© The Fidelity Law Association

conscious intention to conceal. Thus, the only way the bond could be rescinded was if the bank could be charged as a matter of law with having had sufficient constructive knowledge of the employee's dishonesty prior to the effective date of the bond, thereby imposing a duty on the bank to notify F&D. The court looked to the case law on discovery of dishonesty for notice purposes. Those cases hold, "[a] bank is not under a duty to notify its insurance carrier until it has knowledge of some specific fraudulent act. Mere suspicion of dishonesty or wrongdoing is not enough."[38] The court concluded that New Jersey would not apply a lesser standard than the foregoing in determining whether an insurance company is entitled to the more drastic remedy of rescission.[39] Accordingly, the court denied rescission.

4. Effect of Misrepresentations Made by the Insurance Agent.

An insurer, in accordance with general principles of agency law, is bound by the actions of its agents when they are acting within the scope of their authority.[40] Accordingly, an insurer will be responsible for any misrepresentations made in the application attributable to its agent. Where misrepresentations have been made by an agent, it is important to ascertain who the insurance agent represented during the transaction. If the agent acted as a broker representing the insured, the insurer should not be bound by the wrongful acts of the agent. On the other hand, if the agent represented the insurer, the insurer will be bound. All of the facts must be examined to determine who the agent represented.[41]

An interesting set of facts involving a dishonest agent was presented in *Hartford Accident & Indemnity Co. v. Hartley.*[42] The managing partner of Thompson Banking Company, who had been embezzling from the bank for several months, completed an application for fidelity coverage, stating that he had no knowledge of any dishonesty on the part of any of the bank's officers or directors. The managing partner also independently operated an insurance agency and placed the fidelity bond coverage through his agency. The court first found that the dishonesty of the managing partner had to be imputed to the bank because he acted as its sole representative. The court then focused on the issue of whether the dishonesty of the managing partner could be imputed to the insurer. Although the court concluded that the managing partner was in fact an agent of the insurer, the court did not apply the general agency rule, explaining that because the agent was acting in his own interest and to the detriment of the insurer, his knowledge could not be imputed to the

[38]*Id.* at 774.
[39]*Id*. at 776.
[40]3 COUCH ON INS. 3D § 48:1 (West 1995).
[41]BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES, 18.02 [e] (10th ed. 2000).
[42]275 F. Supp. 610 (M.D. Ga. 1967), *aff'd*, 389 F.2d 91 (5th Cir. 1968).

© The Fidelity Law Association

insurer.[43] Accordingly, Hartford could not be said to have known of the dishonesty and was not held liable to the bank under the fidelity bond.

B. CONCEALMENT

In general, concealment of a material fact entitles the party relying on the fact to rescission when it learns of the concealment.[44] Although this rule also applies to fidelity bonds, the case law demonstrates that courts are not always willing to grant rescission where insureds fail to disclose information not expressly requested.

The court in *Home Savings and Loan v. Aetna Casualty and Surety Co.,*[45] for example, held that an insured savings and loan association did not have to disclose the existence of a suit seeking over a million dollars because of the dishonesty of an employee when it applied for coverage with Aetna, because Aetna failed to inquire about pending cases. Rather, Aetna inquired as to whether there had been any losses sustained in the past six years. The S&L answered "none over the deductible amount." The court concluded that this was truthful, and rejected Aetna's argument that the insured had some independent duty to disclose the existing litigation in the application. It held that "[i]t is an insurer's duty to ascertain the facts, and if nothing is concealed, and it makes no inquiries, it cannot complain that the situation was not what it was supposed it to be."[46] The court held this rule equally applicable to fidelity bonds,[47] and reasoned that:

> [t]he insurer, as the expert in risk allocation, can be relied upon to ask the questions it deems material to deciding whether to approve a policy application. As noted in our recitation of the standard of review applied to insurance applications, problems arising from an insurer's failure to clearly make relevant inquiries rest with the insurer.
>
> . . . .
>
> We also note that it would have been a simple matter for Aetna to include inquiries in the bond application designed to reveal the omitted material information. Simple questions could have been drafted regarding dishonest former employees and the pendency of lawsuits or other circumstances that might cause a covered loss.[48]

There was a dissent, however, which cited to the applicable Utah statute which reads in part that "[m]isrepresentations, **omissions**, concealment of facts, and incorrect statements shall not prevent a recovery under the policy or contract unless:

[43] *Id.*
[44] 2 COUCH ON INS. 3D § 31:76 (West 1995).
[45] 817 P.2d 341 (Utah Ct. App. 1991).
[46] *Id.* at 359 (citing 9 COUCH ON INS. 2D § 38:72 (1985)).
[47] *Id.* at 360 (citing U. S. Fid. & Guar. Co. v. Howard, 67 F.2d 382, 383 (5th Cir. 1933)).
[48] *Id.*

© The Fidelity Law Association

(a) fraudulent; or (b) material either to the acceptance of the risk, or to the hazard assumed by the insurer . . ."[49] The dissent argued that the statute imposes a duty on the insured to disclose facts material to the hazard, disagreeing with the majority, which held, in effect, that critical relevant facts may be omitted if the insurer fails to explicitly request such information.[50] The dissent concluded:

> An applicant for fidelity insurance has a duty to provide material information in its application, such as pending claims against the insured, even if not directly requested to provide such information. It is true that, in general, the insurer is the expert in risk assessment and therefore has a duty to make inquiries that it feels are relevant to the assessment of the risk. That does not mean, however, that a sophisticated purchaser of insurance, such as Home, may turn a blind eye to the obvious.[51]

