RESCISSION AND OTHER DEFENSES TO MISREPRESENTATION

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Overview – Initial Considerations

• Initial considerations
  – Identifying the misrepresentation
  – Investigation
    • claims
    • underwriting
  – Legal standards
Overview – Rescinding the Policy

• Rescission
  – Initial actions
    • Premium refund
    • Filing suit
  – Timing issues
    • Prompt action
    • Underlying litigation
Overview – The Rescission Case

• Litigation
  – Discovery (documents and depositions)
  – Motion practice

• Trial
  – Burdens of proof
  – Defenses and counterclaims
Overview – Bad Faith and Alternatives

• Bad faith issues
  – Reasonable basis
  – Continuing defense

• Alternatives to Rescission
  – Reformation
  – Denial of coverage
  – Cancellation
Identifying the Misrepresentation

• Analyze underlying claims/pleadings
• Read together with policy and application
• Anything outside insured risk
• Activity insured did not disclose
Examples of Misrepresentation

• Nondisclosure of ineligible risks:
  – Liquor Law violations in prior 5 years
  – Construction work in New York

• Disclosure of false information:
  – “We are NOT a fraternity”
Reserving Rights

• Generally ineffective for rescission
• May investigate under reservation
• May waive other coverage defenses
• Or rescission, based on ratification
Examples of Ratification

• Accepting premium payments after notification of rescission
• Renewing policy
• Cancellation
Interview with the Insured

- Part of claim investigation
- Insured discloses prior knowledge
- Or different role in underlying events
- Criminal or other issues
Information from Defense Counsel

- Investigation reports
- Deposition testimony
- Discovery disclosures (documents, depositions, admissions)
- NOT privileged communications with insured
Application and Underwriting Materials

• Scope of insured’s activities
• Prior claims history
• Prior knowledge of circumstances
• Date of application
Analysis of Information from Insured

• Documents requested from insured
• What insured knew and when
• Non-disclosure to underwriters
• Prepare timeline
Examination under Oath

• Required by policy
• Evidentiary rules suspended
• Explore documents/subjective states of mind
• Impeachment value
Private Investigators

- Obtain records
- Find witnesses
- Take statements
- Testify at trial
Other Sources

• Public records
• News sources
• Internet
• Social media
Interview with Underwriter

- Understanding of insured risk
- Significance of application information
- Importance of undisclosed information
- Policy not issued; higher premium, etc.
Underwriting Guidelines

- Business classification
- Undisclosed information:
  - Prohibited category
  - Underwriting hold
- Underwriter’s discretion
Binding Authority

- Underwriting by MGA
- Agreement may grant discretion
- Course of dealing with Company
- Company’s oversight
Brokers & Agents

• Advise applicant or complete application
• Determine agent’s principal
• Sources of agent’s information
• Course of dealing
Premium Audit

• May contain undisclosed information
• Determine when Company first obtained such information
• Impact on timeliness and waiver issues
• Constructive notice issue
Rescission Statute

- Tex. Ins. Code § 705.004
  - False statements in application have no effect unless:

  “it is shown at trial that the matter misrepresented:

  (1) Was material to the risk; or
  (2) Contributed to the contingency or event on which the policy became due and payable.”

  These are factual questions.
Objective/Subjective Standards

• Whether a fact is true is an objective question
• Whether applicant has knowledge is a subjective question
• Whether applicant has knowledge that a fact is true is a mixed question
Examples of Application Questions

• “Is the applicant aware of any fact, circumstance, or situation that could give rise to a claim that would be covered under this insurance?”

• “Has the insured’s business ever been the subject of any investigation or action by any civil or criminal authority, federal, state, or local?”
Fraud/Negligence Standards

• Fraud standard requires subjective intent to deceive insurance company
• Negligence standard based on “reasonable” insured
• Applicable standard varies by nature of question and by state
Examples of Actual Fraud

• Applicant states it has not been denied any insurance policy or coverage with prior three years

• Applicant states it has had no Liquor Law violations in prior five years
Example of Legal Fraud

- Applicant denies knowledge of FDA seizure of products to obtain coverage for those products
Underwriting Intent/Applicant’s Intent

• Intent significant to scope of covered risk
• And to meeting of minds
• *Ergo*, policy void where underwriter’s intent and applicant’s intent differ
• Rescission not sole remedy for this
Duty to Update Application

- Applicant must advise Company of changes up to policy issuance
- Failure to do so may be misrepresentation
- Insurer generally has no duty to inquire
- Respective obligations vary by state
Update Examples

- Insured adds/discontinues product or line of business
- Insured becomes target of investigation or action
- Insured acquires/divests business
Tender of Premium Refund

- Tender of premium may be condition precedent of rescission
- Premium for entire policy term
- Statutory interest from policy inception
- Refund may be delayed till time of trial
Binding the Injured Claimant

- Rescission sometimes unavailable with respect to pending claims
- Where available, injured claimant should be named in rescission action
- Absent joinder, rescission may not bind third parties
Acceptance of Refund

• Insured’s acceptance of tender effects rescission
• Valid as between insured and Company
• Not binding on third parties (e.g., injured claimant)
• Release advisable
Release Example

• In consideration of payment of the Return of Premium, and in consideration of the mutual promises herein, the Parties agree that the Policies shall be rescinded, rendering them null and void *ab initio*.

