

Insurer Entitled to Rescind Advertising Injury Policy and Seek Restitution From Insured, Directors and Officers

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November 2007

In a November 2007 decision, the California Court of Appeal affirmed the trial court's ruling that an insurer was entitled to rescind a policy for liability arising from advertising injury (*LA Sound USA, Inc. v. St. Paul Fire & Marine Insurance Company*). Further, the Court of Appeal remanded for determination of the amounts owed by the insured and its directors and officers as restitution of the benefits received under the rescinded policy.

LA Sound USA, Inc., the insured, had obtained a policy providing \$1 million in coverage for liability arising from personal injury or advertising injury. On the insurance application completed by the insurance broker (i.e., not by LA Sound itself), boxes were checked to indicate "NO" to the following questions:

- Has applicant been active in or is currently active in joint ventures?
- Is there a labor interchange with any other business or subsidiaries?

However, six months before the application, LA Sound (along with its two officers and directors) had entered into a written joint venture agreement with another entity. The joint venture stalled, and litigation later followed, including claims by the other entity against the insured and the two officer/directors for unfair competition (trademark infringement).

The insurer negotiated a partial settlement for \$1 million, which left unresolved the claims against the two officer/directors for conduct *outside* of their duties as directors/officers/employees of LA Sound.

The remainder of the litigation proceeded, with the two officer/directors (along with a related entity) ultimately paying \$2.85 million to settle the remaining claims.

In the insurance coverage action: (1) plaintiffs brought a bad faith claim, and sought to recover the \$2.85 million and the unpaid defense costs; and (2) the insurer sought to rescind, and to recover the amounts it incurred in defending and settlement payments.

After trial, the trial court found that coverage under the policy was void *ab initio* due to material misrepresentations by the insured, and entered judgment jointly against the insured and the two officers/directors for over \$3.1 million for defense costs, settlement costs, and interest.

The Court of Appeal affirmed the decision of rescission, holding that the misrepresentation was material:

"LA Sound applied for a policy covering advertising injury; the application specifically asked whether LA Sound was involved in joint ventures; the application misrepresented LA Sound involvement in a joint venture to market audio products; and LA Sound filed a claim asking [the insurer] to defend trademark infringement claims related to the joint venture. It is difficult to conceive of a more material misrepresentation."

The Court of Appeal further held that, under the applicable case law and the statute, the insurer was not required to show that the misrepresentations were intentional. Of interest, the insurer established the misrepresentation's materiality with the testimony of a senior underwriter, rather than the testimony of the specific underwriter who approved the application. The senior underwriter testified that joint ventures pose increased risks, require additional underwriting, and warrant charging an additional premium.

The Court of Appeal rejected the argument that the insured was obligated to produce the underwriter who actually approved the application, because the senior underwriter's testimony sufficiently showed the material effect that truthful answers about the joint venture would have had upon St. Paul.

The Court of Appeal reversed the judgment, insofar as it held the formerly-insured and its officer/directors jointly liable for the judgment. On this subject, the Court of Appeal held that the insurer had the burden of establishing the allocation of the defense and indemnity costs between LA Sound and its officers/directors, and that a new trial, limited to that issue, should take place.

This result demonstrates potential importance to an insured, and to its officers/directors, of the accuracy of the representations in an application for an advertising-injury insurance policy.