Insurers: To Rescind Or Not to Rescind?

By Akos Swierkiewicz

Rescission of an insurance policy is serious business. Such action could result in serious financial difficulties to insureds, especially if it occurs after a major loss. Furthermore, costly and protracted litigation almost inevitably follows to contest the rescission.

Fortunately, insureds and their brokers can minimize the potential for rescission by simply exercising greater care to ascertain the accuracy of underwriting information, and by providing all material information to insurers. Also, rescission decisions are made by insurers only if they are convinced that they have adequate justification for them.

An insurer may rescind its policy in the event of material misrepresentation or concealment of a fact by the insured. Misrepresentation is false statement of a fact by the insured. Concealment is the neglect to reveal a fact that the insured knows and ought to communicate to the insurer.

Misrepresentation or concealment is material if it affects the underwriting decision of the insurer. For example, the premium would have been higher had the insurer been aware of the true and complete facts.

Property-casualty policies typically include conditions pertaining to the subject of rescission, such as:

• The policy is issued in reliance upon the truth of representations made by the insured.

• The policy is void if the insured intentionally conceals or misrepresents a material fact.

• The insured, by accepting the policy, agrees that the statements in the policy declarations are accurate and complete.

In most cases, rescission is based on materially misrepresented facts in the policy application, or in underwriting information provided by the insured or its broker. However, unless there is a satisfactory answer to each of the following questions, the rescission is not justifiable:

• Is the fact known only to the insured?

If the insurer possesses a fact that differs from what the insured had provided, then it must attempt to reconcile it before proceeding further with consideration of rescission.

• Is it false?

The insurer must have incontrovertible evidence to demonstrate that the fact obtained from the insured is false.

• Is the falsity material?

Materiality is determined within the context of probable and reasonable influence on the insurer by the false fact. Consequently, if the insurer’s underwriting decision is not affected, then the falsity

cannot be deemed material.

• Is it reasonable to rely on it?

The insurer cannot reasonably rely on a fact received from the insured alone if it is aware of a conflicting fact.

• Did the insurer rely on it?

There must be clear evidence to demonstrate that the insurer did rely on materially false facts when making its underwriting decision.

State insurance codes and legal precedents also have an impact on the insurer's decision-making process concerning rescission.

For example, the California Insurance Code allows policy rescission even in cases of unintentional misrepresentation or unintentional concealment, and it provides that materiality is to be determined solely by the probable and reasonable influence of the facts on the insurer.

Also, case law precedent prevents insurers from relying solely on representations contained in the policy application or underwriting information if an inspection of the insured's property is conducted.

A policy may be rescinded even after a loss that would otherwise be covered by the policy. Since rescission could have severe negative financial impact on the insured, the insurer must be certain that the reasons for rescission are based on solid grounds and able to withstand potential legal challenge.

In a 2001 case, an insurer rescinded their policy following a major fire loss, alleging material misrepresentation and concealment by the insured, pertaining to several matters, including square footage of the premises.

The pre-trial discovery proceedings included examination of ambiguous questions contained in the insurer's application form, and the accuracy of the inspection report provided by an independent inspection company retained by the insurer.

Major weaknesses emerged in the insurer's justifications for its decision to rescind the policy, including:

• The insurer previously issued policies for a previous owner, covering the same premises, and therefore it had prior knowledge of the underwriting information, including square footage, which differed from what the insured had provided.

• Just because the square footage information provided by the insured differed from the prior information in the insurer's underwriting files, it was not sufficient for the insurer to conclude that the insured's statement is false, especially since its insurer failed to make any attempt to reconcile the difference.

• The square footage figures provided by the insured and its broker in the application were lower than the figure in the inspection report that was ordered by the insurer after it issued the policy. In asserting materiality, the insurer disregarded another inspection report subsequently ordered by the insured, which confirmed the original figures in the application for the policy.

Based on the above points, it was not reasonable for the insurer to rely on the square footage information provided by the insured, and the insurer's contention that it did rely on the square footage data provided by the insured was questionable.

Although this case was resolved and the insured received payment for its claim, the pre-trial discovery process took over a year, with detrimental financial consequences to the insured.

The lesson from cases like this is that all parties should take thorough measures to ensure the accuracy and completeness of underwriting information, and that conflicts or ambiguities are promptly resolved before coverage is bound.

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