• The releases set forth herein also shall extend to any Person who may claim entitlement to coverage under the Policies
Starting the Action

- State or federal court
- Jury or bench trial
- Necessary and proper parties
- Amount in controversy
Pleading Rescission

• If fraud standard:
  – Elements must be pled with particularity
  – Misrepresentation, intent, reliance
  – “Information and belief” may not suffice
  – Append smoking gun documents
Avoidance of Ratification

• Accept no premium payments
• Do not renew or nonrenew
• Cancellation not an option
• Continuing underlying defense okay
Preserving Coverage Defenses

• Reserving rights
• Alternative pleading allowed
• Insurer may elect remedies
• Same facts may establish exclusion, even if intent can’t be proven
Timeliness of Rescission

- Insurer must act promptly to rescind
- Gauged from time sufficient facts are available
- Timeliness part of insurer’s burden of proof
- Consider “sufficiency” of misrepresentation facts
Waiver/Estoppel

- Primary defenses to rescission claim
- Failure to act promptly on any prior information
- Acceptance of premium after learning any relevant facts
- May arise from prior policy periods
Pending Claims

• Rescission may be unavailable for pending claims
• Theoretically claimant’s rights under policy “vested” at time of accident
• Rescission is prospective only
Defense Issues

• Best practice to continue defense pending rescission action
• Not an estoppel if insured properly informed
• Not a conflict of interest
• Recoupment may be available
Discovery

• Document intensive:
  – All underwriting submissions
  – Underwriting guidelines
  – Binding authority agreements
  – Broker documents
  – Documents from underlying litigation
  – Public records
Depositions

• Multiple witnesses required:
  – Insured
  – Underwriter
  – Claims professional
  – MGA
  – Broker
Motion Practice

• Texas statute says issue of fact
• Summary judgment not available
• May be available on egregious facts
• May be advisable to narrow issues
Examples of Motion Issues

• Whether there was a misrepresentation
• Whether there is a waiver or estoppel
• Whether another remedy is available
Necessary/Proper Parties

- Appearance/participation may complicate litigation
- Request waivers of service
- Agreement to be bound
- Settlement/dismissal may not be possible
Examples of Proper Parties

- Underlying plaintiff
- Underlying co-defendants
- Underlying third-party defendants
- Anyone potentially an insured
Settlement

- Rescission case may be settled
- Requires agreement of all parties
- Or hold harmless for Company
- Carefully drafted release
Insurer’s Burden of Proof

• Insurer has burden of proving:
  – Material misrepresentation
  – Intent (if required)
  – Promptness
  – Broker was insured’s agent

• Where fraud standard, heightened burden of proof
Examples of Burdens

• Clear and convincing evidence:
  – Heightened standard
  – Consistent with fraud theory

• Preponderance of the evidence:
  – Default standard
  – More likely than not
Insured’s Burden of Proof

• Insured has burden of proving:
  – Waiver
  – Estoppel
  – Ratification
  – Broker’s role
  – Counterclaims (e.g., bad faith)
Fact Witnesses

• Case in chief:
  – Claims professional
  – Underwriter
  – MGA
  – Investigator
  – Broker
  – Insured
Expert Witnesses

• As necessary:
  – Underwriting expert
  – Handwriting expert
  – Industry expert
Jury vs. Bench Trial

- Jury allows more opportunity to persuade
- Consider pro-insured bias
- Consider local bias
- Evaluate judge’s record
Post-Judgment Issues

• If successful:
  – Premium refund with interest
  – Recoupment of defense costs

• If unsuccessful
  – Fee-shifting
  – Continuing defense costs
Bad Faith

- Objective facts establish misrepresentation
- Continuing underlying defense shows good faith
- Document each step of process
Reformation

• Alternative to rescission
• Requires mutual mistake
• Or unilateral mistake, plus fraud
• May be retroactive and prospective
• May entail additional premium
Election of Remedies

• Misrepresentation may be an exclusion
• *E.g.*, if prior knowledge of circumstances
• Or breach of warranty
• Requires specific policy wording
• Consider applicable law
Cancellation

• Inconsistent with rescission
• Prospective only
• Requires strict compliance with statute and policy wording
• Premium refund is prorated