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The International Comparative Legal Guide to:

Insurance & Reinsurance 2012

A practical cross-border insight into insurance and reinsurance law

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Published by
Global Legal Group Ltd.
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General Chapters:

Country Question and Answer Chapters:

Rescission for Misrepresentation or Nondisclosure: Practical Considerations for Insurers and Reinsurers

Mark J. Leimkuhler

Jack B. Gordon

Lewis Baach PLLC

At the fictional Acme Insurance Company, its claims director, Justin, had just returned to his desk from the weekly claims department meeting when his phone rang. On the line was George, an auditor. Justin had retained George to review the U.S. worker's compensation claims of one of Acme's insureds, the fictional Widget Manufacturing Company. Widget was self-insured for worker's comp, and over the last five years Acme had provided Widget with aggregate excess insurance above an annual attachment point of $10 million. George was auditing Widget's claims pursuant to the audit and inspection clause in the Acme policies, because Widget's incurred loss figures for worker's comp in 2007, the earliest Acme policy year, had recently risen substantially and were now above the $10 million attachment point. Later years were also trending upward substantially.

"Justin, I'm at the offices of Widget's third-party administrator," said George. "I know you weren't expecting to hear from me until I finished this audit, but I just read something that we need to discuss. Back in 2006 Widget asked a consultant to review its workers' comp reserves. The consultant came back with a report indicating that the reserves were too low. The consultant analysed what Widget's reserves should have been for 2005, and estimated that they should have been about $14 million, almost three times the $5 million that Widget had on its books at the time."

With George still on the line, Justin pulled data regarding Widget on to his computer screen. "George, we wrote this business starting on 1st January 2007, and the underwriting submission and notes I have are all from November 2006. Do you know when this report was prepared, and whether it was given to Widget before we went on risk?"

"The report is dated August 2006, and the copy I just saw has a cover letter indicating that it was sent to Widget's risk manager that month," George replied. So at the time Widget placed the excess cover, it had the consultant's estimate that claims for 2005 would be higher than the attachment point for the 2007 coverage."

Justin told George he would call back but that he first wanted to fully review the underwriting submission. When he did, among the materials were reserve figures for 2003, 2004, and 2005 – none above $8 million. There was no mention of the consultant's report or its estimate of what 2005 reserves should have been. Justin hastily arranged a meeting with the underwriter of the Widget policies and they went over the underwriting materials together. Justin asked, "Is there any possibility that you were given this information, or the broker discussed it with you, and it just didn't make it into the file?"

"Not a chance," the underwriter replied. "If I had known about the information your auditor just reported, I never would have written this risk."

* * *

In the foregoing hypothetical scenario, Justin and his fictional employer Acme are, of course, looking at the possibility that Acme's fictional policyholder Widget procured insurance coverage based upon misrepresentation or nondisclosure during the placement of the coverage. Depending on how certain factual issues play out, Acme may be entitled to rescind the excess workers' comp policies it issued to Widget, and thus avoid liability for potentially millions of dollars in otherwise covered losses. On the other hand, if Justin or his colleagues make a misstep in addressing the information they just discovered, they risk waiving the right Acme may have to void the policy, even if the insurer otherwise can meet the requirements for rescission.

Rescission for misrepresentation or nondisclosure is a potent remedy for an insurer or reinsurer – some courts have called it a "drastic remedy." Perhaps for that reason, U.S. courts impose many requirements – substantive and procedural – that an insurer or reinsurer must satisfy to prevail on a rescission claim. Also important, in many U.S. jurisdictions an insurer seeking to avoid a contract must refrain from taking certain actions that could be viewed as inconsistent with the rescission remedy. If an insurer acts – or fails to act – in a certain manner, it could lose its right to seek rescission just when it realises that it has that right. Moreover, in the U.S., the law regarding rescission of insurance or reinsurance contracts can vary substantially from state to state, so it can be difficult for an insurer to know precisely what it can and cannot do, or whether it has a claim for rescission in the first instance.

Thus, an insurer confronted with facts indicating that there may have been a material misrepresentation or nondisclosure during placement may have a number of issues to assess and decisions to make in a relatively short period of time – and may have to do so with limited information. A short (and by no means exhaustive) list of such issues includes:

- Based on the facts that are currently available, does it appear the insurer has a viable rescission claim? Could the viability of the claim depend on where it is litigated and the choice of law rules that would be applied? And where might the rescission claim be litigated?
- What should the insurer do (and also important, what should it ***not*** do) to gather more information about the possible misrepresentation or nondisclosure?
- Can the insurer accept additional premiums from the policyholder? Can it keep the premiums it has already been paid? Should it continue to pay the policyholder's claims?
- What if anything should the insurer communicate to its policyholder, and when?
- What procedural steps in court will the insurer have to take to preserve and properly present its rescission claim?

- Are there alternative remedies that might be preferable to rescission?
- Is the insurer prepared to incur the financial, commercial, and other costs of litigating allegations that it was misled by its policyholder, and the allegations that the policyholder may make against the insurer in response?

We address these questions in the sections that follow. The discussion is intended only to illustrate the types of issues an insurer or reinsurer may confront after it learns it may have a rescission claim. The best first step for an insurer presented with potential grounds for rescission is promptly to identify counsel experienced in rescission matters to assist in the investigation, to advise on available options, and to ensure that steps are taken – and avoided – to preserve and best position the potential claim for resolution.

