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Calling in the Marker – Cancellation and Lapse

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Lapse and Cancellation

The terms lapse and cancellation are often used interchangeably. The two are not the same and differing rules typically govern each. The case law that addresses these issues always arises in the context of a loss, making it all the more important that an insurance company's response is accurate and clear on both the policy history, status at loss, and resulting claim decisions. Here, we'll set about distinguishing each situation and explore some of the underwriting complications that can impact claim decisions in these contexts.

Lapse

Lapse occurs when an insured fails to pay premiums and the coverage stops immediately, rather than at the natural expiration of the policy term. Without policy language to the contrary, statutory or regulatory intervention (below), policy lapse occurs automatically and without further notice to the insured. Lapse almost always occurs in the life insurance context, given the nature of the product and it's unique characteristics *vis-à-vis* other insurance products; in addition, lapse is almost always the result of an insured's failure to pay premiums. Thus, the remainder of this article focuses on life policy lapses for failure to pay premiums.

Grace Period

When an insured fails to pay a life premium, either by its terms or by applicable state law, the policy doesn't automatically fall into lapse. Rather, most policies and every state but one have specific regulations that require a grace period for late payment of life insurance premiums. The applicable grace period is determined by the policy and the home state law of the policy holder. When a policy is in the grace period, the coverage remains intact. A loss is owed, but generally a carrier can deduct the unpaid premium from the benefit payment.

Most policies have 31 day grace periods built into the terms of the policy and this matches a good almost half of the U.S. states' laws and regulations.[i] Moreover, since 25 states mandate a 30 day grace period, adhering to a 31 day policy term grace period ensures a carrier does not run afoul of the laws in those states or result in a breach of contract. Connecticut does not have a mandatory grace period for life policies and therefore only the policy terms apply. No surprise here, New York and California lead the way with requiring longer grace periods, requiring 61 days and 60 days respectively.

Effect of Lapse

If the grace period expires without payment of a premium, the policy falls into lapse. If a loss (death) occurs while a policy is in lapse, the general rule is there is no coverage for the loss. It does not matter if the policy is later reinstated.

Reinstatement

Almost all policies provide for reinstatement of a lapsed policy if premiums are brought current. Most states do not have regulations directly applicable to reinstatement, so the policy terms most often control. It is permissible to require an affidavit or certification from the insured regarding continued insurability and/or that no loss has occurred during the lapse period and prior reinstatement.

Reinstatement is a common practice and benefit to the insured. It allows for continued coverage without the need for new underwriting, which could impact eligibility and premiums. It is not without its hazards, however. Notably, the repeated reinstatement can expose a company to arguments that a loss should be covered even if technically the policy is in lapse based on course of dealings, waiver and estoppel, particularly in situations where the reinstatement process is not consistently managed and strict compliance with reinstatement policy terms and company practices are lacking. Therefore, when a loss occurs after a lapse, and there is a prior history of lapse and reinstatement, a carrier should carefully review the prior reinstatement process, the notices provided to the insured prior to the lapse and any other premium payment history and data available, along with applicable state law and notably anti-lapse statutes.

California Life Insurance Anti-Lapse Statute (Cal. Ins. Code §§ 10113.71 & 10013.72)

In 2013, California adopted anti-lapse statutes applicable to life policies. The statutes apply specifically to lapse, and not to cancellation, rescission, or non-renewal. The statutes require:

- (1) A 60 day grace period that cannot run concurrently with the period of paid coverage
- (2) Notice of pending lapse and termination of coverage to the named policy owner, any assignee and "designee" within 30 days of the unpaid premium due date and at least 30 days prior to the effective date of lapse and resulting termination of coverage; and
- (3)Annual notice to the policy owner of the right to designate ate least one person who, in addition to the policy owner/applicant, will receive notice of the pending lapse due to non-payment of premiums

When the anti-lapse statutes were enacted, the California Department of Insurance contemporaneously agreed with the insurers' interpretation that the Statutes only applied to policies issued *after* January 1, 2013. However, in 2021, the California Supreme Court held that statutes apply to *all in force policies as of January 1, 2013, regardless of issue date*. *McHugh v. Protective Life Ins. Co.*, 494 P.3d 24, 12 Ca.5TH 213

(2021).

In a recent opinion, the Ninth Circuit took up the issue of causation and damages under the statute and with the context of a challenge to the propriety of a class action thereunder. In *Small v. Allianz Life Ins. Co.*, 122 F.4th 1182 (9th Cir. 2024), the U.S. appellate court reconsidered the district's court's granting class certification of two subclasses. At issue was whether in order to pursue a claim for violation an insured plaintiff needs to only show the notice requirements were violated or whether an insured must also demonstrate the statutory violation caused them harm. *McHugh,* 494 F.4th at 1187-88.

Due in part to the change in interpretation regarding which policies the act applied to, it was undisputed that Protective Life did not provide the statutory notice to some policyholders, approximately 1800. The plaintiffs sought class certification and either death benefits paid for those insureds who did not receive the required notices and have passed, or a declaration that the policies were still in effect for those insureds who were still living. *Id.* at 1189.

