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NEWSLETTER

Utah D&O Policy Void if CEO "Knew or Should Have Known" of Misrepresented Financial Statements

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The United States Court of Appeals for the Tenth Circuit, applying Utah law, has held that a D&O insurer can rescind a policy on the basis of restated financials if the CEO who signed the application "knew or should have known" that the financial statements incorporated into the application were false. *ClearOne Communications, Inc. v. National Union Fire Ins. Co.*, 2007 WL 2122053 (10th Cir. July 25, 2007).

The insurer issued a policy on the basis of an application, signed by the CEO, that incorporated the company's 10-K and other SEC filings. During the underwriting process, the underwriter sought additional information concerning the company's revenue recognition policies and confirmation that the company certified its financials in compliance with Sarbanes-Oxley. In a conference call, the company's CFO advised that the financials were certified and that no issues existed with respect to non-compliance with the revenue recognition policies. Several months after the policy was issued, the company disclosed that its financial statements—including those incorporated into the application—could not be relied upon. The company had overstated net income by prematurely recognizing revenue from product shipments to distributors that were permitted to pay as the goods were sold rather than within 90 days as required under company policy. After the insurer rescinded the policy, the company settled the shareholder litigation with a combination of cash and issuance of common stock. This coverage litigation ensued.

The Tenth Circuit held that three of the four elements required for rescission under Utah law had been established. First, the court concluded that Utah law did not preclude the insurer from relying on financial statements incorporated into the policy by reference rather than being physically attached. The court also rejected the company's argument that it had not warranted the truth of the financials, finding that the Utah statute permitted rescission based upon either a misrepresentation or breach of warranty. Second, the court concluded that there was no factual dispute as to the materiality of the misstated financials. Third, the court agreed with the district court that the insurer investigated the financials adequately and reasonably relied upon them.

The court remanded the case, however, with respect to the issue of scienter. Under Utah law, "rescission may

not be grounded solely on an 'innocent misrepresentation,'" but the court observed that the Utah courts have not yet articulated with precision what degree of knowledge must be shown. Based upon its reading of the Utah authorities, the Tenth Circuit concluded that "[a] misstatement is not innocent . . . if the applicant *knew or should have known* about its falsity." Accordingly, in addition to the applicant's actual knowledge, the court held that the insurer could properly rescind if it established that the applicant "should have known about a misstatement in the application and still presents it to the insurer." In the court's view, the relevant knowledge was that possessed by the CEO who signed the application. The court expressly left open the question whether another director's or officer's knowledge could establish scienter. The court remanded the case to the district court for a determination of whether the CEO knew or should have known of the revenue recognition misstatement, including consideration of whether the CEO "utilized reasonable internal controls that would have ferreted out the financial misstatements" or whether she reasonably relied on the company's outside auditors.

In light of the remand, the court declined to decide the parties' dispute concerning the effect of the partial severability clause contained in the application. However, the court observed that the partial severability clause by its terms only applied to specific questions on the application, not the question pursuant to which the financials were submitted. The court therefore concluded that if the insurer successfully established a non-innocent misrepresentation, the severability clause would not preclude rescission of the policy in its entirety.

Finally, the court held that a director, who was also the company's largest shareholder, did not suffer any "loss" through dilution of his interests resulting from the issuance of stock to settle the shareholder suits. The court agreed that any loss "is attributable to his status as a major shareholder, not as a director of ClearOne." The court also directed the district court to consider the company's claims for bad faith and punitive damages on remand, which it had failed to address in light of its holding that the policy had been validly rescinded.