1. Does the insurer have a viable rescission claim (and does that depend on where the claim is brought)?

The basic substantive elements of a rescission claim for misrepresentation are determined by statutory or common law. As a very general matter, an insurer seeking to rescind an insurance contract will be required to prove that it issued the policy in reliance on a misrepresentation (or non-disclosure) that is material to the risk to be insured. *See*, *e.g.*, NY Ins. Law § 3105; Va. Ann. Code § 38.2-309; *Old Republic Ins. Co. v. Rexene Corp*., 1990 WL 176791 (Del. Ch. 1990) (discussing Delaware and Texas law). Materiality is central to the rescission analysis; in general, a circumstance is "material" if it may have influenced the insurer in its decision whether to underwrite the risk or on what terms to do so. *See*, *e.g., Mutual Ben. Life Ins. Co. v. JMR Elecs. Corp*., 848 F.2d 30, 32 (2d Cir. 1988) (citing *Geer v. Union Mutual Life Insurance Co.*, 273 N.Y. 261, 269 (1937)) (court states that the "question…is not whether the company might have issued the policy even if the information had been furnished; the question in each case is whether the company has been induced to accept an application which it might otherwise have refused"); *Farley v. St. Charles Ins. Agency, Inc*., 807 S.W.2d 168, 170 (Mo. App. 1991) ("A misrepresentation of fact is material, if the fact, stated truthfully, might reasonably have influenced the insurer to accept or reject the risk or to have charged a different premium"). Beyond these basic elements, however, the law on rescission can differ markedly from state to state on specific issues that may be critical to the success or failure of a particular claim. As part of an insurer's initial analysis of a potential rescission claim, it should evaluate (i) in what states the insurer could potentially litigate a rescission claim; and (ii) based on choice of law considerations and other factors, which of the potential forum states can be expected to apply legal standards on various rescission-related issues that will provide the best prospects for success on the claim.

Identifying potential forum states for a rescission claim begins with an assessment of which states have contacts with the insurer, the policyholder, or the risks being insured. (This would not apply, of course, if the insurance or reinsurance contract has an arbitration clause broad enough to encompass a rescission claim, or otherwise specifies a particular forum to resolve disputes.) Whether a state could serve as the forum will depend on the specific jurisdictional and venue requirements of the courts in that jurisdiction, but typically, a policyholder will be subject to suit at least in the state where it was incorporated as well as in the state of its principal place of business. It might also be subject to suit where it has substantial business activities, particularly activities connected to the risk in question. If, in our hypothetical situation, Widget Manufacturing was incorporated in Delaware and has its headquarters in New York, and the Widget factories where Acme Insurance Company provides workers comp insurance are in New Jersey and Pennsylvania, any one of those four states might be an appropriate forum to litigate a rescission claim. Moreover, if Acme is a U.S. company, its own state of incorporation and principal U.S. location might provide additional forum options. Once potential forum states are identified, the insurer, with the assistance of counsel, can begin to identify and evaluate specific legal issues relating to the rescission claim in each state, including each state's choice of law rules, that might lead to a conclusion that one forum would be preferable to the other alternatives.

In the hypothetical case of Acme and Widget, for instance, the policyholder might argue that the rescission claim is predicated not on an affirmative misrepresentation of its worker's comp reserves (assuming that Widget disclosed reserves that were actually on its books) but on an alleged failure to disclose the consultant's report regarding their adequacy or the "alternative" reserve estimate. In other words, the policyholder may try to defend against the rescission claim based on assertions that it is predicated on the alleged non-disclosure of information rather than affirmative misstatements; and that the alleged nondisclosure was of someone's opinion, estimate or prediction and not objective, verifiable facts. Widget might also argue that any failure to provide complete and accurate information to the Acme underwriter was innocent, or that it was inadvertent and not intentional. Depending on the court in which the rescission claim is brought and the facts as they are developed, the policyholder's arguments might be able to defeat the rescission claim.

Can nondisclosure support a rescission claim? In the insurance context, rescission claims are often predicated on non-disclosures as opposed to affirmative misstatements, and a policyholder defending a rescission action can be expected to argue that it had no duty to disclose information that the insurer did not specifically request. Some U.S. courts have declined to recognise a "general" duty of disclosure and therefore in some states a non-disclosure of a material fact, without more, may not necessarily support a rescission claim. However, most jurisdictions apply principles regarding disclosure which can be significant in the insurance and reinsurance context. Courts have found that a duty of full disclosure exists where there is a relationship of trust and confidence between the parties to a transaction; where, based on the circumstances of a transaction, such as applicable custom and practice, the contracting parties or their representatives recognise a requirement of full disclosure; or where a party has made a partial disclosure of information that requires full disclosure to prevent the partial disclosure from creating a misleading impression. A duty of full disclosure can also arise where one party possesses superior knowledge, not readily available to the other, and knows that the other is acting on the basis of mistaken knowledge. Courts may apply a duty of full disclosure where the failure to disclose amounts to a knowing concealment. *See, e.g.*, *Lighton v. Madison-Onondaga Mut. Fire Ins. Co*., 106 A.D. 2d 892, 893 (N.Y. App. Div. 1984). But different courts may apply these principles in different ways.