In a similar case, the insurer in *FSLIC v. Transamerica Insurance Co.,*[52] asserted that the bank's failure to notify it of the existence of a cease and desist order rendered the bond void ab initio. The court disagreed, reasoning that although an insurance applicant must be truthful in its response to an application's inquiry, Illinois courts have declined to impose a duty on the insured to volunteer to the insurer information material to the risk involved. "Rather, Illinois imposes 'the obligation and duty upon the insurance company to determine and advise the applicant or the insured, as the case may be, what information the insurance company must have before it will consider whether or not to insure the risk.'"[53]

The question in *State of Washington v. United Pacific Insurance Co.,*[54] was whether a school district was obligated to disclose that one of its employees had been charged with forgery in 1966 while an employee of the school district, when the charge was unrelated to his job. Upon learning of the charges, the employee was suspended, but was reinstated on the condition that he make restitution.

In 1973, the school board applied for and obtained a surety bond covering all its employees. The application asked for a list of losses of the type covered by the bond over the past five years. No other information concerning acts of malfeasance by employees was requested. An audit later revealed that the employee in question had been falsifying payroll checks and cashing them for his own use, and United Pacific denied coverage of the school district's claim. The trial court found United Pacific liable for coverage, and on appeal the court affirmed, reasoning that the insurer

[49] *Id.* at 358 (quoting UTAH CODE ANN. § 31A-21-105 (1986)).
[50] *Id.* at 379.
[51] *Id.*
[52] 705 F. Supp. 1328 (N.D. Ill. 1989).
[53] *Id.* at 1339.
[54] 612 P.2d 809 (Wash. Ct. App. 1980).

© The Fidelity Law Association

did not ask about non-work related defalcations on the bond application. Accordingly, the insurer could not have been misled by the school board's failure to report the 1966 incident. The court cited the applicable statute that misrepresentations in the negotiation or application void coverage only when made with intent to deceive. It concluded that if an innocent misrepresentation did not void coverage, the failure to provide information not requested by the insurer would not vitiate coverage absent proof that such silence amounted to fraud or bad faith.[55]

Similarly, in *St. Paul Fire & Marine Ins. Co. v. Comer,*[56] an employee was discharged because of a shortage in his accounts. He was later rehired by the employer but only upon the condition that he obtain a fidelity bond in favor of the employer. The employee obtained such a bond from St. Paul. St. Paul did not contact the employer prior to issuing the bond. The court held that the employer was under no duty to volunteer any information about the employee, absent a request for such information. The dereliction, if any, was attributable to St. Paul for neglecting to inquire into the prospective employee's background.[57]

The court in *United States Fidelity & Guaranty Co. v. Empire State Bank,*[58] held that where the bond application required disclosure of all losses over the past five years and contained a certification that to the best of the insured's knowledge and belief, the present officers and employees of the insured have performed their duties honestly, suspicions regarding a former employee need not be disclosed in the absence of a request for such disclosure.[59]

Once the insurer has asked the question, however, insureds not only must answer truthfully, but are under a continuing duty to update their responses while their application for coverage is pending. The court in *FDIC v. Moskowitz,*[60] concluded that F&D was entitled to rescission because of the failure of the insured, United Savings Bank, to disclose to F&D criticisms made by federal regulators while its application for fidelity coverage was pending. The court held that United was under a duty to disclose this information and its failure to supplement the application amounted to a misrepresentation sufficient enough to support the rescission of the bond.[61] The court stated the rule as follows:

> It is well settled that, where an application for insurance has been submitted to an insurer and, before the policy is issued, a change of conditions material to the risk occurs or is discovered by the applicant,

[55] *Id.* at 72.
[56] 227 So. 2d 859 (Miss. 1969).
[57] *Id.* at 862.
[58] 448 F.2d 360 (8th Cir. 1971).
[59] *Id.* at 366.
[60] 946 F. Supp. 322 (D. N.J. 1996).
[61] *Id.* at 331.

© The Fidelity Law Association

> he is under an obligation to inform the insurer promptly. The knowing suppression or failure to make timely disclosure of such information constitutes a material misrepresentation.[62]

The court in *Fidelity & Deposit Co. of Maryland v. Hudson United Bank*,[63] reached the opposite result. In that case, the bank interpreted a chart entitled "six-year loss information" as requesting only information regarding losses which had actually been filed with the bank's insurance carriers. Accordingly, information which the bank learned after it had applied for F&D's bond, but before it was issued, did not have to be disclosed because that information was not the subject of a proof of loss until well after the issuance of F&D's bond.[64]

The court in *Banco de San German, Inc. v. Maryland Casualty Co.,*[65] was faced with issues of concealment in connection with requests for increases in coverage. The bank president became aware of certain irregularities at his bank and increased the limit of coverage from $150,000 to $450,000 on its banker's blanket bond. Thereafter, on the eve of an audit, he increased the coverage on the bond to $750,000. The court ruled that the irregularities were material and should have been reported to the insurer when a request for an increase in coverage was made. The court concluded that the bank was estopped to recover any amount over the $150,000 limit. The court, however, refused to void the bond as to the original amount. The court stated:

> In this connection, it is important to distinguish between circumstances or suspicions material to the increased risk which in equity and good conscience should have been reported to the insurance company as a condition to the obtaining of increased insurance and notice of knowledge of losses or unlawful, fraudulent or dishonest acts the concealment of which might breach express or implied conditions of the bonds; the court concludes that there was no concealment of the latter nature.[66]

C. FRAUD

When an insurer can prove fraud on the part of the insured in connection with the issuance of a policy, it may obtain rescission. To establish fraud, the insurer must demonstrate that the insured made a false statement either with knowledge of its falsity or with reckless disregard to its truth. The insurer must also show that it relied

[62]*Id.* (citing Weir v. City Title Ins. Co., 125 N.J. Super. 23, 29, 308 A.2d 357 (App. Div. 1973)).
[63]653 F.2d 766 (3rd Cir. 1981).
[64]*Id.* at 772-73.
[65]344 F. Supp. 496 (D. Puerto Rico 1972).
[66]*Id.* at 509.

