Directors & Officers Insurance

Under Georgia Law, Insurers May Not Rescind a Policy For Falsity in the Application Process Absent Deliberate Misrepresentation or Deliberate Omission during Application Process

Wrongful Rescission By An Insurer May Constitute Statutory Bad Faith under Georgia Law, But Not When the Insurer's Grounds for Rescinding Are Reasonable, Albeit Erroneous

Executive Risk Indemnity, Inc. v. AFC Enterprises, Inc., 510 F.Supp.2d 1308 (N.D.Ga. 2007)

Case at a Glance

A directors and officers liability insurer failed to establish that its insured's representatives made any knowing misrepresentations, incorrect statements, or omissions concerning the insured's financials during application process or that any misrepresentation was material to the risk, and therefore insurer was not entitled under Georgia law to rescind the policy, where (1) the policy conditioned rescission on knowledge of an untruth in the application; (2) the insured's representative stated that, to the "best of [his] knowledge and belief," the insured's prior publicly-filed financial statements were entirely true and correct; and the insurer's underwriters approved issuance of the policy even after knowing full well of insured's intent to restate its earnings, and knowing full well that securities claims had been filed against insured. Nevertheless, even though the insurer's decision to rescind was a mistake, and even though all of the grounds upon which this decision was made were erroneous, the insurer's attempt to rescind was not unreasonable under the circumstances. Consequently, the insurer was not liable for statutory bad faith under Georgia law.

Summary of Case

This case examines the circumstances surrounding Executive Risk Indemnity's (ERI) renewal of a directors & officers liability (D&O) policy it had issued to AFC, which operated, developed and franchised quick-service restaurants bearing the name "Popeye's Chicken & Biscuits." AFC's decision to change of a key accounting standard and restate its earnings shortly after the renewal policy issued resulted in a number of securities class actions and shareholder derivative suits. Although AFC and its auditor were debating the applicable accounting standard during the renewal application process, AFC neither agreed to the change nor disclosed the change to ERI until after the renewal policy issued. Thus, the core issue was whether AFC procured its renewal policy by means of "misrepresentations, omissions, concealment of facts [or] incorrect statements[.]" ERI sought a declaratory judgment that it properly rescinded the policy, and AFC counterclaimed for breach of contract and bad faith.

Insurance Application. AFC had bought executive protection insurance policies from ERI for at least a decade. These included policies covering fiduciary breaches, various crimes, kidnap and ransom, and employment practices, and D&O liability. Various policies AFC bought had different policy periods. Before the claim giving rise to this lawsuit, AFC had not suffered any losses or made any claims on any of the policies referred to herein.

The established method of renewing the ERI policies was to conduct renewal applications and discussions during the three months or so before the policy ended. AFC's D&O policy ran annually from

meeting. At this meeting, one or another of the underwriters asked the questions found on the list. Question 9 asked the following: "Have there been any significant changes in accounting practices? Please discuss AFC's relationship with its new auditor?" Some of the questions asked at the meeting inquired about whether AFC was considering restating its earnings. There was nearly general agreement later that AFC's CFO indicated that the new auditor was "checking things out" and that everything was "fine," as between AFC and KPMG. Toward the end of the meeting the intermediary asked if ERI would increase the D&O coverage to $10M.

On February 20, 2003, AFC submitted its application for D & O insurance. The CEO signed the application on behalf of AFC and declared that the statements within the application and in the attached financial statements were true to the best of his knowledge and belief. The financial statements attached included AFC's latest 10-K, 10-Q, 8-K and 13d reports filed with the SEC, plus its latest proxy statement. In the application, the CEO stated that AFC had changed auditors within the last three years. The application itself stated that AFC had a continuing duty to inform ERI if there was "any material change in the answers to the questions [contained in the application] prior to the policy inception date."