U.S. courts differ on whether the dealings between an insurer and the party procuring insurance inherently create a "relationship of trust and confidence" and thus a duty of full disclosure on the part of the party obtaining insurance. Some courts have found such a requirement inherent in the nature of the insurer-insured relationship. *See*, *e.g., Farley v. St. Charles Ins. Agency, Inc*., 807 S.W.2d 168, 170 (Mo. App. 1991) (as a matter of law the policyholder had a duty to disclose a prior loss based on the requirement of "honesty, good faith and fair dealing, [and] the doctrine of *uberrima fides*" [*i.e.*, utmost good faith] that applies to

dealings between insurers and policyholders); *Seidler v. Georgetown Life Ins. Co*., 402 N.E.2d 666, 669 (Ill. App. Ct. 1980) ("good faith regarding disclosure is demanded of the parties to an insurance contract"). The Second Restatement of the Law of Torts provides that "certain types of contracts, such as those of . . . insurance . . . are recognized as creating in themselves a confidential relation and hence as requiring the utmost good faith and full and fair disclosure of all material facts". Restatement (Second) of Torts, § 551, comment f. *See also Lighton v. Madison-Onondaga Mut. Fire Ins. Co*., 106 A.D. 2d at 893 (applying New York law) ("If the applicant for insurance is aware of the existence of circumstances which he knows would influence the insurer in acting on the application, he is required to disclose that circumstance to the insurer, though unasked.").

In the context of personal insurance (such as life, automobile, or fire), however, a court might find that the policyholder has no duty to disclose additional information that is not sought in the insurance application or questionnaire. *See, e.g., Hingham Mut. Fire Ins. Co. v. Mercurio*, 878 N.E.2d 946, 951 (Mass. App. Ct. 2008), review denied, 881 N.E.2d 1142 (Mass. 2008) (holding that an applicant for a personal umbrella liability policy was not obligated to disclose information not specifically asked of him by the insurer). Some decisions presume that any subjects not addressed in the questionnaire are immaterial. *See, e.g.*, *Allstate Ins. Co. v Shirah,* 466 So. 2d 940, 944 (Ala. 1981). However, an insurer could argue that decisions involving personal lines are inapplicable to non-disclosures by commercial policyholders because of differences in the knowledge and sophistication of the policyholders involved.

While authorities in the U.S. disagree on whether a duty of full disclosure inheres in all insurance relationships, there appears to be a consensus that for certain types of coverage, there is an inherent relationship of trust and confidence that requires full disclosure. In the placement of reinsurance, for instance, the prevailing view is that a relationship of trust and confidence is inherent between the cedant and its reinsurer and creates a duty of full disclosure. *See, e.g.*, *Christiana Gen. Ins. Corp. v. Great Am. Ins. Co*., 979 F.2d 268, 278 (2d Cir. 1992) ("relationship between a reinsurer and a reinsured is one of utmost good faith"). On the direct side, a duty of full disclosure is generally found in placements of marine insurance. *See, e.g*., *Home Ins. Co. v. Spectrum Info*. Techs., 930 F. Supp. 825, 836 (E.D.N.Y. 1996) (placement of marine insurance is subject to "the highest degree of good faith" and requires the assured to disclose to the insurer all known circumstances that materially affect the risk); Restatement (Second) of Contracts § 161 comment f ("marine insurance" is one type of contract "recognized as creating … confidential relations and hence as requiring the utmost good faith and full and fair disclosure"). Moreover, in the London insurance market the policyholder, and its agent the London broker, are deemed to have knowledge of the custom and practice in the London market that a policyholder must disclose all circumstances material to the risk, whether or not the underwriter has made inquiry. While in the London market the duty of full disclosure may also be a matter of English law, the "custom and practice" of full disclosure among the participants in that market may be most significant to an American court applying its own or another U.S. jurisdiction's law: the court may predicate the duty of full disclosure on the factual circumstances of the transaction, *i.e.*, that the parties involved understood that they were bound by that duty.

Regardless of where the coverage was placed and the type of risk involved, in the hypothetical scenario involving Acme and Widget, Acme may also be able to establish a duty of full disclosure by pointing to a "partial disclosure" by Widget (its worker's comp reserves) without providing the fuller disclosure needed to prevent creating a false or misleading impression (a consultant's report indicating that the posted reserves were inadequate and providing a much higher reserve estimate). *See, e.g., Trustees of Northwest Laundry & Dry Cleaners Health & Welfare Trust Fund v. Burzynski*, 27 F.3d 153, 157 (5th Cir. 1994) (Texas law) ("Even without a special relationship, there is always a duty to correct one's own prior false or misleading statement. A speaker who makes a partial disclosure assumes a duty to tell the whole truth even when the speaker was under no duty to make the partial disclosure."); *Commonwealth Land Title Ins. Co. v. IDC Props*., Inc., 547 F.3d 15, 22 (1st Cir. 2008) (Rhode Island law) ("a half-truth or failure to speak when necessary to qualify misleading prior statements does amount to a misrepresentation"); *Spinelli v. Monumental Life Ins. Co*., 476 F. Supp.2d 898, 911 (N.D. Ill. 2007) (incomplete answers on an insurance application "may constitute a misrepresentation when the omission prevents the insurer from adequately assessing the risk involved") (citing *Methodist Med. Ctr. of Illinois v. Am. Med. Sec. Inc*., 38 F.3d 316, 319 (7th Cir. 1994)).

Whether an insurer's arguments to establish a duty of disclosure would succeed, however, may depend on how broadly a particular jurisdiction will apply such a duty. An insurer evaluating a rescission claim based on non-disclosure, therefore, should closely evaluate the legal standards likely to apply in each potential forum state (including, importantly, each state's choice of law rules) to determine whether a potential forum will find a duty of full disclosure in the circumstances.

