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When Little White Lies Lead to Big Gray Areas

I. The Role Of Policy Applications In Insurance

Evaluating Risk With Accurate Information Is A Critical Part Of Insuring A Policyholder

The ability of insurers to properly price policies and allow the insurance market to function as it should hinges on the accurate exchange of information prior to policy issuance. If an insured is able to inaccurately characterize its risk in the underwriting process without consequence, insurers are forced to pay losses that should otherwise not be covered. That drives up the price of insurance, and forces other policyholders to absorb the increased cost that should otherwise be borne by one insured.

It is for this reason that insurers have a remedy when they learn that an insured misrepresented facts that lead to the issuance of a policy. The equitable remedy of rescission allows an insurer to void the policy *ab initio*, with the effect being as though the policy never existed in the first place. Whether an insurer should pursue rescission requires an in-depth analysis of a number of issues.

The Language Of A Policy Application Should Be Clear

Whether an insurer has the option of pursuing rescission first hinges on whether the information provided by the insured is inaccurate. Of course, the information provided by the insured is responsive to the questions posed by the insurer. For that reason, the language used in policy applications is pivotal in determining whether a misrepresentation was made. Asking the insured open-ended questions may be helpful in soliciting information that identifies the risk, but there is only so much information an insured can disclose on an application. "Yes" or "no" questions can also be helpful, but the language of those questions needs to be precise so there is no basis for an insured to argue that the inquiry was unclear or ambiguous. Similarly, an insurer dealing with insureds that speak a foreign language may need to ensure that the application is properly translated so the correct information is captured.

The Broker May Play An Important Role – But Is The Broker The Insurer's Agent or Insured's Agent?

Insurers and insureds often interact through intermediaries, especially when dealing with commercial insurance. Those parties have many names – brokers, agents, producers, wholesale brokers, retail brokers, managing general agents, and more. Where one of those entities completes an application to be submitted to the insurer, who is that entity acting on behalf of? The laws of agency often control the issue, and courts are inclined to look to see who controlled the acts of the entity, what representations were made by both sides, what contracts exist that control the parties' relationship, and how custom and practice in the industry impact that relationship. This can be a difficult analysis that can often preclude summary judgment on both sides.

Evaluating whether a misrepresentation was made will necessarily include who provided that information to the insurer. If inaccurate information is provided by an entity that is deemed the agent of an insurer, the insurer may have a difficult time showing that the misrepresentation can be the basis for rescission. Conversely, where an agent is acting at the behest of a policyholder, courts are inclined to find that the agent's representations bind the insured and can support a claim for rescission.

The Application May Require An Insurer To Supplement

An application requires disclosure of a set of information known to the prospective policyholder at the time the application is submitted. But what if that information changes shortly after the application is submitted? In some applications, the policyholder is asked to supplement the information provided to the extent the information changes through the duration of the policy. This request can be critical, as the risk facing a policyholder may increase substantially if the nature of its business changes, or if it merges with or subsumes another company.

II. Considering Whether Rescission Should Be Pursued

Rescission is an equitable remedy afforded an insurer where it underwrote a policy in reliance on information that was not complete or not true, and that information materially impacted the risk to be insured. Rescission is different from cancelation, where policy coverage ceases as of a certain date but the policy is still in force for the term prior to the cancellation date. Determining whether to pursue rescission involves not only the legal standards in a particular jurisdiction, but also certain business considerations.

The Legal Standard For Rescission

Whether an insurer can pursue rescission based on a misrepresentation depends on the law of each jurisdiction. Many states have codified the insurer's burden in rescinding a policy, whereas others rely on the common law. Those laws may provide temporal limits on rescission that we will not address in detail in the presentation. The general rule, however, is that rescission is available where the insurer reasonably relies on a material misrepresentation in the policy application.

The threshold issue is whether a misrepresentation was made in the first place. This inquiry often focuses on the application language and whether the insured was asked to provide

information that it failed to disclose (see above). In the absence of a question that solicits that information, a misrepresentation does not exist.

