Overextended warranties

What policyholders should know to protect themselves from overbroad warranty statements

When purchasing directors and officers liability insurance, policyholders are often asked to warranty that they are not aware of any facts that might lead to a claim under the prospective policy.

While such warranty statements are common in D&O underwriting, in recent years insurers have increased their efforts to aggressively use the warranties — which are often broadly worded — to deny coverage for almost any claim involving facts that predate the relevant warranty.

A December 2018 decision by the 2nd U.S. Circuit Court of Appeals in *Patriarch Partners LLC v. Axis Ins. Co.* highlights the importance of policyholders closely reviewing the precise terms and potential implications of any warranty statement they are asked to provide, and the risks they face when they provide broadly worded warranty statements to insurers.

Risks of broad warranty statements

Patriarch concerns a warranty statement signed by Patriarch's CEO at the request of a new excess D&O insurer. The warranty states that no "director or officer of Patriarch is aware of any facts or circumstances that would reasonably be expected to result in a Claim under the (excess policy)" and that the excess policy "does not provide coverage for Claims relating to facts or circumstances that, as of the date of this letter, Patriarch was aware of and would reasonably have expected to result in a Claim."

The CEO was Patriarch's sole officer and sole director. When she signed the warranty letter, she was aware that the Securities and Exchange Commission was conducting an "informal investigation" of Patriarch. Additionally, Patriarch's outside counsel — but not the CEO — was aware that the SEC had issued an internal order directing investigation into "possible violation" of federal securities laws by Patriarch in the "structuring and marketing" of collateralized loan obligations that it sold. In signing the warranty statement, Patriarch did not mention this investigation to the insurer.

After the excess policy was issued, Patriarch received a formal subpoena from the SEC, provided notice of the subpoena as a claim under the excess policy, and sought coverage for the cost of defending the subpoena. The insurer denied coverage, asserting that Patriarch—at the time it signed the warranty statement—should have reasonably expected the SEC investigation to result in a claim, such as the subpoena, and thus was not entitled to coverage based on the warranty statement.

This dispute eventually reached the 2nd Circuit, which held in favor of the insurer. The court observed that while the first sentence of the warranty statement concerned the knowledge of any "director or officer of Patriarch," the second sentence concerned the knowledge of "Patriarch," and concluded that the outside counsel's knowledge was relevant to the accuracy of the warranty. Based on outside counsel's knowledge of the order to investigate Patriarch's "possible violation" of securities laws when its CEO signed the warranty statement, the court held that Patriarch "would reasonably have expected" a claim by the SEC and that coverage was therefore foreclosed by the warranty statement.

Key considerations for policyholders

While the facts of *Patriarch* may be somewhat uncommon, the considerations that it highlights are not. These include: (1) the fact that many insurers aggressively use warranty statements to disclaim coverage; (2) the importance of clearly identifying whose knowledge is relevant to a warranty; (3) the importance of clearly identifying precisely what knowledge is being warranted; and (4) the possibility that a warranty statement dispute may result in prolonged coverage litigation. Policyholders should give substantial attention to these considerations, preferably before signing a warranty statement.

Most obviously, *Patriarch* demonstrates that insurers will aggressively use warranty statements to deny coverage for otherwise covered claims, even when facts suggest that a warranty's signatory believed her statements were accurate. Any policyholder asked to provide a warranty statement should carefully review each term in any warranty before signing and consider discussing these terms with experienced coverage counsel. While insurers in many situations will refuse to issue coverage without a warranty statement, the terms of that warranty may be negotiable.

More specifically, *Patriarch* underscores the importance of preemptively identifying the individuals whose knowledge is relevant to a warranty statement. The *Patriarch* warranty statement referenced the knowledge of both Patriarch and directors and officers, and the 2nd Circuit held that "Patriarch" included the company's agents, including outside counsel. While other courts might disagree with this broad reading or find *Patriarch* limited to its facts, policyholders should be aware that insurers may construe warranties provided on behalf of a corporate entity to encompass the knowledge of all the company's employees and agents.

Since almost no company can confirm whether each employee and agent knows of facts likely to result in a claim, policyholders should demand that any warranty be limited to the knowledge of specific individuals. For instance, insurers will sometimes agree to limit a warranty statement to the knowledge of a company's senior executives. Alternatively, even if the knowledge of individuals beyond senior executives is relevant to a warranty, an insurer may agree that only the knowledge of senior executives can be imputed to the company and impact coverage for the company.

Additionally, some insurers will agree that the knowledge of each individual to whom the warranty applies is severable, and only an individual who has knowledge inconsistent with a warranty will be precluded from coverage. While many D&O policies contain similar severability and nonimputation language in their general conditions, some courts have held that such general provisions do not automatically extend to warranty statements, so policyholders should be prepared to demand that such language be expressly incorporated into any warranty statement.

Patriarch also highlights the risk presented by warranties that turn on vague descriptions of what a policyholder knows about future claims. In *Patriarch*, an individual knew only that the SEC had ordered the investigation of a "possible violation," but this was still found to be awareness of a fact that "would reasonably be expected to result in a Claim." Other warranty statements contain even broader language — for example, some insurers request a warranty that no insured "could have reasonably foreseen that a claim might likely be made." To address this issue, policyholders should seek the clearest possible terms to describe the knowledge being warrantied — while some uncertainty in language may be unavoidable, that only underscores the need to clearly define whose knowledge is relevant to a warranty.

Of course, once the universe of relevant knowledge has been defined as clearly as possible, a policyholder must communicate with the relevant individuals and understand what pertinent information they possess for purposes of the warranty. If that process yields information about a potential future claim that might be precluded by the warranty under discussion, the policyholder should evaluate whether it can provide a notice of circumstance to its existing D&O insurers that might lock in coverage for the potential future claim under those existing policies (and thus limit any future disputes regarding the potential claim and the warranty).

Lastly, *Patriarch* is a reminder that disagreements over warranty statements can result in substantial coverage disputes and litigation. Policyholders must be cognizant of issues that may arise in this context. Most notably, they should be aware that courts interpreting warranty statements may apply different tests depending on the applicable law and facts. The first test looks to what an objective policyholder should have known and at what potential claims they objectively should have expected based on that information. The second test — which is most commonly applied by courts — looks at what a policyholder actually knew and at what potential claims they objectively should have expected based on that subjective knowledge. The third test looks at what a policyholder actually knew and at what potential claims they subjectively expected based on their subjective knowledge. Determining which of these tests to apply is often critical in disputes over warranty statements. Policyholders also should anticipate disputes over discovery — for example, policyholders should be prepared to demand information regarding an insurer's drafting and prior use of warranty statements and to resist overbroad insurer requests regarding every detail of the underlying claim.

For all of these reasons, policyholders should be careful to closely review any warranty statements they are asked to provide and be ready to negotiate the scope of such warranties.

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