How to Tell the Story

Defending Insurers in Rescission Actions

By Michael A.S. Newman

Luckily an insurer has arguments that can shift the story's focus from a sympathetic policyholder or the insurance beneficiary to the law, the practicalities of insurance transactions, and fairness.

Every litigation is a story, and every trial lawyer is a storyteller. But sometimes the task of telling that story is difficult, although not because the case lacks merit, but because the client does not naturally garner sympathy.

In a lawsuit over an individual's policy benefits, for example, the attorney defending the insurer often has the harder job of telling a compelling tale. An insurer is not a sympathetic protagonist; the individual policyholder almost always is. An insurance company has no face, feels no pain, and occupies a position of seeming power. To make matters worse, people often have long-ingrained prejudices against insurance companies.

And then there is a kind of rough-justice calculus that a judge or a jury might consciously or unconsciously entertain: If one party is to suffer injustice, this intuition dictates, why not saddle the insurer with it? The insurer can endure to be wrongfully parted from its money with far greater ease than can the hapless policyholder be deprived of his or hers. The insurer is Goliath to the policyholder's David. The insurer is the Empire; the policyholder is the Rebel Alliance. No one has ever written a courtroom drama during which, at the last minute and against all odds, the plucky defense counsel triumphantly defeats the insurance policyholder.

In this respect, defending an insurance company's right to rescind an insurance contract based on misrepresentations on the insurance application presents particular difficulties. In a typical insurance rescission case, an insured individual dies or seeks coverage within the contestability period, and the beneficiary makes a claim for benefits.

When an insured dies within the contestability period, this means that the insurer has the right to investigate the insured's application to determine if the applicant made any inaccurate statements. The investigation often involves a review of the medical or financial records, or both. If the investigation uncovers inaccuracies, the insurer will then make a determination about whether the facts concealed or misrepresented were material to coverage—

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i.e., had the insurer known the true facts, would it have issued the policy, charged the same premium, or neither? If it determines that it would not have issued the same policy or charged the same premium, then the misstatement is "material," and depending on the particular requirements of its jurisdiction, the material misstatement may form the basis of a rescission.

It is a basic principle of law that the party at fault should bear the burden, not the innocent party; or put another way, no one should benefit from his or her own wrong.

In some jurisdictions, rescission is permitted even if the misstatement or concealment was unintentional. Cal. Ins. Code §331 ("Concealment, whether intentional or unintentional, entitles the injured party to rescind insurance."); *Curanovic v. New York Cent. Mut. Fire Ins. Co.*, 307 A.D.2d 435, 436, 762 N.Y.S.2d 148, 150 (N.Y. App. Div. 2003) ("Rescission is available even if the material misrepresentation was innocently or unintentionally made."); *Carroll v. Metro. Ins. & Annuity Co.*, 166 F.3d 802, 805 (5th Cir. 1999) ("[W]hether the misrepresentation was intentional, negligent, or the result of mistake or oversight is of no consequence."); *F.D.I.C. v. Moskowitz*, 946 F. Supp. 322, 329 (D.N.J. 1996) ("[T]o rescind a policy, an insurer need not show that the insured actually intended to deceive.").

Other states have different tests. For example, in some jurisdictions, fraud *or* materiality is sufficient to justify rescission. 215 Ill. Comp. Stat. Ann. 5/154 ("No such misrepresentation or false warranty shall defeat or avoid the policy unless it shall have been made with actual intent to deceive or materially affects either the acceptance of the risk or the hazard assumed by the company."). If the insurer opts to rescind the policy, then it restores the premium paid and notifies the insurer of the cancellation of the policy.

Here is where, in resulting litigation, the storytelling advantages all skew in favor of a policyholder or the beneficiary. For example, the person seeking benefits in a life insurance case is very often not the person who applied for the insurance or who made misrepresentations to the company. The person who concealed or misrepresented facts might already be dead by the time that the insurance company seeks to rescind the policy. Thus, the wrongdoer is no longer around, and the bereft life insurance beneficiary, already a pathetic figure, becomes more sympathetic still by virtue of his or her total innocence of wrongdoing. Furthermore, when it comes to life insurance, many can sympathize even with the wrongdoer, who lied not to secure benefits for him- or herself, but to protect a loved one. Moreover, the financial circumstances of a beneficiary dealing with the death of a loved one can often be dire.