© The Fidelity Law Association

on the fraudulent statement.[67] Although proof of fraud may be more difficult to establish than mere misrepresentations and omissions, in some states there are advantages to establishing fraud. For example, in Louisiana, in addition to rescission, attorneys' fees and damages are recoverable.[68]

The court in *Aetna Casualty and Surety Co. v. Retail Local 906 of AFL-CIO Welfare Fund,*[69] held that the insurer in the case effectively established fraud and granted rescission of the policy. At issue were omissions in a renewal application for a fiduciary responsibility insurance policy (FRIO) issued by Aetna to a Welfare and Pension Fund. In particular, Aetna was led to believe in the renewal application that there were only a few hundred members of the plan, when in fact there were thousands of new members because of a new scheme which allowed associate members to join. Under the new scheme, associate members were not required to be employed by employers who had collective bargaining agreements with the local union, thereby changing the sponsorship of the plan. Further, the union withheld from the insurer the fact that as a result of the increase in membership, their health care provider had cancelled coverage and asserted a counterclaim for fraud when it was sued by the pension plan.[70]

The court held that the:

> '[f]ailure to disclose is as much a misrepresentation as a false affirmative statement.' Nevertheless, "'an applicant is under no duty to volunteer information where no question plainly and directly requires it to be furnished.' . . . However, where the nondisclosure, as to a matter which the insured has not been directly asked, constitutes fraud, the policy may be voided. To constitute fraud, the nondisclosure must be 'in bad faith with intent to mislead the insurer.' In other words, "'[i]f the applicant is aware of the existence of some circumstance which he knows would influence the insurer in acting upon his application, good faith requires him to disclose that circumstance, though unasked.'[71]

The court found that, although Aetna was careless in reviewing the material provided to it, the fund's concealment of the tremendous increase in membership, the

[67] 2 COUCH ON INS. 3D § 31:82 (West 1995).

[68] LA. CIV. CODE ANN. art. 1958 (West 2001).

[69] 921 F. Supp. 122 (E.D.N.Y. 1996).

[70] In granting rescission, the court stated the following: "Under New York law, 'an insurance policy issued in reliance on material misrepresentations is void from its inception.' To rescind, the insurer must prove that the "'applicant for insurance made a misrepresentation and that had the insurer known the truth it would not have issued the exact same policy it did issue.'") 921 F. Supp. at 131. In other words, "the insurer need not prove that it would not have issued any policy at all, but that the policy in question would not have been issued." *Id.*

[71] *Id.* at 131-32.

© The Fidelity Law Association

change in the status of the plan from a multiemployer-collectively-bargained-for plan, and the health care provider's cancellation of coverage with the associated lawsuit, constituted a designed, knowing and intentional withholding of material facts with the intent to defraud. The fund in honesty and good faith ought to have communicated such facts to Aetna in connection with the 1991 renewal application.[72] This information was clearly relevant and material to Aetna's decision to issue the FRIP it did issue. Because Aetna relied on the misrepresentations, the FRIP was held void from its inception.[73] Although this case did not involve a fidelity bond, it exemplifies the issue of fraud by omission and concealment in connection with the issuance of a policy of insurance.

Fraud is not always difficult to prove, especially where the fraud results from intentional misrepresentations. For example, the court in *Hartford Accident & Indemnity Co. v. Hartley*,[74] found fraud in the application for a fidelity bond and rescinded coverage. The court explained that under Georgia law:

> '[w]here it is shown that a material statement made in such application was false, that its falsity was known to the insured at the time it was made, that it was made with the view of procuring insurance, that the company (insurer) had no notice of its falsity, and that the company (insurer) acted upon it to its injury, the law will conclusively presume an intent to deceive, and a case of actual fraud will be made out, although the insured may not have really intended to prejudice the rights of the company (insurer).'[75]

The application was signed by the managing partner of a partnership which owned the bank. In signing the application, the managing partner attested to the fact that he knew of no dishonesty on the part of any of the officers or directors of the bank. In fact, however, the managing partner himself had been embezzling from the bank, making the fraud in the application obvious. Accordingly, the bond was held to be void ab initio.

D. Breach of Warranties

A breach of a warranty at common law renders an insurance policy voidable, regardless of the materiality of the statement or promise. This is in contrast to a misrepresentation which had to be shown to be material before rescission of a policy would be granted.[76] The same rules were also applied in Louisiana, a civilian

[72] *Id.* at 132.
[73] *Id.* at 133-34.
[74] 275 F. Supp. 610 (M.D. Ga. 1967).
[75] *Id.* at 617 (citing Northwestern Life Ins. Co. v. Montgomery, 43 S.E. 79 (Ga. 1902).
[76] FDIC v. Underwriters of Lloyd's of London, 3 F. Supp. 2d 120, 139 (D. Mass. 1998).

