

## **Second Circuit Affirms Policy Rescission Based on Misrepresentations and Rejects Ratification Arguments**

The Second Circuit Court of Appeals recently affirmed the U.S. District Court for the Southern District of New York's judgment rescinding a professional liability policy, as the insured's application for coverage failed to disclose information regarding participation in a fraudulent scheme by certain insureds. *Continental Cas. Co. v. Boughton*, No. 16-2384, 2017 WL 2416902 (2d Cir. June 5, 2017). The Second Circuit also held that the insurer did not forfeit its rescission rights through any ratification of the policy.

Continental sought rescission of a professional liability insurance policy issued to a public accounting firm, Marshall Granger & Company, LLP (the "Firm"). One of the Firm's former clients and his company (the "Intervenors") intervened in the lawsuit after one of the Firm's principals assigned his rights to them.

Continental alleged that, prior to the Policy's issuance, the Firm submitted an insurance application (the "Application") in which the Firm asked, among other things; (1) whether the Firm or its personnel rendered investment advisory services, (2) whether the Firm rendered services under any other name, and (3) whether any Firm professionals were aware of circumstances that might be expected to be the basis of a claim.

The Firm answered "No" to each of these questions. However, at that time certain Firm principals were perpetrating a securities fraud scheme intended to defraud clients into

participating in a fictitious investment opportunity. The SEC eventually filed an enforcement action against two of the Firm's principals, and one of the principals was subsequently indicted on criminal charges.

After Continental issued the Policy, the Firm notified Continental of the SEC lawsuit and the criminal case against the Firm's principal, as well as claims by former Firm clients who lost money as a result of the scheme. After investigating whether rescission was appropriate, Continental then filed its rescission action.

The District Court granted rescission, finding that the Firm made material misrepresentations on the Application and none of Continental's actions constituted waiver of the right to rescind the Policy. With respect to the limited issue of whether Continental forfeited its right to rescind by unreasonably delaying filing its lawsuit, the Court permitted limited discovery, and, ultimately, a jury found in Continental's favor on this issue.

On appeal to the Second Circuit, the Intervenors argued that Continental could not rescind the Policy, notwithstanding any misrepresentations, because (1) it ratified the Policy and (2) it unreasonably delayed in seeking rescission.

The Second Circuit upheld the District Court's finding that Continental did not waive the right to rescind the Policy. The court initially noted that, under New York law, "an insurer may not

rescind a policy if, after having the requisite knowledge of the insured's fraud, it commits an act that affirms the policy." But the court disagreed with the Intervenor's contentions that Continental ratified the Policy by (1) sending a letter to one of the Firm's owners denying coverage of a claim; (2) paying \$12,500 in defense costs as required by the Policy; (3) issuing administrative endorsements changing the insured's name and address on the Policy; and (4) offering "extended reporting" coverage to the insured and sending a non-renewal letter.

In rejecting the Intervenor's arguments, the Court found that none of Continental's alleged conduct affirmed the Policy. The appellate court explained that Continental's policy amendments were ministerial in nature, Continental was legally obligated to pay the Firm's legal costs until a court entered a judgment granting rescission, New York law required Continental to offer "extended reporting coverage" to the Firm, and the non-renewal letter indicated Continental was investigating rescission and reserved its rights to rescind the Policy.

## Comment

The Second Circuit's ruling reaffirms the principle that an insurer that learns of possible misrepresentations in a policy application is entitled to investigate the situation in order to determine whether to file a rescission action. The court's discussion regarding ratification is informative to both insurers and insureds, as the court makes clear that the insured is entitled to certain policy benefits (i.e. defense against claims and the right to extended reporting coverage) and the insurer will not be penalized for continuing to provide those benefits while investigating and seeking rescission. The court recognized that an insurer will not be deemed to ratify a policy by taking certain actions that it is required to take by law, while concurrently investigating or pursuing policy rescission.

*If you have any questions about this Update, please contact the author listed below or the Aronberg Goldgehn attorney with whom you normally consult:*

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