2025 Insurance Roundtable

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ALL BETS ARE OFF: WHEN AN INSURER CAN WALK AWAY

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A. THE STAKES

Rescission of an insurance policy is the most severe remedy available to an insurance carrier. Often, where there is a misrepresentation on the application by the insured, there is an emotional response which demands redress. However, rescission as a remedy must be analyzed under business considerations and principles of contract. From the carrier's perspective, the misrepresentation has caused a policy to issue against risk that is greater than originally contemplated.

Needless to say, once the decision to seek rescission is made, litigation is often complex. While your initial read might be that the misrepresentation is indisputable, prevailing in a rescission action often requires the determination of factual issues such as whether the insured "reasonably believed" that the application was truthful or whether the signatory to the application performed the requisite investigation. Moreover, the severability provision within a policy may render a rescission impossible.

The bottom line is that an insurance carrier must think carefully before initiating a rescission action. They are factually intensive and expensive; two things insurance companies loathe.

B. PICK YOUR POISON: GROUNDS FOR A RESCISSION

Material misrepresentation within an application or omission concerning the breadth of the insured risk are the most common grounds for rescinding an insurance policy. However, because an insurance policy is nothing more than a contract, an insurance carrier may rescind its policy on any basis applicable to contracts.

As for insurance policies specifically, less common grounds for rescission are mutual mistake, fraudulent inducement, duress or breach.

At common law, a contract could be voided if induced by either a fraudulent or a material misrepresentation. A misrepresentation that one knew, or should have known, was false or one that was likely to induce a reasonable person to enter into the contract was a basis to void the contract. Since the development of common law, many state legislatures have adopted statutes that codify the common law rules.

Sometimes the common law is reverse engineered. After a state has adopted statutory recission requirements, some courts have changed the common law rules to match the statue.

States that have either codified rescission standards or rely upon the common law have almost universally applied the same set or some combination of the same factors to determine whether a misrepresentation will enable an insurer to avoid the policy. The four most widely used factors are as follows:

1. Was the misrepresentation fraudulent? Was the misrepresentation made with knowledge of its falsity or with a total disregard for the truth?

2. Was the misrepresentation material to the risks assumed, that is, would a reasonable insurer have refused to issue the policy at the rate specified had the insurer known the true facts?

3. Would the insurer have issued the policy at the same premium had it known the truth?

4. Did the facts misrepresented "contribute to the loss"? Did the loss arise from the facts that were misrepresented? (Ask me how I know this one intimately!)

These factors appear in varying combinations in different states. Obviously, there is substantial overlap. A condition that contributes to a loss is likely to affect the insurer's decision as to whether to accept the risk, and a condition that would lead a reasonable insurer to reject an application will in many cases lead the insurer to do so.

C. STACKING THE DECK AGAINST THE HOUSE

Rescission of an insurance policy based upon a misrepresentation within the application sometimes requires the carrier to show that the misrepresentation was made with "actual intent to deceive."

The majority of jurisdictions, however, allow rescission if the carrier can show that the misrepresentation materially affected by acceptance of the risk or hazard assumed by the company. See, *e.g. Nat'l Blvd. Bank v. Georgetown Life, Ins. Co.*, 129 Ill. App. 3d 73, 81, 472 N.E. 2d 80 (First Dist. 1984) (under Illinois law either the actual intent to deceive or a material misrepresentation which affects either the acceptance of the risk or the hazard to be assumed can defeat or avoid the policy period). Therefore, when considering whether to bring a rescission action, the carrier must first discern which state's law will apply to the dispute and second,

determine whether intent to deceive must be proven or whether negligent misrepresentation of a material fact will suffice.

Where a misrepresentation, even innocently made, can serve as a basis to void the policy, the carrier has a substantially lower burden. *Golden Rule Ins. Co. v. Schwartz*, 203 Ill.2d 456, 464, 786 N.E.2d 1010 (2003). This theory is called negligent misrepresentation. To prevail on a claim of negligent misrepresentation in an insurance application, the carrier must plead and prove three elements:

(1) A false statement;

(2) The statement must either have been made with an actual intent to deceive or must "materially affect the acceptance of the risk or hazard assumed by the insurer;

(3) The misrepresentation must be material, that is, would a reasonable person think the misrepresentation significantly increased the risk insured against and if the insurer would have rejected the application.

Williams v. Globe Life & Accident Ins. Co., 2016 Ill. App. (1st) 152189.