On February 28, 2003, ERI bound the new "Directors and Officers Liability Insurance Policy." It was to run from March 2, 2003 to March 2, 2004. The policy contained three coverages: The first covered claims made during the policy period against persons insured for "Wrongful Acts" for which the insured company either pays or is committed to pay. The second coverage was for loss from "Securities Claims" first made against the company during the policy period. The third coverage, which is optional, extended coverage to the "Offering Underwriter" that the insured company either pays or promises to pay pursuant to the terms and conditions of the applicable "Underwriting Agreement." The aggregate limits stated in the binder were $10 million for two of the coverages and $10 million for a third coverage, for a total of $20 million.

The Alleged Misrepresentation. This lawsuit was an indirect consequence of the Enron scandal. AFC's financial statements had been audited by Arthur Andersen. That accounting firm collapsed during the Enron scandal. AFC chose KPMG as its new outside auditor in early 2002. AFC picked KPMG partly because it had superior experience in the quick-service restaurant industry; indeed, it audited the majority of AFC's peer group.

AFC was under considerable pressure to make sure that it filed its 2002 financial statement with the SEC in a timely manner. There have been previous late SEC filings by AFC, and there was apparently some danger that "another late filing would result in the company being de-listed by NASDAQ—a catastrophic occurrence for a public company." Unfortunately, as the new audit went forward, there were a large number of issues that were slowing down the audit process.

The most complicated and serious audit issue pertained to the method AFC used to account for the impairment of long-life assets, specifically, "whether to record a charge as a result of losses being incurred at any of AFC's retail outlets." Previously, AFC had evaluated such impairments by aggregating all of its retail outlets within a market. This "market-based" approach had been a minority approach in the quick-serve industry but was formerly "an accepted accounting principle and was used by several other national quick-service restaurant chains."

The key word in the previous sentence is "formerly" because the Financial Accounting Standards Board had issued FAS-144, a new standard entitled "Accounting for the Impairment or Disposal of Long-Lived Assets," about a year before AFC prepared its 2002 financial statements. The previous standard on this topic was termed "FAS-121." One of

believed that the market-based approach to impairment valuing was superior, and he strongly disagreed with using FAS-144. KPMG disagreed. There was a meeting on December 19, 2002 of the AFC Audit Committee at which the entire matter was discussed, including the evolving disagreement with KPMG. One of the reasons for this would be that if AFC moved from a market-based analysis to a unit-based analysis, there would have to be a revision in the reports of the previous three quarters in 2002 and of the entirety of 2001. However, when the insurance meeting occurred on January 24, 2003, no internal decision had been reached on how to deal with the requirements of FAS-144.

AFC's Audit Committee held a special meeting on February 28, 2003. AFC's CFO was there; a senior audit partner from KPMG was there; AFC's general counsel was there. No decision was reached. On the next day, Saturday, March 1, 2003, a group of AFC officers met to discuss completing the audit. Time, which was of the essence, was running short given the filing deadlines. KPMG had some reluctance about accepting a market-based analysis; AFC's CFO was firm in his position; KPMG was requesting documentation regarding how AFC's accounting department had been thinking about FAS-144. There was an outsider present at this meeting. That person was a partner in another national accounting firm, and the General Counsel of AFC invited him, since he apparently believed that there were significant differences between KPMG and AFC. "AFC personnel were confused and frustrated at KPMG's position on market-based impairment analysis given that Andersen had always approved AFC's use of the approach." This outsider explained that there were dramatic auditing differences between Andersen and KPMG. The former would advise AFC about what methods to use. In contrast, KPMG would not. Instead, AFC "'needed to make the [accounting and reporting] decisions [without advice from the auditor], take them to KPMG, and then KPMG would either agree or disagree.'"

Later on March 1, 2003, the CFO, the General Counsel, the CEO, and the outsider met to discuss the content of the earlier meeting. No decision had been made in the earlier, larger meeting, and no decision was made at the later meeting. No one at either of these meetings had authority to "decide whether to pursue a re-audit and possible restatement, as any such decision was required to be approved by AFC's Audit Committee, and then recommended to and approved by AFC's Board of Directors."

