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NEWSLETTER

Ninth Circuit Affirms Cutter & Buck Rescission

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On August 1, 2005, the United States Court of Appeals for the Ninth Circuit upheld an insurer's rescission of a D&O policy due to intentional misrepresentations in the application for insurance. *Cutter & Buck, Inc. v. Genesis Ins. Co.*, No. 04-35218 (9th Cir. Aug. 1, 2005). In a *per curiam* opinion, the Ninth Circuit affirmed the decision by the district court that the severability provision in the policy allowed the insurer to rescind the policy in its entirety. The Ninth Circuit also affirmed the district court's ruling that the insurer had not waived its right to rescind. Wiley Rein & Fielding LLP represented the insurer in the case.

Background

Cutter & Buck, Inc. 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 chief financial officer (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 its annual report, 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, 2002, it 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 wrongful rescission. 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, chief operating officer and controller all pled guilty to federal criminal charges in connection with the attempted cover-up of the transactions.

The District Court Opinion

The district 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. The court held the insurer fulfilled these requirements. The court found that the materials submitted in support of 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 held, and the company did not contest, that the company's misrepresentations were material to the underwriting process. Finally, 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 then 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 Ninth Circuit Decision

The company raised two primary arguments on appeal. First, the company argued that the severability provision did not permit the insurer to rescind the policy in its entirety because the parties had intended the policy to provide full severability. Second, the company contended that the insurer had waived its right to rescind because the August 12, 2002 press release gave the insurer sufficient knowledge to rescind.

The Ninth Circuit affirmed the district court's interpretation of the severability provision. The Ninth Circuit held that the severability provision unambiguously stated that knowledge by the application signer of misrepresentations in the application materials would be imputed to all other directors and officers. Accordingly, because the company's CFO, who signed the application, had knowledge of the misrepresentations, the insurer was permitted to rescind the policy in its entirety. The Ninth Circuit rejected the company's argument that the parties had intended the policy to provide full severability. The Ninth Circuit held that the extrinsic evidence the company offered was not admissible under Washington law, which permits consideration of extrinsic evidence in the interpretation of contracts only when the evidence shows an objective manifestation of the parties' mutual intent.

The Ninth Circuit also affirmed the district court's holding that the insurer had not waived its right to rescind. The Ninth Circuit held that the August 12, 2002 press release did not give the insurer specific information as to any particular director's or officer's knowledge of, or involvement in, the accounting misdeeds. Specifically, the Ninth Circuit held that the insurer did not have full knowledge of its right to rescind until it learned that the company's CFO had knowingly made misrepresentations in the application.

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