In telling an insured's story, an attorney typically does not merely focus on the pathetic position of the insured, but also goes on the offensive by faulting the insurance company for failing to investigate the insurability of the applicant more fully at the time of the underwriting. In particular, counsel generally will argue that the insurer could have and should have done more at the application stage, and therefore the insurer should be barred from rescinding now. Why did the insurer simply take the word of the applicant and not do more? Why did it not order medical records at the time to verify the responses of the applicant? Why did it ignore clues that the insured was lying? (Never mind that these can only be characterized as "clues" with the benefit of hindsight.) Why did it gladly accept premiums, only to conduct a full investigation *after* the death? In almost every case, the insurer "could have done more"—so why didn't it? Why should it be allowed to do so now?

Such arguments often form the core of the story presented by an insured's attorney. And, if not vigorously countered, they can be effective and even persuasive. Luckily, however, an insurer often has multiple arguments at its disposal that have the potential to change the focus of the story to shift the focus of the court or the jury back to the law, to the practicalities of insurance transactions, and to the underlying issues of fairness. Here are some of the arguments the insurer may employ.

The Party at Fault Should Bear the Burden

It is a basic principle of law that the party at fault should bear the burden, not the innocent party; or put another way, no one should benefit from his or her own wrong. *Tenamee v. Schmukler*, 438 F. Supp. 2d 438, 444 (S.D.N.Y. 2006) ("[N]o party should benefit from its own wrong."). This is a doctrine so firmly established in Anglo-Saxon jurisprudence that even old cases characterize the doctrine as old: "[T]hat no one shall be permitted to take advantage of or derive benefit from his own wrong, [is] among the oldest maxims of the law, and too well recognized to require citation of authorities." *Fletcher v. Trewalla*, 60 Miss. 963, 964 (Miss. 1883). In California, this doctrine is enshrined in the "Maxims of Jurisprudence," a wonderful group of aphorisms enacted in the Civil Code in 1872. Cal. Civ. Code §3517 ("No one can take advantage of his own wrong.").

In the rescission context, it is the policyholder that has committed the wrong by his or her fraud, concealment, or misrepresentation. The insurer, meanwhile, has the right to rely on the truth of those statements, and thus the insurer need not bear the burden of that wrong. *Carroll*, 156 F.3d at 805; *United Auto. Ins. Co. v. Salgado*, 22 So. 3d 594, 601 (Fla. Dist. Ct. App. 2009) ("[A]n insurance company has the right to rely on an applicant's representations in an application for insurance and is under no duty to further investigate."); *Brandwein v. Butler*, 218 Cal. App. 4th 1485, 1499 (Cal. Ct. App. 2013) ("[A]n insurer has the right to rely on an applicant's answers without verifying their accuracy."). Two parties have contracted, but one of those parties has behaved dishonestly or negligently, and under the law, it is the guilty party that should bear the burden.

Fairness clearly dictates this result. As the California Court of Appeal noted in *Lunardi v. Great-W. Life Assurance Co.*, "[a]n insured who withholds information and then blames the insurer for not discovering it is at best exhibiting gamesmanship; he cannot have it both ways." 37 Cal. App.

4th 807, 822 (Cal. Ct. App. 1995). *See also Merchants Fire Assur. Corp. v. Lattimore*, 263 F.2d 232, 243 (9th Cir. 1959) ("[A]n insured may not 'escape the consequences of his deception by placing on the insurer the burden of investigating his verified statements.'") (citations omitted).

Even when the beneficiary is innocent of direct wrongdoing—for example, if an insured (now deceased) had lied on his or her application for insurance without the knowledge or collusion of the beneficiary—the fact remains that the beneficiary is attempting to *benefit* from the wrongdoing of the insured. This constitutes unjust enrichment, which is barred by longstanding doctrines of equity. *Schumacher v. Schumacher*, 627 N.W.2d 725, 729 (Minn. Ct. App. 2001) (unjust enrichment occurs where a party "knowingly received something of value to which he was not entitled, and that the circumstances are such that it would be unjust for that person to retain the benefit."); *Wahlcometroflex, Inc. v. Baldwin*, 2010 Me. 26, ¶ 20, 991 A.2d 44, 49 (Me. 2010) ("[U]njust enrichment is defined as the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience."). A beneficiary may start out "innocent" of fraud or concealment, but such innocence ceases the minute that the beneficiary seeks to benefit from the wrongful conduct of the insured.