© The Fidelity Law Association

jurisdiction. For example, in *City Bank & Trust Co. v. Commercial Casualty Co.,*[77] the court distinguished warranties from representations, stating that:

> '[t]he distinction between a representation and a warranty in an insurance contract is, that the former precedes and is not a part of the contract, and need be only materially true, while the latter is part of the contract and must be strictly fulfilled, or the policy is void. Another difference between a warranty and a representation is that a warranty must be strictly true; a representation need only be substantially true. The falsity of a representation may render the contract voidable for fraud; but a noncompliance with a warranty is an express breach of the contract. Although the effect of a breach of a warranty and of a material misrepresentation may be the same on a policy, yet they cannot be confounded together in deciding on pleadings or on a special verdict'.[78]

In *Employers' Liability Assurance Corp., Ltd., of London v. Wasson,*[79] the bank stated that it would check its bank book and the account in question every month. The court found this statement to be a condition precedent, compliance with which was essential to the plaintiff's right of recovery. The court found this statement to be a warranty, not a representation.[80] In fact, neither the bank book nor the account was checked, constituting a breach of warranty, and recovery on the bond was precluded.[81]

Perhaps because of the harsh consequences of breaching a warranty, warranties have not been favored by courts and are strictly construed against the insurer.[82] In fact, most states have now enacted statutes which treat warranties made in the application for insurance coverage like representations, requiring a showing of materiality, and/or an intent to deceive, or an increase in the risk.[83]

---

[77] 176 So. 27 (La. App. 2d Cir. 1937).

[78] *Id.* at 31 (quoting 14 Ruling Case Law, P.1026, §§ 206-208).

[79] 75 F.2d 749 (8th Cir. 1935).

[80] *Id.* at 755.

[81] *Id.*

[82] 6 COUCH ON INS. 3D § 83:1 (West 1996).

[83] *See, e.g.*, ALA. CODE § 27-14-7 (2000); ALASKA STAT. § 21.42.110 (Michie 2000); ARIZ. REV. STAT. ANN § 20-1109 (West 2000); DEL. CODE ANN. tit. 18 § 2711 (2000); FLA. STAT. ANN. § 627.409 (West 2000); GA. CODE ANN. § 33-34-7 (2000); HAW. REV. STAT. ANN. § 431:10-209 (Michie 2000); IDAHO CODE § 41-1811 (Michie 2000); 215 ILL. COMP. STAT. ANN. § 5/154 (West 2000); KY. REV. STAT. ANN. § 304.14-110 (Michie 2000); LA. STAT. ANN. § 22:619 (2000); ME. REV. STAT. ANN. tit. 24-A § 2411 (West 2000); MASS. GEN. LAWS ANN. CH. 175 § 186 (West 2000); MONT. CODE ANN. § 33-15-403 (2000); NEB. REV. STAT. ANN. § 44-358 (Michie 2000); NEV. REV. STAT. ANN. § 687B.110 (Michie 1999); N.C. GEN. STAT § 58-3-10 (2000); OKLA. STAT. ANN. tit. 36 § 3609 (West 2000); OR. REV. STAT. ANN. § 742.013 (1999); S.D. CODIFIED LAWS § 58-11-44 (Michie 2000); TENN. CODE ANN. § 56-7-103 (2000); UTAH CODE ANN. § 31A-21-105 (2000); VA. CODE ANN. § 38.2-309 (Michie 2000); WASH. REV. CODE ANN. § 48.18.090 (West 2000); W. VA.

© The Fidelity Law Association

The court in *FDIC v. Underwriters of Lloyd's of London*[84] explained the effect of the applicable Massachusetts law on warranties,[85] noting that the purpose of the statute was to eliminate the distinction between warranties and representations so that a breach of warranty was no more onerous than a false representation. Thus, the same burden of proof as to materiality applies to both warranties and representations.[86] Accordingly, to void a policy, the insurer must show the misrepresentation or warranty increased the risk of loss, or was made with actual intent to deceive.[87]

The court in *St. Paul Fire and Marine Insurance Co. v. Boston Housing Authority,*[88] applied the same statute, and concluded that the warranty breached increased the risk of loss, allowing the insurer to avoid liability. This case concerned two public employees' blanket bonds issued to the Boston Housing Authority. The Authority stated in its renewal application that bank statements would be reconciled monthly by someone not authorized to deposit or withdraw funds. The statements were not reconciled and an employee embezzled hundreds of thousands of dollars from the Authority. The court determined that the representation that bank statements would be reconciled by a person other than one with authority to deposit or withdraw was a promissory representation, and should be treated as a warranty and governed by Section 186.[89] Finding that the Authority was not in compliance with the promissory representation, and the violation of the promissory warranty increased the risk of loss as a matter of law, the insurer could avoid liability. Accordingly, summary judgment in favor of the insurer was affirmed.[90]

III. Defenses to Rescission

A. ADVERSE INTEREST

A general rule of agency law is that a principal is charged with the knowledge of its agent. A common defense to the insurer's assertion that the policy should be

---

CODE § 33-6-7 (2000); WIS. STAT. ANN. § 631.11 (West 2001); WYO. STAT. ANN. § 26-15-109 (Michie 2000).

[84]3 F. Supp. 2d 120 (D. Mass. 1998).

[85]MASS GEN. LAWS ANN. CH. 175 §186 (West 2000) provides as follows:

> 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.

[86]*Id.* at 139.

[87]*Id.* at 140.

[88]514 N.E.2d 363 (Mass. App. Ct. 1987).