On March 3, 2003, a Monday, the CFO backed-down and "recommended to AFC's Audit Committee that AFC re-audit and, as necessary, restate its financial statements for 2001 and the first three quarters of 2002 period." The Audit Committee agreed; the matter was sent to the Board of Directors, and it was approved. This last event took place on March 10, 2003.

Thus, the decision to re-audit was made more than a week after the new policy period had begun. Hence, there was "no evidence that the dates of coverage for the D&O policy were a consideration for anyone at AFC when these decisions were being made."

On March 24, 2003, AFC publicly announced that it would commence the work to restate earnings. Within sixteen hours of that announcement, several securities class action lawsuits and shareholders' derivative actions were filed in various courts. These "underlying actions" sued not only AFC, but also current and former officers and directors, and the "Offering Underwriters of [both] AFC's initial and secondary public offerings, [namely,] Goldman Sachs, Credit Suisse, and Deutsche Bank." Thus, both of the independent coverages were triggered and the entire $20 million was in play.

The Insurance Claim. After ERI received notice of the lawsuits its claims adjuster "concluded—based upon the timing of the restatement in relation to the

AFC settled the securities cases. On July 1, 2005, AFC settled the derivative cases. These settlements were approved by another judge sitting in the Northern District of Georgia. AFC's total costs in the underlying cases was $25,507,464. This number included settlement costs, attorneys' fees, and expenses. In addition, the settlements contained contingent obligations of up to $6M, depending upon the outcome of the case under discussion here.

ERI's declaratory judgment action and AFC's breach of contract and bad faith claims were interrelated and turned on whether AFC's made misrepresentations, incorrect statements, and omissions justifying rescission of the policy. There were no substantive coverage issues. The entire matter was controlled by three principles of Georgia law: First, the insurer bears the burden of proof with respect to its affirmative defenses; second, "[i]n order for misrepresentations to void the coverage, such statements must be [1] made for the purpose of procuring insurance [2] not otherwise procurable, must be [3] material to the acceptance of the risk, [4] must be false, and [5] [must be] made with intent to defraud." *Insurance Co. of West v. Dills*, 243 S.E.2d 549, 552 (Ga. 1978); and third, the insurance contract itself can limit the insurer's right to rescind. Under the policy ERI issued to AFC: (A) an application is part of a policy only if it is actually attached to the policy when it is issued. (B) AFC—the applicant for insurance—did not provide any warranties in connection with its answers to the questions on the application or the attachments. (C) The application itself stated that the signatory thereto only declares that the propositions therein are true to the best of his knowledge and belief." S/he does not assert that there are actually ("by God!") true. (D) A condition of the policy states that each insured had represented that the "particulars and statements" contained in the application are "true, accurate and complete, and agrees that this policy is issued in reliance on the truth of that representation[.]" However, "no knowledge or information possessed by any Insured will be imputed to any other insured except for material facts or information known to the person or persons who signed the application."

Thus, a policy can be voided with respect to *this* person but not *that* person, *that* person but not *yet another* person, and so forth. ERI "generally cannot rescind coverage for insureds that did not possess knowledge of material misstatements on the application." In addition, the ERI "contract specifically requires *knowledge* as a pre-requisite to rescission." Mistakes based on mere ignorant beliefs are not enough. Thus, ERI's burden of proof to justify full and complete rescission involves at least one of the following two: "(1) that every insured '*knew* of [an] untruth' in the application; or (2) that [the CEO who signed the application] *knew* of a material misstatement in the application." (Emphasis added.)