Can matters of opinion form the basis of a rescission claim? Another "general" principle of the law of rescission is that a misrepresentation typically is of fact, rather than opinion. If the fictional rescission claim by Acme against Widget were litigated, Widget might assert that the posted reserves, as well as the consultant's analysis and alternative reserve estimate, are not the proper basis of a rescission claim based on the contention that they are not facts but opinions, estimates, or projections of future events. But in some circumstances opinions are actionable, especially if an opinion has been developed by a person with superior or specialised knowledge of the subject matter. Projections or forecasts of future events made by experts, in particular, may form the basis of a rescission claim as if they were objective facts, even though they arguably could be considered to be "opinions." *See Kociemba v. G.D. Searle & Co*., 707 F. Supp. 1517, 1525 (D. Minn. 1989) (opinions actionable "[w]here parties possess special learning or knowledge on the subject to which their opinions are given") (citation omitted); In *re Jogert, Inc*., 950 F.2d 1498, 1507 (9th Cir. 1991) (California law) (predictions of future events actionable "where a party holds himself out to be specially qualified and the other party is so situated that he may reasonably rely upon the former's superior knowledge") (citation omitted); *Haralson v. E.F. Hutton Grp., Inc*., 919 F.2d 1014, 1029 (5th Cir. 1990), modified on other grounds, No. 88-2999, 1991 U.S. App. LEXIS 1029 (5th Cir. Jan. 25, 1991) (Texas law) (estimates of value based on "superior access to information" are actionable and not to be disregarded as mere opinion); *Grove v. Principal Mut. Life Ins. Co.*, 14 F. Supp. 2d 1101, 1110 (S.D. Iowa 1998) ("where a statement, in a business transaction, can be viewed as coming from one with superior knowledge of the subject matter and is made to induce the listener to rely on it, such a statement may be deemed a statement of fact rather than opinion").

In *American Home Assurance Co. v. Fremont Indem. Co.*, 745 F. Supp. 974, 977 (S.D.N.Y. 1990), for instance, the court indicated that the non-disclosure of projections indicating losses likely exceeding a reinsurance contract's attachment point could be material, finding the issue to be a question of fact to be resolved based on industry custom and practice. Another court found that,

even though loss reserves might otherwise be viewed as an "opinion," in the insurance industry, the publication of loss reserves is viewed as a statement "that those figures reflect a considered and honest judgment as to the liability which has been incurred to date. If the figures so published are determined arbitrarily and with the intent to deceive and are in fact false, then the publisher is guilty of fraud regardless of whether his expression is one of fact or one of opinion." *Glacier Gen. Assurance Co. v. Casualty Indem. Exch*, 435 F. Supp. 855, 860 (D. Mont. 1977). *See also Stephens v. American Home Assurance Co*., 811 F. Supp. 937, 949-950 (S.D.N.Y. 1993), vacated and remanded in part on other grounds, 70 F.3d 10 (2nd Cir. 1995) (actuarial report estimating future losses that were undervalued by millions of dollars could form the basis of a non-disclosure claim if it is material to the risk at issue; the materiality of the report presented an issue of fact).

In the *Acme v. Widget* hypothetical, whether the disclosed loss reserves or the undisclosed consultant's report about them are actionable might depend on the policyholder's belief in their accuracy or unreliability; the consultant's area of specialisation and degree of expertise, the rigor of the consultant's evaluation and estimation methods, and/or the extent to which the policyholder relied on the disclosed reserves or the consultant's undisclosed alternative figure. But how a court might apply rescission principles relating to opinions, estimates, or projections also may vary from state to state.

Must the misrepresentation (or nondisclosure) be intentional, or can a negligent or innocent misrepresentation also be actionable? The law on rescission varies among U.S. courts with regard to whether the policyholder's culpability is required – *i.e.*, whether the policyholder's knowledge or intent or, alternatively, negligence, is an element of a rescission claim. Some courts may require that an insurer demonstrate a policyholder's "intent to deceive" to rescind a policy based on a misrepresentation or nondisclosure in an insurance application. *See, e.g., Scottsdale Ins. Co. v. Tolliver,* 127 P.3d 611, 614 (Okla. 2005) (discussing cases interpreting requirements of an Oklahoma insurance statute). Others permit a "negligent or inadvertent" misrepresentation to be the basis of a rescission claim. *See, e.g., Mitchell v. United Nat'l Ins. Co.*, 25 Cal.Rptr. 3d 627, 633-34 (Ct. App. 2d Dist. 2005). New York courts permit an innocent misrepresentation to be the basis of a rescission claim. *See, e.g., Mutual Benefit Life Ins. Co. v. JMR Elecs. Corp*., 848 F.2d 30, 32 (2d Cir. 1988).

A policyholder's intent to deceive, if required for a rescission claim in a particular forum, could be the most difficult element of the claim for an insurer to prove because it would depend on evidence that the policyholder's personnel or agent had a knowing (or reckless) state of mind. Without filing an action and taking discovery of a policyholder, it might be difficult for an insurer to reliably assess the strength of an allegation that the policyholder knew or recklessly disregarded that it was misleading the insurer during the placement of coverage. If an insurer has more than one choice of jurisdiction in which to litigate a rescission claim, it may wish to choose the forum likely to apply the most lenient standard with regard to culpability.

Other issues that may affect the viability of a rescission claim or where it should be asserted. There may be other issues pertinent to insurer's determination of the forum in which to bring a rescission claim. For example, if the insurance placement was made long ago, a state's applicable statute of limitations (and whether the court in that state might "borrow" another jurisdiction's limitations law) could be a key factor to consider so that a rescission action is not time-barred in the forum where it is brought. The applicable burden of proof may also differ among potential forum states: while many states require "clear and convincing evidence," others may only require a party seeking rescission to prove its case by the more lenient "preponderance of the evidence" standard. And as discussed in the sections that follow, the law among U.S. jurisdictions can vary as to whether an insurer must return or tender premium at the outset of a rescission claim; whether certain conduct might constitute a waiver of the rescission claim; what evidence may establish the materiality of the misrepresented or undisclosed information; or whether certain obligations (such as a duty to defend) are terminated or continue while a court considers the propriety of an insurer's decision to rescind.