Another significant limitation to consider is whether the jurisdiction hearing a rescission action requires that the application be attached to the policy. For years, the minority rule has required that the insurance application must be attached to the policy as a condition of bringing a rescission action. The purpose of this archaic requirement is to allow for objective evidence of negotiations at the time of the application for the protection of the insured from possible fraud by insurance agents in falsifying the answers given by the insured in applying for the coverage. In such a case, if the application is not attached to the policy, so that the insured can examine it carefully, he labors under the mistaken impression that he is protected by the insurance policy issued to him when, in fact, he may not have any coverage. The purpose of this requirement was

therefore for the protection of the insured. *Inter-Ins. Exch. Of Chicago Motor Club v. Milwaukee Mut. Ins. Co.*, 61 Ill. App. 3d 928, 931, 378 N.E. 2d 391 (3rd Dist. 1978).

The majority rule, however, is that there is no requirement to attach the application to the policy. *Brandt v. Time Ins. Co.*, 302 Ill. App.3d 159, 168, 704 N.E.2d 843 (1st Dist. 1998).

Oftentimes the attestation to an insurance application states that the signatory states that the information within the application is true "on information and belief." Some jurisdictions hold that this phrase allows an insured to escape rescission if the attestation was made with "knowledge and belief." In other words, if the affiant believed that the information within the application was true, rescission is unavailable.

Along these lines, one court held as follows:

> What the applicant, in fact, believed to be true is the determining factor in judging the truth or falsity of his answer, but only so far as that belief is not clearly contradicted by the factual knowledge on which it is based. In such an event, a court may properly find a statement false as a matter of law, however, sincerely it may be believed. To conclude otherwise would be to place insurance companies at the mercy of those capable of the most invincible self-deception-persons who having witnessed the Appollo landings, still believe the moon is made of cheese. *Golden Rule Ins. Co., v. Schwartz,* 203 Ill.2d 456, 466, 786 N.E.2d 1010 (2003).

Stated another way, if the application is made "on information and belief," the inquiry changes from determining the truth or falsity of the applicant statement to applicant's statement to a determination of the applicant's actual knowledge and belief, and whether, once the applicant's knowledge is ascertained, that knowledge defies belief. *Certain Underwriters at Lloyd's, London v. Abbott Labs*, 2014 Ill. App. (1st) 132020, ¶46, 16 N.E.3d 747 (1st Dist. 2014).

Along these lines, a state statute may determine the "scienter" required for a material mispresentation to give rise to an insurer's right to rescind. *Larson v. Northwestern Mut. Life Ins*.

Co., 855 N.W.2d 293, 295, (Minn. 2014). Thus, before initiating a rescission action, it is important for the carrier to determine how the jurisdiction handles the "on information and belief" attestation.

D. THE MATERIALITY JACKPOT

The only way an insurance carrier can ever prevail on a rescission action based upon a misrepresentation within the application is where the misrepresentation was material. Courts usually employ a reasonable insurer standard for this inquiry. As such, the misrepresentation must substantially increase the chance of an insured event occurring or cause a reasonable insurer to reject the application or require different conditions, like higher premiums for the risk actually insured. *No. Life Ins. Co. v. Ippolito Real Estate*, 234 Ill. App. 3d 792, 802, 601 N.E.2d 773 (1st Dist. 1992). Stated in another way, the misrepresentation must be a statement of fact which is untrue and affects the risk undertaken by the insurer. *Garde By Garde v. Country Life Ins. Co*., 147 Ill. App. 3d 1023, 1031, 498 N.E.2d 302 (4th Dist. 1986).

In most jurisdictions, materiality is a question of fact reserved for the trier of fact. And, as if things couldn't get more difficult, ambiguities within the application questions are interpreted against the insurer. *Gibbs v. N. Am. Co. for Life, Accident & Health Ins*., 2 Ill. App. 3d 496, 501, 276 N.E.2d 49 (2nd Dist. 1971).

Another important aspect of rescission is the insurance company's evidence of materiality. In particular, courts may consider underwriting guidelines as a way to demonstrate that certain facts are material to a carrier when assessing the risk. When an underwriting manual states that a policy will not issue if certain conditions are present, failure by the applicant to verify the absence of those conditions can be a material misrepresentation. In any material misrepresentation case the insurer should examine the underwriting criteria and enlist the support of the underwriting

department at an early stage. See, *Friedman v. Prudential Life Ins. Co. of Am*., 589 F. Supp. 1017 (S.D.N.Y. 1984).

E. PLACE YOUR BETS: MATERIAL OR IMMATERIAL

See if you can guess whether a misrepresented fact was material or immaterial for purposes of a rescission action:

- Failure to disclose an AIDS diagnosis on a life insurance policy?

MATERIAL – See, *N. Life Ins. Co. v. Ippolito Real Estate*, 234 Ill. App. 3d 792, 601 N.E.2d 773 (1st Dist. 1992).

- The non-disclosure of a 20-year-old driver residing in the same household as the insured?

MATERIAL, See, *Ratliff v. Safeway Ins. Co.*, 257 Ill. App. 3d 281, 628 N.E.2d 937 (1st Dist. 1993).

- Insureds failed to disclose previous doctor visits on an application for health insurance made on "information and belief."

