

# Court Rescinds Policy Based on Fraud in Application

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The United States District Court for the District of New Jersey, applying New Jersey law, has granted summary judgment in favor of an insurer, holding that rescission of a professional liability policy was warranted on both legal and equitable grounds because of material misstatements made by the president of the insured company in the insurance application. *TIG Ins. Co. v. Privilege Care Marketing, Inc.*, 2005 WL 994581 (D.N.J. Apr. 27, 2005).

The insurer issued a professional liability policy to a company in the business of promoting the sale of employee benefit plans to small employers. The policy provided coverage to the company as the named insured, as well as to "any partner, director, officer, or employee thereof, while acting within the scope of his duties as such." The president of the company signed the insurance application on behalf of the company and principals of the company. The insurance application contained the following relevant questions: "1. Does any person to be insured have knowledge or information of any act, error, or omission which might reasonably be expected to give rise to a claim against him/her?; 2. after inquiry, have any claims been made against any proposed insured during the past five (5) years?" The policy defined "claim" as "1) a demand in which damages are alleged; or 2) a Wrongful Act that has happened that is likely to result in a demand for damages." The president answered both questions in the negative.

After the policy was issued, the company sought coverage for several claims arising out of the company's issuance of health insurance coverage. The insurer rescinded the policy on the grounds that material misrepresentations were made by the company, which failed to disclose a cease and desist order against the company and one of its principals by the Oklahoma insurance commissioner. In addition, the Colorado Division of Insurance had issued a cease and desist order against two principals of the company for selling unauthorized insurance products. The Washington insurance commissioner similarly issued a cease and desist order against another company and its principals, who were also insureds under the professional liability policy at issue. Moreover, at the time that the application was filed, a civil complaint had been filed against one of the principals of the company.

The court found that rescission was warranted under the facts based on both legal and equitable fraud theories. The court explained that in order to rescind an insurance policy based on the more narrow legal fraud theory, the insurer has to prove that "the insured's application for insurance contained

misrepresentations, which were knowing and material when made with the intention that the other party rely on them, resulting in reliance by that party to its detriment."

Addressing first whether the insured made a knowing misrepresentation, the court examined the company president's negative response to the question of whether any claims had been made against any insured. The court found that the various cease and desist orders did not constitute a claim as that term was defined in the policy. However, the court found that the civil complaint against the company's principal did constitute a claim and therefore that the answer to the question regarding prior claims in the application for insurance was incorrect. The court also found that the sale of insurance without proper licensure, which resulted in the cease and desist orders, clearly constituted "act(s), error(s) or omissions which might reasonably be expected to give rise to a claim," particularly since some of the cease and desist orders extended to individuals, as well as the company.

Next, the court addressed the materiality prong of the test. On this point, the court explained that a misrepresentation is material if it "naturally and reasonably influenced the judgment of the underwriter in making the contract at all, or in estimating the degree or character of the risk, or in fixing the rate of the premium." The court concluded that it was "obvious" on the facts that had the insurer known about the Oklahoma order, as well as the regulatory orders entered against the individual insureds, it would have either refused to insure the company or offered insurance at a higher premium. Therefore, the court found the company's misstatements were material. In determining that the company intended for the insurer to rely on its statements, the court pointed to the president's signed declaration in the application that all statements made in the application were "true" and that he had not "misstated or misrepresented any material facts." The court found that the insurer relied on the company's statements in the application based on a provision in the application that explicitly stated that the insurer "h[as] relied on your representations and warranties in issuing the policy and modifying this policy." Having found all elements of legal fraud were met, the court ordered rescission of the policy based on legal fraud.

The court also addressed the insurer's equitable fraud argument for rescission. The court noted that the difference between the legal and equitable fraud doctrines is that in an equitable fraud claim, the party with the burden need not prove that the other party had knowledge of the falsity of his statements or the intention to gain an undue advantage thereby. Addressing the prior claims question, the court found that, even under the lower standard for equitable fraud, because the cease and desist orders did not rise to the level of a claim, there were no misrepresentations with respect to the president's answer to this question, except for, again, the civil complaint against the principal. Regarding the question concerning act(s), error(s) or omission(s) that might give rise to a claim, the court found that having met the more onerous burden of proving legal fraud, the insurer also demonstrated equitable fraud with respect to the company's misstatements. Accordingly, the court found that the insurer could rescind the policy under both a legal and equitable fraud theory.

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