2. Steps to take, and what to avoid, while assessing the potential claim

Some of the substantive and procedural rules that may apply to rescission seem to be at cross-purposes, and navigating them can be tricky. In some courts a rescission claim might require a party to allege knowledge or an intent to mislead, and such an accusation should never be made without a solid factual basis. A court may require such allegations to be pleaded with particularity, and this may also require that the insurer conduct an extensive investigation and acquire substantial information about the alleged misconduct before filing suit. At the same time, however, the law may require an insurer to assert its right to rescission within a reasonable time after it learns of the factual basis for the claim; an unjustified delay might waive an insurer's right to rescission. One court applying New York law stated that an insurer "must promptly disaffirm the contract upon learning of the misrepresentations – and certainly it may not continue to derive benefit under it" – although it further noted that an insurer is not estopped from rescinding unless a delay prejudices the policyholder. *GuideOne Specialty Mut. Ins. Co. v. Congregation Adas Yereim,* 593 F. Supp. 2d 471, 483 (E.D.N.Y. 2009) (citing *Sumitomo Marine & Fire Ins. Co. v. Cologne Reins. Co.* 552 N.E.2d 139 (N.Y. 1990). *See also Foremost Guar. Corp. v. First Nat'l Bank*, 910 F.2d 118, 129 (4th Cir. 1990) ("upon discovering a basis for rescission, an insurance company must take action to avoid the policy within a reasonable time or it will be deemed to waive the right to do so"). Some policies (particularly life and health policies) contain incontestability clauses that purport to limit the time after issuance in which an insurer can void the policy for misrepresentation except for fraud. But if the insurer avails itself of tools which might allow it to better and more efficiently investigate and evaluate the basis for a rescission claim – such as audit or inspection rights that might be provided by the insurance policy – it might be deemed to affirm the contract and thus waive the claim. In sum, the intricacies of rescission law may require the insured to move with reasonable speed, but very carefully. Its procedural constraints may require that the insurer have detailed information to support its claim but impede the insurer's ability to obtain that information.

An insurer presented with a possible rescission claim should promptly gather as much information as it can ***internally*** to fully understand the risk in question and to ascertain what was disclosed by the policyholder at the time of the placement. It is important to review the underwriting files and to interview any underwriting staff involved in the risk as soon as practicable. Counsel should probe the underwriter's decision-making process regarding the risk in question. What does the underwriter recall as being significant to the evaluation of the risk? Doing so may help the insurer to evaluate what the impact of the newly disclosed or corrected information would have been on the underwriting analysis. The insurer should investigate more than just the underwriter's consideration of the risk in question; it should evaluate how its underwriting personnel have historically evaluated other risks of a

similar type. If the case proceeds to litigation, the policyholder can be expected to pursue the same analysis.

Information about a potential misrepresentation or non-disclosure may also exist outside the insurer's control; that information can and should be pursued, but with important caveats. Relevant data in the public domain should be collected – news articles, the policyholder's regulatory filings, information on the internet, and the like. The insurer and its counsel should consider interviewing former employees – particularly former underwriters who were involved in the risk – if those employees remain on good terms with the insurer, but caution must be exercised. Before interviewing them, the insurer and counsel should consider whether an attorney-client privilege would apply to discussions with former employees, or whether former employees might communicate informally to others (perhaps even the policyholder or its broker) about the discussions.

Of course, some of the most important information may be in the control of the policyholder, but an insurer that pursues it outside of formal discovery may do so at its peril. If the policyholder is asked to provide information regarding the accuracy and completeness of disclosures made during placement, that will likely reveal that the insurer is contemplating rescission. As a result, a policyholder may consider whether to bring its own coverage action first, potentially in a forum favorable to it and not the insurer. On the other hand, probing the policyholder for information through stealth might lead to later assertions of waiver or bad faith. In all events, extreme caution must be exercised in any contact the insurer has with the policyholder, whether or not related to the rescission issue. Any statements or actions that might be inconsistent with the insurer's position that the contract is void could be used by the policyholder to argue that the insurer has waived its right to rescission.

For instance, some insurance contracts (and most reinsurance contracts) give the insurer (or reinsurer) the right to inspect the books and records of the policyholder or cedant. Exercising that right may be tempting to probe what the policyholder knew at the time of placement, but doing so when an insurer knows of grounds for rescission might waive a rescission claim on the theory that the inspection right only exists if the contract is valid. In the Acme/Widget hypothetical, Justin the claims director has a difficult decision to make. He has an auditor at Widget's third-party administrator's offices when he learns of potential grounds for rescission – and the auditor is there because of Acme's inspection rights under the insurance policy. When Justin calls his auditor back, does he tell the auditor to pack his things and leave the TPA's office at once? If the auditor leaves abruptly in the middle of the audit, what suspicions will be raised with the policyholder? But if the auditor stays and finishes the inspection, will that conduct lead to an argument by Widget that Acme has waived the rescission claim?

A somewhat easier question is whether an insurer evaluating a possible rescission claim should accept an installment of premium on the policy. It should not. This could be viewed as accepting a contract's benefits while denying its validity. Courts have ruled that an insurer cannot do both, and a court could find that the insurer accepting premiums – after knowing that grounds for rescission exist – has chosen to affirm the contract and forgo the rescission remedy. *See, e.g., Scalia v. Equitable Life Assurance Soc'y.*, 215 A.D. 2d 315 (N.Y. App. Div. 1998) (holding that insurer waived – or was estopped from exercising – the right to rescind by continuing to accept premiums after learning facts that would allow rescission); *Continental Ins. Co. v. Helmsley Enter.*, 211 A.D.2d 589 (N.Y. App. Div. 1995) (same).