Dishonest Applicants Often Win the Gamble

In many jurisdictions, an insurer may rescind only within a particular statutory period after the issuance of a policy, or the policy itself may contain a time period after which rescission is impossible. After the expiration of this short period, rescission is barred. This is called the contestability or incontestability period. *E.g.*, Tex. Ins. Code Ann. §1101.006 (two years for life insurance); N.J. Stat. Ann. §17B:25-4 (same); Va. Code Ann. §38.2-3107 (same).

Therefore, an applicant who makes a false statement in his or her application for insurance in effect gambles that the insurance company will not learn about the misstatement before the period expires. It stands to reason that many, if not most, applicants who so calculate win their gamble. For example, under a two-year contestability period, a life insurance applicant who fraudulently misrepresents his or her medical condition need only survive for two years after the issuance of the policy to be entirely insulated from the risk of rescission.

For an advocate representing an insurance company, it may be helpful to point out this fact in response to policyholder attorneys who claim that it is unfair or wrong for the insurance company to wait till the death of the applicant to investigate the accuracy of the insured's application. Because of the shortness of most contestability periods, the deck is already heavily stacked in favor of the dishonest applicant who gambles that he or she can run out the clock before the insurer detects the subterfuge. For this reason, under most circumstances the insurer will have to bear the entire burden of the applicant's dishonesty. At very least, the insurer should be allowed to investigate the application within the contestability period.

Moreover, the contestability period serves two important purposes, each of which acts as a counterweight to the other. First, it prevents an insurer from disturbing insurance that has been in place for a particular period, even if the applicant engaged in fraud or concealment. This confers a strong measure of security to the policyholder. Second, and just as importantly, it permits an insurer to cancel the insurance *within* the contestability period. This second aspect is just as important as the first, since it deters the most egregious forms of fraud by insurance applicants. A terminally ill individual might think twice before seeking insurance if he or she expects to be dead within a short period of time. To interfere with the insurer's ability to investigate within the contestability period tends to frustrate this egregious fraud.

Contestability Periods and the Doctrine of Waiver Already Encourage the Insurer to Be Reasonably Vigilant

Policyholders' attorneys often argue that permitting an insurer to investigate the truth of the insured's representations after the death of the insured effectively permits the insurer to behave with willful ignorance at the time of the application for insurance. This is a faulty argument for several reasons.

First, such an argument ignores the fact that due to the contestability period, an insurer might quickly run out of time for such investigation—a fact that incentivizes an insurer to behave with reasonable prudence in evaluating the insurability of an applicant at the initial underwriting stage. More importantly, many jurisdictions have doctrines providing that an insurer waives the right to rescind if the information that was concealed was available to it and ignored at the time of the application. In this way, the law penalizes an insurer that ignores decisive evidence demonstrating misrepresented or concealed information.

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Thus, for example, in California, the right to rely on the true statements of an applicant may be waived by neglect to make inquiries pertaining to such facts "where they are distinctly implied in other facts of which information is communicated." Cal. Ins. Code §336. Other states have similar laws. *E.g.*, *Carroll*, 156 F.3d at 805 (under Mississippi law, "[e]ven if a misrepresentation exists, however, an insurance company cannot rely on it to rescind the policy if facts were known that would cause a prudent insurer 'to start an inquiry, which, if carried out with reasonable thoroughness, would reveal the truth.'"). In other words, there are already strong checks in place to prevent an insurer from insuring applicants without due attention to their insurability.

And What If the Insurer *Had* Been More Skeptical?

A policyholder's argument that an insurer had an obligation to further investigate the insured's insurability at the application stage—and to treat the statements of the

applicant with skepticism—runs into problems if we ask the following hypothetical questions: What if the insurer *had* investigated the truth of the applicant's answers at the time of the application? If the insurer would not have issued the policy at all, how does that support the policyholder's position? Had the insurer declined to issue the policy, the applicant would have had no policy at all.

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Put another way, the insured has merely been denied the chance to defraud the insurance company successfully by outlasting the contestability period before the insurer found out the truth about the insured. This begs another question, which might present a pertinent topic for discovery: Would the applicant have been able to obtain alternative insurance had the insurer denied the application? In this way, following the policyholder's arguments to their logical conclusions can be helpful, depending on the facts.

The Law *Allows* an Insurer to Rely on the Truth of an Applicant's Statements

The simple fact is that state legislators or the judges who have developed the common law have already decided that an insurer is permitted to rely on the truth of an insurance applicant's statements. This point may seem obvious, but regardless of the justifications for such law, the very *fact* that the law says this has important repercussions, since it means that insurers will reasonably rely on the law.