Analysis of the Application. The court found that the CEO's answers to the questions in the application were not false or incorrect, and no evidence of any kind was offered to establish that [he] knew of any false matter associated with the application." ERI's principal contention was that the CEO "had knowledge that the company's financial statements, which were deemed to constitute part of the application, were incorrect." According to the court, however, "the evidence does not establish a misrepresentation or incorrect statement by [the CEO]." The important date where this kind of proof has to be found is February 20, 2003, the date upon which the CEO completed the application. In addition, he was not involved in the day-to-day process of AFC's audit; he was "not primarily responsible for dealing with KPMG"; and he relied upon the CFO "to let him know about any significant issues involving the audit." On the day the CEO signed the application for D&O insurance he had never been "informed that AFC's financial statements were not true and correct, and, as of February 20, 2003, he fully

by someone with substantial audit experience as "professional," and there was no reason to believe the relationship was anything but "fine" as of January 24, 2003. In addition, although internal accountants at AFC were considering what a change in its public reports from FAS-121 to FAS-144 would look like, "the evidence failed to establish that AFC had made any 'significant changes in accounting practices'" as of January 24, 2003. Significantly, "the market-based approach in consultation with Andersen. . .had been fully disclosed in AFC's previous financial statements and had been submitted to the SEC—which [had] lodged no complaint [as] to the method." Indeed, "the changes were not made until AFC filed its restated financial statements on December 15, 2003. The mere fact that internal accountants were discussing accounting issues does not rise to the level of establishing a basis to rescind the Policy." *Duty to Update.* The judge found that the defendants did not violate any duty to update information to RSI. The court assumed that there was such a duty, but indicated that this "duty could be no broader than the contract of insurance." The application stated this: "If there is any material change in the answers to the questions, prior to the policy inception date [AFC] will notify the company in writing and any outstanding quotation may be modified or withdrawn." Thus, if there was a duty to update, it was restricted to answers to the questions the insurer had actually asked in the application. The insured had no duty to provide information on topics not actually asked about explicitly, directly and (presumably) clearly. There was no evidence in support of any such breach of duty, and the court relied upon evidence from a variety of sources, including "an attorney with substantial expertise in the area of corporate government and a member of AFC's Board of Directors[.]" "Finally, to the extent that AFC's decision to commence the process to restate certain financial statements could be considered a 'material change in the answers to the questions, despite the fact that no such question was asked, the court finds that any such change did not occur prior to the inception date of the Policy."

Material Misrepresentation. The judge held that ERI did not prove any material misrepresentations. Proof of *materiality,* of course, is crucial. Under the applicable Georgia statute (O.C.G.A. § 33-24-7(b)(3)), the following is the applicable rule. The insurer must establish that it "in good faith would either not have issued the policy or contract[,] or would not have issued a policy or contract in as large an amount[,] or at the premium rate as applied[,] or would not have provided coverage with respect to the hazard resulting in the loss[,] if the true facts had been known to the insurer[,] as required either by the application for the policy or contract or otherwise."

Not only did the court hold that ERI had not proved its case, it held that the evidence "established that the very facts that [ERI]. . .claimed were misrepresented were *not* material to the risk." (Emphasis added.) ERI did not ask AFC whether it was planning to restate its earnings either in the application or at the January 24, 2003 meeting. "Under Georgia law, '[a]n insurance company cannot assert that a factor is material to the risk about which it neither made inquiry [n]or apprised its prospective insured.'" *Georgia Farm Bureau Mutual Insurance Co. v. First Federal Savings & Loan Association,* 262 S.E.2d 147, 149 (Ga. App. 1979). "If [ERI] truly considered the prospect of a possible restatement of earnings to be material, it could have easily included a question in the application inquiring about the subject, but [it] chose not to do so." Interestingly, ERI sold some D&O policies to others based on an application that asked whether the applicants knew of any facts which *might* result in a restatement of earnings." (Emphasis added.) Moreover, the evidence showed that U_1 and U_2 "approved issuance of the Policy even after knowing full well of AFC's intent to restate its earnings, and knowing full well that securities claims had been filed against AFC." U_2 even

expenses but those of the other defendants as well. These were almost $8.8M, and all attorneys' fees and litigation expenses were reasonable, according to the court. There was coverage for all of these types of expenditures. Consequently, the court found that AFC was due $20 million from ERI by virtue of ERI's breach of contract. In addition, there was prejudgment interest which the court found to be accumulating at nearly $4,000 a day.

