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NEWSLETTER

Submission of False Financial Statements in Application for D&O Policy Justifies Rescission

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In an unpublished opinion, a federal district court has ruled that a D&O insurer properly rescinded its policy where the insured company submitted financial statements that it knew to be false in connection with its application for the D&O policy. *ClearOne Communications, Inc. v. Lumbermens Mutual Cas. Co.*, 2005 WL 2716297 (D. Utah Oct. 21, 2005). The court concluded that financial statements submitted with an insurance application were material to the insurer's underwriting decision, and that their falsity therefore supported rescission of the policy issued in reliance on those statements. It also determined that an individual insured's claims that he was injured by virtue of dilution of his stockholdings in connection with the underlying settlement was not subject to coverage, as that injury was suffered in his capacity as a shareholder, not as a director.

The insurer issued a D&O policy to a company that sold communications equipment. When applying for the policy, the company provided the insurer with various financial statements filed with the Securities and Exchange Commission. The policy application stated that "[a]ll written statements and materials furnished to the insurer in conjunction with this application are hereby incorporated by reference into this application and made part hereof." It was later determined that the company had significantly inflated its financial statements through an improper revenue recognition scheme.

Both the SEC and shareholders of the company sued the company and its directors and officers based on its inflated financial statements. The company settled both actions. The insurer refused to defend or indemnify the company or its directors and officers against the lawsuits, indicating that it intended to rescind the policy due to the submission of false financial statements with the application. In the ensuing coverage litigation, the insurer sought summary judgment on its rescission claim.

The court concluded that the insurer properly rescinded the D&O policy under Utah Code § 31A-21-105(2). That statute provides that an insurer may rescind a policy for "misrepresentation or breach of an affirmative warranty" where: "(a) the insurer relies on it and it is either material or is made with intent to deceive; or (b) the fact misrepresented or falsely warranted contributed to the loss." Reviewing the extensive evidence before it, the court determined that the financial statements were unquestionably false. It further concluded that the misstatements were material, in that their falsity diminished the insurer's opportunity to evaluate the risk involved in issuing the D&O policy. Citing *Cutter & Buck, Inc. v. Genesis Insurance Co.*, 306 F. Supp. 2d 988 (W.

D. Wash.), *aff'd*, 144 Fed. Appx. 600 (9th Cir. 2005), the court noted that "[a] company's financial statements are indicative of its financial health and, therefore, generally evaluated by an insurer before issuing a policy." Based on the undisputed evidence before it, the court concluded that the insurer had reasonably relied upon the company's financial statements in deciding to issue the D&O policy.

The court held that rescission was proper because the company's financial misstatements were not merely innocent misrepresentations. Noting that Utah law provided that innocent misrepresentations were not sufficient to support rescission, the court determined that the record before it established that the company intentionally recognized revenue in violation of generally accepted accounting principles. The court determined that these violations directly caused its financial statements to be false, and thus that the misstatements were not "innocent." Accordingly, the court explained that the terms of the statute were satisfied and rescission was warranted.

The court then rejected the company's argument that the insurer could not rely on the false financial statements because they were not incorporated into the policy. The company cited a Utah statute requiring that "any agreement or provision" sought to be included in a policy be set forth in the policy or a document attached thereto. The court determined that the statute did not apply to false statements in an application because those statements did not constitute "an agreement or provision" of the policy. The court also rejected the insured's argument that it never contended that the financial statements were accurate, as the application specifically provided to the contrary.

The court also granted summary judgment to the insurer regarding a claim for coverage of a shareholder and former director of the company. As part of the company's settlement of the shareholder suit against it, the company had agreed to issue additional shares of its stock. The director claimed he was entitled to recover from the insurer the amount by which his stock value was "diluted" by the issuance of the additional shares. The court concluded that the director had brought his claim in his capacity as a shareholder, rather than as a director, and that his alleged damages therefore did not constitute a compensable "Loss" under the D&O policy.

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