[89]*Id.* at 368

[90]*Id.* at 368-369

© The Fidelity Law Association

rescinded because of fraud or misrepresentation in the procurement of fidelity coverage is based on an exception to that rule. The adverse interest exception provides that if an agent is acting adversely to his principal, it will not be assumed that the principal has been made aware of the agent's knowledge. This exception, however, does not apply when the agent is the only person through whom the principal acts. In such a case, the knowledge of the agent will be imputed to the principal in accordance with the general rule.[91]

The adverse interest exception was applied in *FDIC v. Lott,*[92] where the president of the bank engaged in fraudulent acts which caused a loss to the bank. The court stated:

> Generally, an officer's or director's knowledge acquired while acting within the scope of his duties will be imputed to the bank. However, where, as here, Lott fraudulently dealt with the bank in his own interest, he is deemed to have an adverse interest and the knowledge possessed by him in the transaction is not imputable to the bank.[93]

1. Effect on Coverage When Dishonest Officer Procures Coverage

The adverse interest exception was also applied in *Puget Sound National Bank v. St. Paul Fire and Marine Insurance Co.,*[94] where a director of a bank engaged in fraud in connection with a premium finance program he had organized at the bank. St. Paul argued that because the director completed the bond application, his wrongdoing should be imputed to the bank. The court cited *Post v. Maryland Casualty Co.,*[95] in which the court reviewed the general agency rules and the sole representative exception and explained the two rules of thought applicable when the wrongdoer completes the application for coverage.[96] The majority rule concludes that the adversity of the agent/director continues to exist and is based on the theory that the agent would never choose to inform his principal of his prior wrongdoing. The minority rule distinguishes between the prior defalcations and the later bond application and holds that if the agent is not acting adversely to the principal in applying for the bond, his knowledge, including that of his prior wrongdoing, will be imputed to his principal.[97] The court in *Post* applied the minority rule and imputed the knowledge of the employee to its principal.[98] The court in *Puget* concluded that the

---

[91]Puget Sound Nat'l Bank v. St. Paul Fire and Marine Ins. Co., 645 P.2d 1122, 1127 (Wash. Ct. App. 1982).
[92]460 F.2d 82 (5th Cir. 1972).
[93]*Id.* at 88.
[94]645 P.2d 1122 (Wash. Ct. App. 1982).
[95]97 P.2d 173 (Wash. Ct. App. 1939).
[96]*Id.* at 175-176.
[97]*Id.* at 176.
[98]*Id* at 178.

© The Fidelity Law Association

court in *Post* had to have found the employee either (i) was not acting adversely to the corporate interests when he obtained the bonds or (ii) was acting adversely but also was the "sole representative" of the corporation.[99] The court concluded that in this case Puget Bank's director was not acting in the interest of the bank in concealing his wrongdoing on the application for the bond. Further, he was not the sole representative of the bank. Accordingly, the *Post* rule did not apply and the knowledge of the director was not imputed to the bank. [100]

The court in *In re Lloyd Securities, Inc.,*[101] held that the fraudulent acts and knowledge of the two principal directors of the corporation could not be imputed to the corporation because of the adverse interest doctrine. The court recognized *Gordon v. Continental Casualty Co.*[102] as the leading Pennsylvania case on agency and fraudulent inducement within the context of fidelity bond claims. In *Gordon*, the CEO and highest ranking officer of the corporation provided false information on an application for a fidelity bond. He stated that he had no knowledge of the dishonesty of any officer of the company when he in fact had embezzled $26,000.[103] The Pennsylvania Supreme Court imputed his knowledge to the corporation. The *Gordon* court recognized the adverse interest exception to the general rule, but held that it applied only when a third person seeks to enforce some demand against the corporation.[104] This exception does not apply where the corporation seeks to enforce the benefit of a fraud perpetrated by its officer on a third person.[105] The court in *Lloyd Securities* distinguished *Gordon* on the basis that the parties attempting to enforce the bond, namely, the trustee for the insured and the customers of the insured, were third parties, not insureds.[106] The court in *In re Payroll Express Corp.*[107]disagreed with many of the foregoing cases in affirming the district court's decision not to apply the adverse interest exception. The court explained that the exception applies when the agent is acting completely adverse to the interests of the principal. Applying New Jersey law on agency, the court concluded "[i]n an action for contract rescission, an agent's misrepresentations bind the principal if the agent was authorized to represent the principal in obtaining the contract."[108] Further, "[a] principal may not disavow an act of its agent while simultaneously taking advantage of the benefits of the fraudulently procured bargain."[109] The court disagreed with the holding in *Puget Sound,*[110] finding it did not explain why the restitution principle of

---

[99]645 P.2d at 1128.
[100]645 P.2d at 1128-29.
[101]No. 90-0985S, 1992 WL 236162 (Bankr. E.D. Pa.).
[102]181 A. 574 (Pa. 1935).
[103]*Id.* at 557
[104]*Id*. at 561-67.
[105]*Id.*
[106]1992 WL 236162 at 11-12.
[107]186 F.3d 196 (2nd Cir. 1999).
[108]*Id.* at 207.
[109]*Id.* at 208.
[110]645 P.2d at 1130.

