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NEWSLETTER

Court Holds Insurer Properly Rescinded D&O Policy Based on Intentional Misrepresentations

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A United States district court ruled on summary judgment that an insurer properly rescinded a directors and officers liability insurance policy. *Cutter & Buck, Inc. v. Genesis Ins. Co.*, No. C02-2569P (W.D. Wash. Feb. 11, 2004). The court also held that the insurer did not waive its right to rescind and did not breach its duty of good faith to its insured. Wiley Rein & Fielding LLP represented the insurer in the case.

The insured company is a clothing designer and manufacturer. In April 2000, the company shipped merchandise to three distributors and accounted for the shipments as sales. In reality, the distributors merely stored the goods until the company found actual buyers. The distributor transactions were designed to allow the company to meet Wall Street's projections and were hidden from the company's board and outside auditors. When the distributors subsequently returned the unsold product, the company's CFO attempted to cover up the returns.

The company's D&O insurance was set to expire in August 2001. In a meeting with the insurer, the company's CFO stated that the company had a very conservative revenue recognition and product return policy. He did not mention the distributor transactions. The company submitted a written application signed by the CFO along with various other required documents, including its annual report, CPA letter regarding internal controls and latest 10-K and 10-Q. Based on these materials, the insurer agreed to renew the company's insurance for another year.

In August 2002, the company again discussed renewal of its D&O insurance. The company's new CEO disclosed that the company would restate its financials because revenue had been recognized from sales in 2000 although the company's product was later returned. The CFO represented that there was no right of return for the company's product and the company would not have booked the revenue in question if it knew the product could be returned. The CFO did not mention that intentional misconduct was causing the company to restate its financials. The insurer agreed to extend the policy for another year.

On August 12, 2002, the company issued a press release announcing that it would restate its financials and suggesting intentional wrongdoing had occurred. The insurer did not immediately rescind the policy, but on August 14, sent the insured a letter requesting additional information regarding the company's accounting irregularities. In late October 2002, after various shareholder lawsuits had been filed against the company, the company gave the insurer documents that showed that the company's CFO had engaged in intentional misconduct in connection with the distributor transactions. The insurer rescinded the policy in December 2002. Shortly thereafter, the company filed suit alleging breach of contract and bad faith. In August 2003, the company entered into a consent decree with the SEC admitting that the recognition of revenue from the distributor transactions was improper. In addition, the company's CFO pled guilty to federal criminal charges in connection with the attempted cover-up of the transactions.

The court held that the insurer properly rescinded the policy. Under Washington law, the insurer was required to prove that the company had made material misrepresentations in the underwriting process with the intent to deceive the insurer.

First, the court held that the materials submitted with the company's 2001 application for insurance and its oral statements regarding its revenue recognition policy during the 2001 and 2002 underwriting processes contained misrepresentations. The court rejected the company's argument that it had never represented the materials it submitted with its application were "true and correct" because the application notified the company that the insurer would rely on the accuracy of the materials. The court held that while the materials were not physically attached to the issued policy, they were incorporated by reference and therefore complied with Washington's "attachment statute," which required application materials to be "attached to or otherwise made a part of" the issued policy. The court also rejected the company's argument that oral representations made outside a written application for insurance could not form the basis for rescission, citing a Washington statute that explicitly contemplated rescission based on oral misrepresentations.

Second, the court held, and the company did not contest, that the company's misrepresentations were material to the underwriting process.

Third, the court held that the company possessed the requisite intent to deceive its insurer because the company's CFO made knowingly false statements to the insurer and the company had failed to offer any evidence to rebut this presumptive intent to deceive.

The court held that the insurer was entitled to rescind the policy in its entirety based on the policy's severability provision. Under the provision, the policy would be considered void if the application and materials submitted therewith contained material misrepresentations made with the intent to deceive "provided, however, that no knowledge possessed by any director or officer shall be imputed to any other director or officer except for material information known to the person or persons who signed the Application. In the event that any of the particulars or statements in the Application is untrue, this Policy will be voided with respect to any director or officer who knew of such untruth." The court held the policy was void in its entirety because the knowledge of the CFO, who signed the application, was imputed to all insureds.

The court also rejected the argument that the insurer waived its right to rescind by failing to rescind immediately after the company's August 12, 2002 press release. First, the court held that the insurer did not possess full knowledge of its right to rescind until October 2002, when it received key documents showing that the company's CFO acknowledged wrongdoing in connection with the distributor transactions. Second, in response to the company's argument that the insurer possessed "constructive" knowledge of its right to rescind after the August 12, 2002 press release, the court held that by requesting additional information on August 14, 2002, the insurer commenced an investigation into its ability to rescind and demonstrated that it did not knowingly and voluntarily waive its right to rescind. The court held that an insurer must be allowed a reasonable time to investigate and determine whether rescission is warranted.

The court dismissed the company's bad faith claims because the claims all rested on the premise that the insurer had wrongfully rescinded the policy.

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