Identifying a misrepresentation can sometimes be obvious. But certain questions require the insured to provide information based upon his or her subjective belief, which create a more challenging scenario. For example, an engineer involved in a construction project may be asked to identify whether he or she is aware of facts or circumstances that could reasonably lead to a claim. A party engaged in a construction project may contend that no claims were anticipated because there are always issues to address on such projects, and they never envisioned a claim developing at the time they completed the application. An insurer should consider all information known at the time of the application to determine if the insured should have provided a different answer.

The majority of case law on rescission concerns whether the misrepresentation was "material." Courts often require that the insurer prove that it would have issued a different policy if the insured had properly disclosed the information requested. This proof can come in the form of underwriting manuals or testimony from underwriters. That evidence may show that the policy would not have been issued, the policy would have contained an endorsement or provision excluding a portion of the risk, or the premium would have increased.

Whether a misrepresentation is material depends on the jurisdiction. What courts appear to be unanimous on, however, is the fact that the misrepresented fact does not need to bear a causal relationship with the loss at issue. So long as the insurer shows that it reasonably relied on that material misrepresentation at the time of policy issuance, it should be able to void the policy regardless of whether the undisclosed facts played a role in the loss.

Additional Factors Should Be Evaluated When Consideration Rescission

Regardless of whether an insurer can prove the legal elements of rescission, there are a number of other factors that could play a role in deciding whether to rescind the policy. The insurer should return the premium, as the policy should be treated as though it never existed in the first place. The insurer should also consider whether it should file a declaratory judgment action in order to properly rescind the policy. Coverage litigation could ensue from any decision to rescind, so evaluating whether any remaining claims could be made under the policy (i.e. claims-made vs. occurrence policy) would be appropriate. Of course, because rescission is an equitable remedy, the insurer should assert it in a timely fashion or risk losing it.

Finally, it is imperative that the underwriting file in its entirety be consulted before pursuing rescission as it may further reveal the parties' intent. A rescission argument could be weakened if the misrepresented fact is addressed elsewhere in the underwriting materials. Moreover, statements by an underwriter about the scope of coverage under a policy can ultimately bind the insurer, even where the policy terms potentially contradict that representation. The insurer may consider whether the insured partially revealed information that could have prompted a further investigation by the insurer.

III. The Restatement's Impact On Rescission

The Restatement Is Not Binding Authority

The American Law Institute (ALI) voted in May 2018 to approve the Restatement of the Law, Liability Insurance. The Restatement touches on a number of significant topics, including misrepresentations in policy applications and rescission. Over the course of the eight-year project, the Restatement went through several drafts, some of which favored rules that represented minority views. It is important to remember that the Restatement is not binding authority. But given the influence of the ALI, the Restatement may be persuasive, particularly in jurisdictions in which the highest court has not ruled on a particular issue.

The Restatement's Requirements For Policy Rescission

Section 7 of the Restatement governs an insurer's ability to rescind a policy. It largely tracks the common law, with some potential differences. The Restatement allows for rescission where the application contains a misrepresentation and: (1) the misrepresentation was "material"; and (2) the insurer reasonably relied on the misrepresentation in issuing the policy.

Materiality requires proof that a reasonable insurer would not have issued the policy or would have issued the policy under substantially different terms if the misrepresentation was not made. The question of what a "reasonable" insurer would do looks to what a reasonable insurer in the insurer's position would have done, not what an average or ordinary insurer would have done. This allows for an argument in favor of rescission that factors in different underwriting philosophies. Still, it may require expert testimony to support a rescission claim.

Reasonable reliance is established where the insurer would not have issued the policy or would have issued the policy under substantially different terms, and it would have been reasonable to do so. According to the comments, this includes a "substantially higher premium."

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An insurer exploring rescission should consider a number of factors before deciding it is the proper remedy. Aside from evaluating the legal standard in the particular jurisdiction, the insurer should consider what facts and evidence would come to light in coverage litigation, whether business factors alter the analysis, and how an insured may defend such a claim when faced with the risk of being uninsured.