



# The Dark Side of Warranty Statements

## When to Sign and When Not to Sign

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Insurance companies frequently ask credit unions to complete warranty statements as part of the application process for either new or renewal policies. So what is a warranty statement and why should you think twice, even three times, before completing it?

Warranty statements mainly apply to Directors and Officers, Employment Practices Liability, Fiduciary Liability and Professional Liability policies. Because insurance companies want to be sure they are not walking into a claim (the act has already occurred, but a claim has not yet been reported) they often require credit unions to provide a warranty statement. It is a very broad statement typically required to be signed by the CEO/President, vowing that “no person or entity proposed for coverage is aware of **ANY** act, error or omission which **MIGHT** result in a claim.” If the answer is “yes,” the insurance company may specifically exclude future claims arising out of that act, error or omission. Failure to respond truthfully can also result in future claims not being covered. The insurance company may even use its ultimate weapon and rescind the policy—return your premium and act as if the policy never existed.

Recently publicized was a case of a credit union that suffered a \$72,500,000 loss due to fraud. The credit union had signed a warranty statement as part of the application for their bond renewal. When it was discovered that the CEO, who signed the

**MATT SWEENEY, MBA, AAI**  
Producer  
816.960.9181  
msweeney@lockton.com



**DAVE BRITTON, CPCU**  
Account Executive  
Lockton Financial Services  
816.960.9928  
dbritton@lockton.com



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application, was the one stealing, the insurance company declined the coverage for the credit union on the basis that the CEO misrepresented the exposure by not disclosing his theft.

Because of the potential far-reaching effects of a warranty statement, it should be signed sparingly. There are only three times the completion of a warranty statement is appropriate:

1. When a specific coverage is purchased for the first time,
2. When additional limits of coverage are purchased, the warranty should only apply to the increased limits, or
3. Coverage is not available at a reasonable cost without completion of a warranty statement.

**Warranty statements should never be signed for a renewal policy, and very few insurance companies require this.**

In situations where the completion of a warranty statement cannot be avoided, the following three tips can help lessen their potential impact:

- A. Most policies contain a representations/severability provision which determines how coverage will be impacted if any misstatements or misrepresentations occur. Because the policy covers both the credit union and individuals, a properly crafted representations/severability provision will limit the imputation of knowledge between the parties. Specifically, the knowledge of any one individual should not be applied to any other individual for

the purpose of determining whether coverage applies. Additionally, only the knowledge of senior management should be allowed to be applied to the credit union. In essence this can prevent the “one bad apple” from jeopardizing coverage for the innocent individuals and credit union.

- B. The insurer should waive its right to rescind coverage for any reason, including any alleged misstatements or misrepresentations in the policy application. Recession is a very drastic action for an insurance company to take as this voids coverage not only for those who may have been involved in the misstatement or misrepresentation, but also for any innocent parties—whether the credit union or the individuals.
- C. It may be possible to negotiate the language of the actual warranty statement to fit a given situation. This should only be done in consultation with your legal counsel.

In conclusion, we recommend that when requested to sign a warranty statement, you should consider the ramifications and examine if alternative approaches can be taken. An insurance policy is only as good as its ability to pay claims, so clearly understanding the provisions and exclusions of any policy—or any contract for that matter—is part of prudent management.