In this way, the law serves as the answer to a policyholder's argument that an insurance company "could have done more" at the application stage to investigate the insurability of the policyholder. Because the law expressly permits the insurer to rely on an applicant's statements, it will nearly always be possible to say that the insurer "could have done more"; but this observation will also have no significance.

If the law requires you to pay a 9 percent sales tax, is it meaningful to say that you "could have done more" by voluntarily paying an additional 1 percent? If the law requires you to drive 25 mph, then what is the significance of the fact that you "could have done more" to drive defensively by keeping to 20 mph? The law, in short, makes it inevitable that the insurer *will rely on the statements of the policyholder*; and thus, the policyholder will be *able to say* that the insurer could have done more. The observation that the insurer "could have done more" is, by the very operation of the law, at once inevitable and irrelevant.

Indeed, even states that heavily regulate insurance strongly defend the right of an insurer to rely on the truthfulness of an insurance applicant's representations. For example, in *Colony Ins. Co. v. Crusader Ins. Co.*, 188 Cal. App. 4th 743 (Cal. Ct. App. 2010), the California Court of Appeal held that the right to rely on the truthfulness of applicants' statements holds even when the insurance company violates its own underwriting guidelines in so doing. In that case, both Colony and Crusader insured a building in Los Angeles, which became the subject of a tenant lawsuit. Colony, seeking an equitable share of the defense costs incurred in defending the tenant litigation, argued that Crusader failed to investigate public records as required by Crusader's internal underwriting guidelines. As a result, according to Colony, Crusader waived the right to challenge misrepresentations made by its insured and was estopped from denying a defense in the tenant lawsuit based on the insured's misrepresentations.

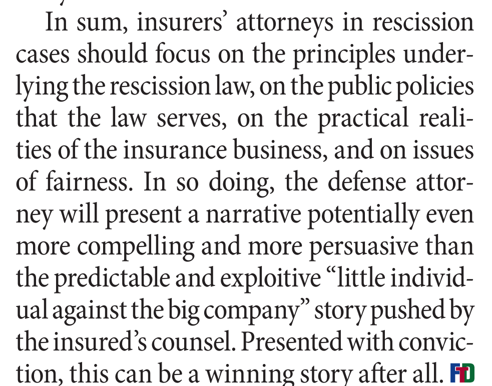
The court of appeal rejected this argument, holding that even if Crusader had acted contrary to its underwriting guidelines by failing to seek additional information, no waiver had occurred since internal guidelines "create[] no legal obligation," and in the context of rescission of insurance, "waiver requires the intentional relinquishment of a known right." *Id.* at 752 (emphasis added). In sum, the *Colony* court rejected the notion that an insurer's internal underwriting guidelines could "rewrite the California statutes expressly permitting an insurer to rely on an insured's representations." *Id.* at 754.

Practicality

Finally, it makes sense, from a practical standpoint, for an insurer to rely solely on the truth of the statements made by an insurance applicant. Otherwise, if an insurer had the duty in every instance to conduct a full investigation of the truthfulness of insurance applications at the outset of the insurance relationship, the process of underwriting might become prohibitively expensive. Allowing an insurer to rely on the truth of an insurance applicant's responses is not merely fair, it is also practical.

An old saying, familiar to all attorneys, is that hard facts make bad law. By "hard facts," we mean circumstances liable to tempt a judge or a jury to bend the law in favor of a sympathetic party. The temptation is understandable. But just as a pilot must favor the instruments over his or her intuitions, so those who adjudicate cases are expected to favor the law, not their biases or even their sympathies.

Otherwise, the effect of such ad hoc adjudicating would degrade and erode the law—with the result, to quote Shakespeare, that "many an error, by the same example/ Will rush into the state." The word "rush" (as in water rushing through the crack in a dam) is very apt. Bad precedent does not inflict a static injury; it creates a growing breach that quickly leads to greater damage to the law's foundations. Hard facts test the resolve of adjudicators to apply the law equally, and thus to preserve the law's integrity. The need to preserve the law's integrity is itself an important part of the story that the insurer's advocate must tell.



In sum, insurers' attorneys in rescission cases should focus on the principles underlying the rescission law, on the public policies that the law serves, on the practical realities of the insurance business, and on issues of fairness. In so doing, the defense attorney will present a narrative potentially even more compelling and more persuasive than the predictable and exploitive "little individual against the big company" story pushed by the insured's counsel. Presented with conviction, this can be a winning story after all. FTD