© The Fidelity Law Association

unjust enrichment does not act as a bar to recovery. "As between the innocent Insured and innocent Insurer, the former should not shoulder the burden created by any falsehoods made by the agent which it chose to represent it in the transaction."[111] The court distinguished *Phoenix Sav. & Loan, Inc. v. Aetna Casualty & Surety Co.,*[112] noting the bond in that case included a clause which stated that the concealment by the signor of the application was not imputable to the Insured.[113] Finally, the court rejected the trustee's argument that, although the insured could not benefit from the adverse interest exception, the insured's creditors could. This argument was successful in *In re Lloyd Securities, Inc.*[114] The court, in *Payroll Express*, refused to follow it, holding that if the insured cannot recover, neither can the insured's creditors.[115] The court ultimately concluded that "[u]nder New Jersey law the corporate principal is responsible for the consequences of its agent's material misrepresentations on an insurance application, even when the principal could have no knowledge of the agent's deceptions."[116]

B. EFFECT OF CONTRACTUAL PROVISIONS ON THE RULES OF AGENCY

The adverse interest exception was applied as a result of the terms of the application, rather than as a matter of law, in *Phoenix Savings and Loan, Inc. v. Aetna Casualty and Surety Co.*[117] The court explained that:

> [a] fraudulent misrepresentation in an application that the insured's employees have been faithful is deemed material to the risk undertaken by the insurer and renders the bond void ab initio. The application, by its terms, however, excluded the knowledge of the signor as to his personal acts from the representations made therein. It was stipulated that the signor participated in all the fraudulent transactions; therefore, his knowledge as to those transactions was not imputable to the corporation by the terms of the application.[118]

In *USF&G v. State of Oklahoma,*[119] the president of a bank signed the application for a bank employee dishonesty blanket bond. The bond contained a clause which stated that to the best of the bank's knowledge all of its employees had performed their duties honestly. It was later discovered that the president had systematically embezzled from the bank. USF&G argued that it was not liable on the

---

[111] 186 F.3d at 208.
[112] 427 F.2d 862 (4th Cir. Md. 1970).
[113] 186 F.3d at 209.
[114] 1992 WL 236162 (Bank. E.D. Pa.).
[115] 186 F.3d at 210.
[116] *Id.*
[117] 427 F.2d 862 (4th Cir. 1970).
[118] *Id.* at 870-71.
[119] 383 F.2d 417 (10th Cir. 1967).

© The Fidelity Law Association

bond because the president was the sole representative of the bank and his guilty knowledge was imputed to the bank. The court rejected this alter ego defense, finding the president was not the only director of the bank. The court also rejected USF&G's argument that the president's actions, as agent of the bank, could be imputed to the bank. The court acknowledged the adverse interest exception, and the qualification to that exception which holds that if the principal retains the fruits of the agent's acts after knowledge of the facts, the principal is chargeable with the agent's knowledge. Nevertheless, the court held that the insurer had contracted away this defense by including a clause in the bond to the effect that the knowledge of the signor of the application as to his own dishonest acts, not known to the bank, will not be imputed to it. The court found that the bond contained no exceptions for sole representatives and when the president of the bank signed the bond, he was the only one who knew of his embezzlement.[120]

On the other hand, in *Hartford Accident & Indemnity Co. v. Hartley,*[121] the knowledge of misappropriation of bank funds by the managing partner of a partnership formed to operate the bank, who had sole control of the operations of the bank, was imputable to the bank even though the fidelity bond application provided that the knowledge of the signor, as to his own dishonest acts, was not imputable to the bank if unknown to the bank. The court stated that had the other partners been active in the business or if the dishonesty of the managing partner had been limited to one act, it might not have imputed the knowledge of the managing partner to the bank.[122] It concluded, however, that it was:

> an undisputed fact that Mr. Thompson had sole and complete control of the operations of the bank and that he also had full knowledge of all the misappropriations of the funds of the bank, being himself the perpetrator thereof. Therefore, it must be held that his knowledge was the bank's knowledge and this notwithstanding the above quoted provision in the application. [123]

Accordingly, the bond was held to be void ab initio.

B. ADVERSE DOMINATION

The court *In re Payroll Express Corp.*,[124] explained that "[a]dverse domination is an equitable doctrine which operates to toll the statute of limitations for a corporation's claims against its officers and directors when the persons in charge of the corporation cannot be expected to pursue claims adverse to their own

[120] *Id.* at 419-20.
[121] 275 F. Supp. 610 (M.D. Ga. 1967), *aff'd*, 389 F.2d 91 (5th Cir. 1968).
[122] *Id.* at 618.
[123] *Id.*
[124] 186 F.3d 196 (2nd Cir. 1999).

© The Fidelity Law Association

interests."[125] This theory has been used by the FDIC with some success in arguing that it should be applied to toll notice provisions relating to discovery of loss under insurance policies covering failed financial institutions.[126]

This case involved a massive fraud of payroll funds by the sole shareholders and principals of a check-cashing business, as well as other employees with net losses exceeding $33 million. The district court held that the misrepresentations contained in the application for employee theft and premises coverage voided the policies, rejecting the adverse domination theory advanced by the bankruptcy trustee. The appellate court affirmed. First, it held that New Jersey law applied and New Jersey had not adopted the adverse domination theory.[127] Second, no tolling was at issue. The policies were voided because of material misrepresentations and the timing of discovery was irrelevant to the holding. Third, applying this doctrine to misrepresentations made in the application to conceal fraud exposed the insurer to risks it would otherwise not have assumed.[128]

C. AMBIGUITY

It was argued in *Graydon-Murphy Oldsmobile v. Ohio Casualty Insurance Co.,*[129] that a material misrepresentation in the application for fidelity coverage had occurred, voiding coverage. At issue was the insured's statement that a CPA audited its accounts annually. In fact, the CPA only reviewed the accounts and records of the insured for purposes of preparing its tax return, but did not perform a certified audit. An underwriter for the insurer stated that he would not have issued the policy had he known the audits were not performed. The case turned on the meaning of the term "audit." The court held that "audit" was susceptible to a variety of meanings and unless it was clearly used in the technical sense, it would be given the meaning which comports with common speech. Any ambiguity had to be resolved against the insurer and in favor of the insured.[130] Accordingly, the finding of the trial court on this issue in favor of the insurer was erroneous.