Other routine conduct relating to the insurance relationship could potentially expose the insurer to an assertion of waiver. An insurer's negotiation of policy endorsements or renewal of an annual contract after it learns of a misrepresentation or non-disclosure might be viewed as a waiver of its rescission rights. *See Securities & Exchange Comm'n v. Credit Bancorp, Ltd.*, 147 F.Supp.2d 238, 257 (2nd Cir. 2001) (New York law); *see also Compagnie de Reassurance d'Ile de France v. New England Reins. Corp.*, 57 F.3d 56, 84 (1st Cir.), *as amended on denial of reh'g*, (July 12, 1995) (Massachusetts law). The issuance of a policy wording – which sometimes takes place well after a policy is bound – might be construed as a waiver. Even though the payment of claims or the acceptance of a tendered defence does not "benefit" the insurer, doing so after it knows of grounds to rescind might also be viewed as inconsistent with the position that the contract is void. While the law may generally require an insurer to act within a reasonable time after it discovers grounds for rescission, it could be a routine matter in the insurance relationship – the arrival of premium, a claim for indemnity, or a tendered defence – rather than the risk of delay that forces an insurer to decide whether to affirm or rescind the contract. If an insurer needs to respond to such a day-to-day matter and cannot yet determine whether it should affirm or rescind, it should address the matter subject to a specific reservation of rights, although this will alert the policyholder that the insurer is evaluating a potential rescission claim.

3. Moving ahead with rescission

Depending on the jurisdiction, an insurer that decides to move ahead with rescission may do so in a number of ways: (i) it can exercise "unilateral rescission" by notifying its policyholder that the insurance contract is void due to a material misrepresentation or non-disclosure; (ii) it can file an action in court for a judicial declaration that the contract is void; or (iii) it can do both. The safest course is "belt and braces" – a request for a judicial declaration coupled with a notice to the policyholder of unilateral rescission. However, there may be circumstances where unilateral rescission – without a contemporaneous claim in court – could be a more practical approach.

For instance, an insurer may be aware of facts that may support a rescission action but lack sufficient information to determine which jurisdiction would be the most appropriate forum in which to litigate the claim. If there is an upcoming event associated with the policy – such as renewal discussions, a premium installment, or a claim payment – the insurer may want to give immediate notice of rescission to avoid any risk of affirming the contract, even if it has not yet decided where to bring suit. Unilateral rescission allows the insurer to invoke and preserve its rescission right without simultaneously filing suit.

Unilateral rescission may offer another benefit over judicial rescission alone: in some jurisdictions, an insurer's contractual obligations are deemed terminated at the time it unilaterally rescinds, even if a court has not yet determined whether the rescission is valid. This may be important where an insurer would otherwise have a duty to defend. *See Atmel Corp. v. St. Paul Fire & Marine Ins. Co.*, 426 F. Supp. 2d 1039, 1045 (N.D. Cal. 2005) (following unilateral rescission, an insurer is not required under California statutes or case law to defend the policyholder until a court enforces the rescission). Arguably, an insurer could advance defence costs under reservation, and seek reimbursement in the event it obtains judicial rescission. Such a remedy could be of little value, however, if the policyholder is or becomes insolvent or bankrupt.

A shortcoming of unilateral rescission is that not all courts have found that it terminates an insurer's obligations without judicial enforcement. Some courts have held that the duty to defend continues until a judicial decree is entered rescinding the policy,

notwithstanding a unilateral rescission. *See Federal Ins. Co. v. Tyco,* 2004 WL 583829 (N.Y. Sup. Mar. 5, 2004), *aff'd, Federal Ins. Co. v. Kozlowski,* 18 A.D.3d 33 (App. Div. 2005) (finding that despite unilaterally rescinding a policy, an insurer was required to continue to provide a defence while its rescission claim remained "unproven" in court). Moreover, if an insurer unilaterally rescinds without seeking a judicial decree, it may be more vulnerable to a potential finding later on that it has breached the contract if the unilateral rescission turns out to be improper. As a tactical matter, an insurer must also be mindful that its policyholder may respond to unilateral rescission with a lawsuit – filed in the forum of the policyholder's choosing. While unilateral rescission gives an insurer an interim option if it wishes to rescind but has not selected a forum, the insurer should still make a forum choice as soon as possible after giving notice of rescission, or the policyholder may choose instead.

An insurer that proceeds with unilateral rescission does so by notice to the policyholder. The notice should identify the specific factual bases for rescission. Many jurisdictions require fraud and similar types of claims to be pleaded with particularity. The particularity standard is a good rule of thumb for an insurer to use in drafting a notice of unilateral rescission. The notice should specify all factual grounds for rescission of which the insurer is aware. Failure to include a particular misrepresentation or non-disclosure, if known to the insurer at the time of the notice, might be found to waive of any future rescission claim based on it. If an insurer has knowledge of other potential factual bases for rescission, but is still investigating them, it should include a reservation of rights to that effect. If the insurer is simultaneously seeking a judicial decree of rescission, the notice should advise the policyholder of that fact. This is courteous, but also may dissuade the policyholder from initiating a competing lawsuit in another jurisdiction by telling the policyholder it will not win any "race to the courthouse."