Observing that the statutes do not provide for a statutory cause of action, the court concludes a breach of contract is the only claim at common law the policy holders may maintain. Causation of damages is an element of a breach of contract claim *Id.* at 1191.

Moreover, the court went on to distinguish life insurance policies from the other types of short term and/or mandatory insurance (like automobile and homeowners' policies), noting that in long-term, voluntary life policies, insureds often commonly *intend* to terminate their life insurance coverage by simply stopping premiums and letting their policies fall into lapse. They often forgo the formal process of cancelling their policies, which requires notice to the insurer and often in writing. *Id.* at 1194. Allowing a recovery without a showing that the failure to give proper notice actually caused damages would create a windfall to those persons who intended that their coverage terminate and therefore suffered no harm by an insurance company's failure to give proper statutory notice. Finally, after considering the foregoing, as well as the state court decisions related to the *McHugh* litigation, the court concluded that class certification would be inappropriate under Fed. R. Civ. P. 23 because a plaintiff must establish actual harm by the failure to give notice and this defeats the commonality requirement of a class action. *Id.* at 1193 and 1197.[ii]

Several other matters are still pending before the Ninth Circuit and will flush out further parameters for recovery under the California anti-lapse statutes. *Farley v. Lincoln Benefit Life Co.* (Case No. 23-16224);*Siino v. Foresters Life Ins. and Annuity Co.* (Case Nos. 23-16176 and 23-16189); *Moriarty v. Am. Gen. Life Ins.* (Case No. 23-3650); *Pitt v. Metropolitan Tower Life Ins. Co.* (Case No. 23-55566).

Cancellation

Cancellation of an insurance policy occurs when the insured and/or company makes a deliberate decision to cancel a policy mid-term, before the policy's natural expiration date. Note that a policy can usually be *cancelled voluntarily by a policy holder*, typically because either a better premium with another company was obtained or the insured no longer needs the coverage (the insured sold a boat, for example).

Cancellation by an insurance company requires grounds pre the terms of the policy and applicable law, as well as compliance with both and return of any unearned premium.[iii]

As to cancellation, there are three broad types: (1) mutual agreement; (2); per the terms of the policy; and (3), by statute. *See, Cook v. Michigan Mut. Liab. Co.,* 154 Ind.App. 346, 352, 289 N.E.2d 754, 758 (1972). First, regardless of either the contract terms or applicable regulatory and statutory law, parties to a contract may mutually and expressly agree to end the contract. The same is true of insurance policies. The insurer and insured can agree to cancellation of the insurance contract so long as the cancellation does not materially affect the rights of third parties, even if the cancellation would not otherwise be allowed under applicable policy language or state law. *See, e.g., MAG Mut. Ins. Co. v. Miles*, 881 S.E.2d 21(Ga. Ct. App. 2023); *Chandler v. Valentine*, 330 P.3d 1209 (Okla. 2014).

Second, the policy terms often (but not always) dictate the terms and conditions of unilateral cancellation. Most policies allow an insured to cancel a policy upon written notice and without any cause whatsoever. This is not generally the case with cancellations by carriers. While some policies do include broad-based powers of cancellation by, most allow cancellation under specific conditions as to timing and as to the circumstances supporting the decision to cancel. If the insurance policy is silent as to cancellation, the general rule is that in the absence of fraud or misrepresentation (which can warrant rescission), neither party can cancel the policy. *See, e.g., Jackson v. Lambert,* 492 So.2d 498, 502 (La.App. 1 Cir. 1986) (citations omitted).

When insureds and carriers have a dispute about cancellation, it almost always centers on both policy terms and statutory/regulatory requirements. It is clear that when an insurance company decides to cancel a policy it must "comply strictly" with both policy terms *and* applicable law. *See, e.g. Majernicek* v. *Hartford Casualty Ins. Co.*, 240 Conn. 86, 95, 688 A.2d 1330 (1997); *Geiger v. Am. Standard Ins. Co. of Wis.*, 117 P.3d 16, 18 (Colo. App. 2004). There is no wiggle room. If the policy terms differ from state law (for example, the required advance notice to be given prior to cancellation), compliance with the term more favorable to the insured is required. Otherwise, a carrier faces either a breach of contract claim or a claim for wrongful cancellation based on violation of state law.

Policy Terms

Most policies expressly state the grounds for unilateral cancellation by the insurer, and the procedural requirements for doing so. Most also include amendatory endorsements specifically tailored to applicable state law that address specific state requirements for cancellation. Common policy provisions supporting cancellation by the insurance company address:

- failure to pay premiums (not to be confused with lapse provisions most commonly found in life insurance policies);
- material misrepresentation in the procurement;
- a substantial change in the risk;
    - Change in property interest
    - Change in conditions

  - Change in applicable regulations/court decisions
  - Change in activity conducted on insured property

  failure to provide information requested (for example, post-issuance underwriting requirements);
- and, the co-author's personal favorite, a proverbial "Breaking Bad" provision: "conviction of a crime having as one of its necessary elements an act increasing any hazard insured against."