D. FAILURE TO ATTACH APPLICATION

Some states require the insurer to attach a copy of the application at the time of issuance as a prerequisite for later rescinding the policy for misrepresentations made in the application.[131] Accordingly, when the only proof of fraud were alleged

---

[125]*Id.* at 205.

[126]*Id.*

[127]*Id.* at 206.

[128]*Id.* at 206-07.

[129]93 Cal. Rptr. 684 (Cal. Ct. App. 1971).

[130]*Id.* at 688-89.

[131]*See, e.g.*, COLO. REV. STAT. ANN. § 10-16-209 (West 2000); IND. CODE ANN. § 27-8-5-5 (West 2000); MICH. STAT. ANN. § 500.4016 (Michie 2000); MISS. CODE ANN. § 83-9-11 (2000); N.M. STAT. ANN. § 59A-18-11 (Michie 2000); OR. REV. STAT. § 742.013 (1999); WIS. STAT. ANN. § 631.11 (West 2001).

© The Fidelity Law Association

misrepresentations made in an application for a fidelity bond and the application was not attached to the policy, the court in *Hudson v. Maryland Casualty Co.*[132] held the application inadmissible under La.R.S. 22:618 (A) which required that the application be attached to avoid liability for misrepresentations made therein.[133]

The court in *FDIC v. Underwriters of Lloyd's of London*,[134] in interpreting Massachusetts law,[135] concluded that the statute did not explicitly require the application be attached to the policy as a prerequisite to invoking the materiality defense. The court reasoned that the statute required only that the misrepresentation be made in the negotiation of the policy. Even if an implicit requirement could be found in the statute, the statute was nevertheless satisfied by a declaration in the application which stated that the application and any other information supplied by the insured shall form the basis of the contract and shall be incorporated within it.[136]

E. Waiver

The FDIC argued in *FDIC v. Underwriters of Lloyd's of London*,[137] that the underwriters had waived their right to a misrepresentation defense by issuing a renewal bond and accepting an increased premium after information about the rogue officers in question had been disclosed in the renewal application. The court rejected the FDIC's argument, noting that in Massachusetts, the insurer must have voluntarily or intentionally relinquished a known right for a waiver to occur. The FDIC had failed to show that the underwriters had full knowledge of the circumstances, warranting rescission of the bond.[138]

Some states bar insurers from asserting misrepresentation as a defense to coverage, unless the insurer can show it gave notice to the insured within a specified period of time after learning of the misrepresentation that it was rescinding the policy.[139] This prevents insurers from continuing to accept premiums and then later using the misrepresentation as a means to defeat coverage when a claim is made.

---

[132] 241 So. 2d 567 (La. App. 2nd Cir. 1970).

[133] *Id.* at 569. Note: La. R.S. 22:618(A) has been amended since this case was decided. It now only applies to life and health insurance.

[134] 3 F. Supp. 2d 120 (D. Mass. 1998).

[135] MASS. GEN. LAWS ANN. CH. 175 § 186 (West 2000).

[136] 3 F. Supp. 2d at 140.

[137] 3 F. Supp. 2d 120 (D. Mass. 1998).

[138] *Id.* at 143.

[139] *See, e.g.,* TEX. INS. CODE ANN. art. 21.17 (Vernon 1999); UTAH CODE ANN. § 31A-21-105 (2000); WIS. STAT. ANN. § 631.11 (West 2001).

© The Fidelity Law Association

F. D'OENCH DOCTRINE

The FDIC has used the *D'Oench* Doctrine as a defense to rescission with mixed results. This doctrine was spawned in *D'Oench, Duhne and Co. v. FDIC*[140] where the Supreme Court declared the existence of a federal policy to protect the FDIC and the fund it administers from misrepresentation as to the value of the assets in the portfolios of the banks insured by the FDIC or to which it makes loans. Accordingly, a secret side agreement not to enforce a note between the parties to a loan could not be used as a defense against the FDIC.[141] The *D'Oench* Doctrine was later codified in 12 U.S.C. § 1823 (e)(1) which provides:

> No agreement which tends to diminish or defeat the interest of the Corporation 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 he Corporation unless such agreement- -
>
> (A) is in writing,
>
> (B) 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,
>
> (C) 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
>
> (D) has been, continuously, from the time of its execution, an official record of the depository institution.

The purpose of Section 1823 (e) is to allow bank examiners to rely on the books and records of the institution in evaluating the worth of the institution's assets.[142]

The FDIC asserted the *D'Oench* Doctrine without success in *FDIC v. Aetna Casualty & Surety Co.*[143] Aetna refused to make payment on a blanket bond it had issued to United American Bank. Misrepresentations were made in the application for the bond by the two brothers who controlled the stock of the bank. In particular, the bank denied in the application that it was under any investigation by either state

---

[140] 315 U.S. 447 (1942).
[141] *Id.* at 459-62.
[142] FDIC v. Aetna Cas. & Sur. Co., 947 F.2d 196, 201 (6th Cir. 1991).
[143] 947 F.2d 196.