Because the remedy of rescission seeks to return the contracting parties to the *status quo ante* to the extent possible, a party that obtains rescission will in most circumstances have to return paid premiums with interest (to the extent they exceed prior claims payments). In some jurisdictions, an insurer seeking to rescind the policy unilaterally may be required to return premiums paid (possibly with interest) when it invokes the remedy; a failure to do so could endanger the rescission claim. Alternatively, a court may require an insurer seeking to rescind certain types of insurance policies to pay the premiums received into court. *See, e.g.*, Ala. Code § 27-14-7(b)(2006) (Alabama statute provides that "[n]o pleas of misrepresentation or fraud in connection with the issuance of a life insurance policy or annuity contract shall be filed unless accompanied by a payment into court of all premiums paid on the policy or contract."). In other states, it may suffice merely to "tender" premium to the policyholder by making a formal offer to return it in connection with the service of a complaint. *See, e.g.,* Cal. Civil Code § 1691. Moreover, some states do not require the return of premium at all if the insurance policy was procured by fraud on the part of the insured. *See, e.g., PHL Variable Ins. Co. v. Lucille E. Morrello 2007 Irrevocable Trust*, 2011 U.S. App. LEXIS 14338, *10 (8th Cir. July 14, 2011) (Minnesota law) ("There is a well-recognized exception by which the insurer is relieved from any duty to return the premium when it was induced to enter into the contract by the actual fraud of the insured"). Concerns about policyholder solvency, as well as an insurer's own cash-flow, could make a jurisdiction that only requires tender (as opposed to the actual return of premium) a more favourable forum option for the insurer.

4. Alternatives to rescission

In assessing its options after discovery of a misrepresentation or non-disclosure, an insurer should consider whether a remedy other than rescission might be more appropriate or easier to attain. Facts that may support a right to rescission could also provide the basis for a claim for money damages based on fraud or negligent misrepresentation, since each cause of action would involve a material misstatement or nondisclosure on which the insurer has relied. Often, an insurer in such circumstances has the option of either seeking to avoid the contract (by rescission) or affirming the contract and demanding damages. While most courts will allow an insurer to plead both "in the alternative," eventually the insurer will have to choose which remedy to pursue, since obtaining both would generally constitute, in effect, a double recovery.

Rescission and money damages have distinct elements, however, and an insurer evaluating the alternatives should be mindful of the differences that may make one form of relief easier or harder to obtain. Depending on the jurisdiction, rescission may not require any culpable conduct by the policyholder. In New York, for instance, it may be available even if the misrepresentation was innocent. In contrast, a claim for money damages typically requires a plaintiff to establish that the defendant committed fraud or at least was negligent in making the misrepresentation or non-disclosure. While the fact of a misrepresentation and its materiality are often self-evident, a policyholder's culpability, particularly knowledge or intent, may be difficult to prove. A rescission action could offer significant advantages to the insurer in such a situation. Moreover, unlike rescission, a claim for money damages requires proof that the insurer sustained injury. An insurer might not be able to establish that it has been injured if it has not yet paid any claims and cannot prove the value of potential future claims to a reasonable degree of certainty. Finally, because rescission is an "equitable" rather than "legal" remedy, a judge and not a jury may sit as the finder of fact on a rescission claim. This could be a significant factor for an insurer concerned about potential juror bias.

A legal claim for money damages may offer advantages over rescission in some situations, however. Legal claims for fraud and negligence do not require the insurer to return or tender premiums at the outset of an action (though they may be offset from a damages award). Moreover, the same conduct that might waive a rescission claim – such as accepting premium or engaging in other conduct that could be construed as "affirming" the existence of the insurance contract – should not have the same impact on a claim for money damages, since a damages claim would be predicated on affirmation of the contract. And if an insurer believes its policyholder's conduct was fraudulent, it may wish to pursue punitive damages in addition to compensatory damages. In most jurisdictions, a party that proves fraud may also seek punitive damages if the defendant's conduct was particularly egregious. Such damages are generally unavailable as an adjunct to rescission or other equitable relief.

Depending on the jurisdiction, and what the policyholder knew at the time of placement, an insurer may also assert that claims under the policy are barred by the "known loss" or "loss in progress" doctrine, which is based on the principle that insurance contracts have an implied requirement of fortuity and that a loss that is known or reasonably expected to occur is not fortuitous. Of course, not all misrepresented or undisclosed facts will support such a coverage defence. Even if material to the risk, previously known facts generally will not establish a "known loss" or "loss in progress" unless they led the policyholder to be aware before the coverage was obtained that there was a "substantial probability that loss or

liability would ensue." *Outboard Marine Corp. v. Liberty Mut. Ins. Co*. 607 N.E.2d 1204, 1212 (Ill. 1992); *City of Corvallis v. Hartford Acc. & Indem. Co.,* 1991 WL 523876, at *8 (D. Or. May 30, 1991) ("loss in progress" or "known risk" doctrine "disallows coverage where the loss to be insured is in progress or substantially likely to occur when the insurance contract was issued").

In some circumstances, another alternative to rescission may be to use a representation made during placement to establish the boundaries of coverage, rather than to seek relief based on the falsity of the statement. This approach is sometimes pursued in reinsurance disputes where a cedant has made representations at the time of placement regarding the nature of the direct business it planned to write under the protection of the reinsurance. If the cedant ultimately writes direct business that is materially different from what it disclosed to the reinsurer, the reinsurer may argue that it did not intend to reinsure the undisclosed type of business, and that claims arising out of that business should not be covered under the contract.