State Laws

Either by regulation or statute, every state has enacted rules to govern the unilateral cancellation of an insurance policy by an insurer, often adding requirements and limitations that differ from those in the policy itself. The laws/regulations typically address the following subjects.

- The time period for giving written notice to the insured. (Verbal notice is never sufficient.) The required period of advance notice can be anywhere from 10 to 120 days and is state specific. Again, these notice statutes apply in circumstances of cancellation which are distinct from those addressing lapse.
- Identification of reason for cancellation. Some jurisdictions require that the written notice of cancellation set forth the reason the policy is being cancelled. In some cases, provision of a notice with an incorrect reason for cancellation has been found to render the notice ineffective. *Brown v. Amer. Std. Ins. Co. of Wisconsin*, 436 P.3d 597, 598(Colo. Ct. App. 2019). Also, many states limit the bases for cancellation, regardless of policy terms that may be broader or unlimited. *See, e.g.*, I.C. § 41-2507.
- Notice to third parties. Many states require notice to third-party stakeholders by the insurance carrier (mortgage companies on a homeowners' policy; motor vehicle commissions on an auto liability policy). The impact of a carrier's failure to provide proper notice to third parties varies.
  - For example in California and Florida, failure to notify the motor vehicle commission of a cancelled auto policy results in an ineffective cancellation. *See, e.g., Allied Premier Ins. v. United Fin. Cas. Co.*, 532 P.3d 708 (Cal. 2023); *National Indemn. Co. v Pennsylvania Nat. Mutal Ins. Co.,* 363 So.2d 151 (Fla. Dist. Ct. App. 1978)
  - For example, in New York, the failure to give notice of cancellation to the motor vehicle commission results in an ineffective cancellation of the policy *as to third parties only* (liability benefits versus medical payments or uninsured motorist coverage). *Progressive Northern Ins. Co. v. White,* 23 A.d.3d 477 (N.Y. App. Div. 2005)
  - In Washington, the statute governing cancellation has been amended. The ***new statute,*** WASH. REV. CODE § 48.18.290***, goes into effect July 1, 2025*** (included following this article). The law requires advance notice delivered to "each mortgagee, pledgee, or other person shown by the policy to have an interest in any loss which may occur

thereunder." (The statute is not specific but this likely includes additional insureds and potentially certificate holders.)

- Method of delivery. In most states, depositing the notice in the mail is sufficient delivery of the notice. The modern statutes and regulations are, in some instances, broadening delivery methods to include email, fax and personal delivery.
- Non-payment of premium. Many, almost all states have specific requirements for cancellation of a policy based on non-payment of premiums. The requirements can include mandatory grace periods and anti-lapse statutes (addresses above) can apply to cancellation situations as well. In failure to pay premium disputes, look carefully at the issues of waiver and estoppel. It is not unusual for insurance companies to administratively process or accept late payments before a determination as to whether a policy continues to be in force on a particular date of loss.
- Misrepresentation or fraud. As with rescission, material misrepresentations and/or fraud can support cancellation. If material misrepresentation/fraud is the grounds for cancellation, in addition to policy compliance, caution is in order. Both statutes and common law weigh in heavily in this area. Moreover, some jurisdictions require a finding of intent to deceive by the insured. Instances of misrepresentation/fraud can include:
    - Undisclosed knowledge of impending loss. *Central Mut. Ins. Co. v. Useong Int'l* 394 F.Supp.2d 1043 (N.D. Ill. 2005)
    - Misrepresentation of loss history. *Klopp v. Keystone Ins. Co.*, 595 A.2d 1 (Pa. 1991).
    - Failure to provide complete information concerning risk insured against. *Bennett v. Hedglin*, 995 P.2d 668 (Alaska 2000).
    - Failure to disclose health history
- Public Policy. In some instances, courts have determined that public policy can preclude cancellation. *See, e.g., L'Orange v. Med. Prot. Co.*, 394 F.2d 57 (6th Cir. 1968) (finding if a medical malpractice insurer did indeed cancel the policy of a dentist who testified as an expert against another dentist in a malpractice case, said carrier was precluded from cancelling ads a matter of public policy and breached contract upon doing so.

[i] See Life Insurance Grace Periods appendix.

[ii] There were additional bases on which the class certification was denied. *Id.*

[iii] Cancellation's fraternal twin, rescission, is the retro-active cancellation of a policy with a return of premium, as if the policy was never issued. Rescission avoids the contract *ab initio* whereas a cancellation merely terminates the policy as of the time when the cancellation becomes effective. *See, e.g., Glokel v. State Farm Mut. Auto Ins. Co.*, 400 N.W.2d 250, 255 (Neb. 1987);

Gov't Employees Ins. Co. v. Chavis, 176 S.E.2d 131, 135 (S.C. 1970). Rescission is a topic separately addressed by our ALFA International colleagues.