Bad Faith. The court held that ERI was not guilty of insurer bad faith. Even though it was "not entitled to rescind the Policy, the court concludes that [ERI] had 'reasonable and probable cause' for its coverage decision." Under Georgia law, [i]f there is any reasonable ground for contesting the claim there is no bad faith and it is error to reward penalty and attorneys' fees." *Commercial Union Insurance Co. v. F.R.P. Co.*, 322 S.E.2d 915, 921 (Ga. App. 1984). The reasonableness of insurer decisions regarding coverage must be determined on the basis of "the facts appearing to [the insurer] at the time of its decision." Bad faith causes of action cannot be based upon facts which occurred after the claimants filed their lawsuit against the insurer. *Downer v. Georgia Farm Bureau Mutual Insurance Co.*, 337 S.E.2d 422 (Ga. App. 1985).

The court based its decision on four considerations. First, the timing of the restatement announcement, with its proximity to the initiation date of the policy, at least suggests that AFC "might have known more about the possible restatement than it disclosed to [ERI] before the inception of the Policy[.]" Second, ERI "promptly initiated and conducted an investigation of the circumstances surrounding the issuance of the Policy, which reasonably led it to conclude [falsely] that the policy had been procured on the basis of material misrepresentations." Third, "AFC's lack of cooperation in that investigation reasonably added to [ERI's] belief that AFC had been less than forthcoming in the negotiations for the policy." Fourth, various bits of testimony appear to be inconsistent with each other. These tensions and testimony led to the conclusion that there were disputed issues which would reasonably lead an insurer to the conclusion that it was (at least) entitled to a trial.

Comment

The court's report of this case is a marvelous teaching tool. It is a virtual encyclopedia of how and why an insurer should actually investigate and think carefully about whether to rescind an insurance policy, at least on the grounds of insurer misrepresentation in the application process. Detailed inquiries into both empirical matters and relevant state law must be conducted and attended to, *in advance of rescission!* Thus, the court's decision is also tantamount to a learned essay for lawyers about how rescission litigation should not be handled, and what rescission advice should be prepared and what it should be.

Insurer Error. If an insurer hypothesizes fraud in policy renewal, it should begin with substantial doubts about its own hypothesis. It should investigate the matter carefully. It should schedule as many "Examinations Under Oath" as possible, assuming that it has the right under the policy to do this. (Even if it doesn't actually have the right to do this, it should try to do it.) Obviously, its own underwriters should (and should be required to) tell the whole truth in the internal investigation. At all times, the insurer should keep in mind the wisdom of Sir Karl Popper to the effect that objective studies begin with hypotheses and proceed by trying to falsify them. *See* Karl Popper, THE LOGIC OF SCIENTIFIC DISCOVERY (1959) It might be a good idea for the insured to keep in mind how influential this idea has been even in today's financial circles. Consider the outlook of George Soros. See Michael T. Kaufman, SOROS: THE LIFE AND TIMES OF A MESSIANIC BILLIONAIRE (2002).

response to ERI's inquiries as "half-hearted at best." AFC's response to the investigation should have been cooperative, prolonged, and fully-hearted, performed in (at least the appearance) of enthusiasm. From the explicit prose in the court's opinion, it does not appear that AFC pursued consequential damages as part of its case. It seems likely that if the insurer had not rescinded the policy and had responded to the class actions quickly, everything could have been done for less than $20 million. If that were provable, then AFC's damages in excess of policy limits would be provably a consequence of ERI's breach of contract. With the right strategy AFC's damages in excess of policy limits would be provably a consequence of ERI's breach of contract. With the right expert witnesses, this case could be established by a preponderance of the evidence. If Georgia law permitted the recovery of consequential damages resulting from an insurer's breach of an insurance contract, all of AFC's damages could have been recovered, even if it could not win the bad faith case. // Quinn