5. Other matters to consider before asserting a rescission claim

There is another set of questions an insurer or reinsurer should consider before deciding whether to seek rescission of an insurance or reinsurance contract – what would be the various costs associated with the rescission claim. Certainly, there will be financial costs. Legal fees can be substantial in any coverage dispute, but rescission cases can be particularly contentious, and costly, since they typically involve significant sums as well as allegations that a policyholder has misled its insurer. If unpaid claims are involved, an insurer can expect counterclaims for breach of contract and even allegations that the rescission action is a smokescreen for a bad faith denial of coverage. Discovery (which can be expensive in any litigation) tends to be particularly extensive and costly in rescission cases, given the burden of proof ("clear and convincing" in many jurisdictions) and the requirement of many courts that an insurer show that the policyholder either knew of the misrepresentation or nondisclosure or was negligent. The insurer must assess its willingness to incur the financial, commercial, and other costs of litigating allegations that it was misled by its policyholder, and the inevitable counter-accusations that the policyholder will make.

There are non-financial costs to a rescission claim as well. Allegations that a policyholder engaged in misrepresentation or nondisclosure, of course, can undermine an insurer's commercial relationship with that policyholder. A rescission claim can also involve a substantial commitment of non-financial resources. Unlike most insurance coverage litigation, where the primary focus is on the policyholder's conduct and/or the circumstances of its claim, a rescission claim also puts the conduct of the insurer – particularly its underwriting staff – under close scrutiny. The policyholder's discovery programme may probe whether a claim of misrepresentation is simply a *post hoc* excuse to avoid granting coverage, whether the underwriter was justified in relying on the truth or completeness of the information provided, or whether the underwriter actually had knowledge – through other means – of the information alleged to have been misstated or undisclosed. Preparing an insurer's underwriting staff to deal with these types of counter-charges can be time-consuming, and the discovery process can take an emotional toll on the underwriters in question, as the policyholder's counter-attack may challenge their competence and integrity. An insurer should be mindful of these non-pecuniary costs before it decides to pursue a rescission remedy.

* * *

While the discovery of a policyholder's misrepresentation or non-disclosure may create an important opportunity for an insurer, the law of rescission can present traps for the unwary. An insurer or reinsurer could potentially be confronted with tough decisions that have no clear answers, which may have to be made relatively quickly and with limited information. A misstep might compromise the potential claim through a tacit admission, or the loss of an opportunity to litigate in a favourable forum, or waiver of the claim altogether. Given the intricacies, variations, and uncertainties in rescission law, it is advisable for an insurer in such a situation to rely on counsel experienced in rescission matters to assist in investigating the claim; to evaluate the insurer's legal options; and most important, to advise on the steps to take, and not to take, to ensure that the claim is properly preserved and best positioned for a favourable resolution.

Acknowledgment

The authors would like to acknowledge the assistance of their colleague Elizabeth L. Marvin in the preparation of this chapter. Elizabeth is an associate with Lewis Baach PLLC and practices in the areas of insurance coverage litigation and other commercial disputes. She can be reached on +1 202 659 7873 and elizabeth.marvin@lewisbaach.com.

Mark J. Leimkuhler

Lewis Baach PLLC
1201 F Street, N.W.
Washington, DC 20004
USA

Tel: +1 202 659 7204
Fax: +1 202 466 5738
Email: mark.leimkuhler@lewisbaach.com
URL: www.lewisbaach.com

Mark Leimkuhler is a partner with Lewis Baach PLLC, and practices in the area of complex insurance and reinsurance coverage disputes, including arbitrations and trial and appellate litigation in federal and state courts. For over 20 years he has represented London Market and U.S. insurers and reinsurers on a wide variety of issues, including environmental, asbestos, pharmaceutical, political risk, professional liability, health hazard, worker's compensation, and other claims; loss allocation; and reinsurance accounting issues.

Mr. Leimkuhler has substantial experience advising and litigating on behalf of insurers and reinsurers with claims of misrepresentation or nondisclosure in the placement of coverage. In one such matter, his clients won a judgment enabling them to avoid $70 million of potential liabilities.

Mr. Leimkuhler has also successfully litigated non-insurance matters involving claims of fraud, breach of contract, professional negligence, interference with property rights, and discrimination in employment and public accommodations.

Jack B. Gordon

Lewis Baach PLLC
1201 F Street, N.W.
Washington, DC 20004
USA

Tel: +1 202 659 7975
Fax: +1 202 466 5738
Email: jack.gordon@lewisbaach.com
URL: www.lewisbaach.com

Jack B. Gordon, a partner with Lewis Baach PLLC, has been a member of the New York and District of Columbia bars for over thirty years. He regularly counsels insurers and reinsurers on coverage issues and represents their interests as lead counsel in domestic and international arbitrations and in federal and state court litigation throughout the United States. He also serves as an arbitrator. He has extensive experience litigating misrepresentation and nondisclosure claims in connection with insurance and reinsurance disputes and numerous other commercial contexts. He recently obtained an order from a U.S. federal court compelling a domestic policyholder to arbitrate a foreign insurer's rescission claim in England. He is recognised by Chambers USA as a leading lawyer in the area of insurance.

Lewis | Baach pllc

Lewis Baach is recognised internationally for its expertise in insurance and reinsurance, as well as international financial disputes and global commercial litigation. For three decades it has helped London-based, U.S., Canadian, and European insurers and reinsurers successfully resolve some of their most challenging disputes in tribunals throughout the U.S. The firm often partners with English law firms to develop innovative solutions to insurance and reinsurance problems that may involve courts or arbitrators on both sides of the Atlantic.

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GLG
Global Legal Group

59 Tanner Street, London SE1 3PL, United Kingdom
Tel: +44 20 7367 0720 / Fax: +44 20 7407 5255
Email: sales@glgroup.co.uk

www.iclg.co.uk