© The Fidelity Law Association

or federal authorities. This was not true. The facts also revealed that one of the shareholders owned and controlled an insurance company through which the bond was issued. This agency acted as Aetna's agent in the transaction. Aetna argued, in responding to the suit filed against it by the FDIC, that the bond was void because of the misrepresentations made in the application. As to its relationship with the agency who had placed coverage, Aetna asserted the adverse interest exception to avoid imputation of the agent's knowledge. All of Aetna's defenses were struck by the trial court and the jury returned a verdict in favor of the FDIC in the amount of $5,950,000. The Sixth Circuit reversed. The court held that the district court was incorrect in finding Section 1823(e) applicable to Aetna's misrepresentation defense. It distinguished the negotiable instrument at issue in *D'Oench* from an insurance policy, noting that because an insurance policy is conditional, there is no certainty that insurance proceeds will be paid.[144] Although the court recognized that the bond contained no provision to the effect that coverage would be withdrawn because of misrepresentations in the application, it also recognized that the bond involved bilateral obligations and to deny Aetna the defense of material misrepresentation would deny Aetna the benefit of its bargain.[145] The court concluded by explaining that "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."[146] Accordingly, when the FDIC takes over an institution with a blanket bond, it acquires the bond with knowledge of the recognized defenses available under insurance law.[147] The court also held Section 1823(e) inapplicable to the adverse agency defense asserted by Aetna for the same reasons it was not applicable to Aetna's misrepresentation defense.[148]

The FDIC, however, was more successful in *FDIC v. Oldenburg.*[149]Misrepresentation in the application for bond coverage was also asserted as a defense in this case. The court noted that conditioning payment on the truthfulness of the statements made in the application was an "agreement" for purposes of Section 1823(e), finding pertinent that the application was separate from the bond, the bond did not condition payment on anything asserted in the application, nor did it incorporate the application by reference.[150] Next, the court determined that the bond was an "asset" of the institution. It concluded that the use of that term in Section 1823(e) was not intended to be so narrowly construed as to be limited only to negotiable interests and promissory notes.[151] The court reasoned that applying Section 1823(e) to fidelity bonds furthered the purpose of the statute since federal

[144]*Id.* at 202.
[145]*Id.* at 207.
[146]*Id.* at 208.
[147]*Id.*
[148]*Id.*
[149]34 F.3d 1529 (10th Cir. 1994).
[150]*Id.* at 1551-52.
[151]*Id.* at 1552.

© The Fidelity Law Association

regulators rely on fidelity coverage as one factor in determining whether a bank is capable of continuing its operations.[152] Moreover, applying this section to fidelity bonds also helps prevent fraud by bank employees by requiring deliberate consideration by the board of the application. Misrepresentations in the application would be noticed and avoided if board approval was required.[153] Further, the overriding policy of promoting the stability and confidence of the nation's banking system favors the application of Section 1823(e) to fidelity bonds.[154] In conclusion, the court noted that although the application for bond coverage was not a "secret" agreement, Section 1823(e) was broader than *D'Oench*, applying to any agreement. What is significant is whether the agreement diminished the FDIC's interest in the asset when it took over the bank and whether the bank's board of directors had approved the agreement and recorded it on its books and records. In this case, the agreement to condition coverage on truthful answers in the application diminished the FDIC's interest in the bond and the agreement did not meet the requirements of Section 1823(e). Accordingly, the court held that the district court was correct in applying Section 1823(e), thereby barring the insurer from asserting misrepresentation as a defense to coverage.[155]

III. Effect of Rescission

Rescission voids the contract of insurance ab initio. In other words, it operates retroactively to the moment the policy came into existence.[156] Generally, where a contract of insurance has been rescinded, the insured is entitled to the return of the premiums paid.[157] Some states regulate the return of premiums by statute. For example, in California and North Dakota premiums are to be returned to the insured when the policy is rescinded, unless rescission occurs because of fraud by the insured.[158]

Although the issue of return of premiums was not raised by the parties in *Hartford Accident & Indemnity Co. v. Hartley*,[159] the court noted that it was inclined to think that whatever premiums had been paid by the bank should be returned.[160] In *Aetna Casualty and Surety Co. v. Retail Local 906 of AFL-CIO Welfare Fund*,[161]the court ordered the return of the premiums paid by the welfare fund.[162]

---

[152]*Id.* at 1553.
[153]*Id.* at 1554.
[154]*Id.*
[155]*Id.*
[156]2 COUCH ON INS. 3D § 30:3 (West 1995).
[157]5 COUCH ON INS. 3D § 79:24 (West 1996).
[158]CAL. INS. CODE § 483 (West 2000); N.D. CENT. CODE § 26.1-24-03 (1999).
[159]275 F. Supp. 610 (M.D. Ga. 1967).
[160]*Id.*
[161]921 F. Supp. 122 (E.D.N.Y. 1996).
[162]*Id.* at 133.

© The Fidelity Law Association

IV. Conclusion

An insurance contract transfers a defined risk from an insured to an insurer in consideration of a premium which is calculated to reflect the risk. The integrity of this process is undermined when an insurer is induced through misrepresentations and omissions into accepting a risk it otherwise would have declined, or into accepting a risk on more lenient terms or for a lower premium than it would have if the true facts had been disclosed.[163] The remedy of rescission addresses that problem in the more serious cases. However, it remains an extreme remedy which courts are reluctant to grant absent a showing of real harm to the insurer and, in many jurisdictions, an intent by the insured to inflict that harm.

[163]FDIC v. Underwriters of Lloyd's of London, 3 F. Supp. 2d 120, 138 (D. Mass. 1998) (citing Joseph K. Powers, *Pulling the Plug on Fidelity, Crime, and All Risk Coverage: The Availability of Rescission as a Remedy or Defense*, 32 TORT & INS. L.J. 905, 906 (1997)).

© The Fidelity Law Association