MATERIAL, See, *Conti v. Healthcare Serv. Corp.*, 378 Ill. App. 3d 202, 882 N.E. 2d 614 (1st Dist. 2007) (no reasonable person could construe multiple doctor visits anything other than "check-ups" and "consultations" as requested by the

application. These misrepresentations materially affected the acceptance of the risk).

- Drivers not disclosed as household members on the insured's application for auto coverage?

NOT-MATERIAL – The application did not specify whether the driver actually lived within the household at the time of the application. See, *Universal Cas. Co. v. Lopez*, 376 Ill. App. 3d 459, 464, 876 N.E.2d 273 (1st Dist. 2007).

- Failure to disclose an additional vehicle at the residence?

NOT-MATERIAL: See *Direct Auto Ins. Co. v. Koziol*, 2018 Ill. App. (1st) 171931, ¶41-43, 117 N.E.3d 465.

F. HIGHER STAKES: RESCISSION PREDICATED ON FRAUD OF THE INSURED

Sometimes the misrepresentation on the application is so bad that an insurance carrier has been defrauded into issuing a policy for a risk it did not intend to cover. Under such circumstances, the carrier can seek rescission based upon fraud to prevail, the carrier has to demonstrate:

(1) a false statement of material fact;

(2) Known or believed to be false by the party making it;

(3) Intended to induce the other party to act;

(4) Acted upon by the other party and reliance upon the truth of the representation; and

(5) Damages to the other party as a result.

Fogel v. Enter Leasing Co., 353 Ill. App. 3d 165, 171, 817 N.E.2d 1135 (1st Dist. 2004).

As with a negligent misrepresentation, a misrepresentation by fraud is "material" if the carrier who seeks rescission would not have issued the policy or would have changed its terms, including premium if it had been aware of the misrepresentation. *Miller v. William Chevrolet*, 326 Ill. App. 3d 642, 649, 762 N.E.2d 1 (1st Dist. 2001).

As an example, an insurance carrier prevailed on a rescission action based on fraud where, its insured, a vehicle rental agency adopted a corporate policy prohibiting the rental of vehicles to persons under the age of 21. A renter presented a California's driver's license that indicated he was 22 years old. In fact, the renter was only 18. Under the circumstances, the rental company was entitled to rescind its agreement and the insurance it provided to the teenager based upon fraud. *Fogel*, 353 Ill. App. 3d at 172.

An insurance carrier who contemplates bringing a rescission action based upon fraud in federal court must be prepared to plead the elements and factual bases with particularity as required under Federal Rule of Civil Procedure 9(b). Moreover, some state courts apply the same particularity requirement. Thus, the carrier must be aware of the heightened pleading standard lest its complaint be dismissed. The heightened pleading standard requires the complaint to identify the "who, what, when, where and how" of the alleged intentional misrepresentation.

G. KNOW WHEN TO WALK AWAY AND KNOW WHEN TO RUN

The decision to pursue rescission is complex, though it can feel rather simple. A misrepresentation on an application for insurance that leads to a claim elicits strong reactions and

emotions from claim departments. The carrier oftentimes feels that it was duped into issuing a policy.

It is, therefore, important for the carrier to analyze the strength of the rescission action clinically and dispassionately. The first step is to determine what jurisdiction's law will apply to the rescission case. The applicable jurisdiction will set the rules and the burden that the carrier must meet to prevail in its attempt to void the policy.

Applying the jurisdictional rules will help the carrier gauge time, cost, and expense. For instance, is negligent misrepresentation even available in the applicable jurisdiction? Even if it is available, what is the *mens rea* of the applicant that the carrier must prove?

Next, the carrier must determine whether the misrepresentation was material. Aside from relevant case law, the carrier must get its underwriting team involved to analyze its guidelines. At trial, the carrier will have to point to a specific guideline that demonstrates without the subject information or representation from the insured, it would not have issued the policy. That is, the carrier must point to its own guidelines that demonstrate the misrepresentation materially affected the decision to underwrite the risk.

Rescission actions are long and expensive. Despite their determination rests on questions of law that must be decided by the court, the carrier must oftentimes prove the underlying facts that entitle it to rescission. This, of course, involves convincing a jury or a judge that the misrepresented information, if known, would have caused the carrier to refrain from issuing the policy or charging a higher premium. The carrier may also have to prove that the insured intentionally misrepresented facts on the application or alternatively was unreasonably unaware of the requested facts.

Taken together, the jurisdictional rules, what must be proved and to what extent should guide the carrier in anticipating the cost of a rescission action through detailed budgeting. Moreover, these factors must be carefully weighed to determine the strength of a rescission defense.

After the initial emotion is removed from this process and the carrier applies sober analysis to anticipated costs and the chances of prevailing, the best course of action may well be to walk away.