# Lawyer Insights

## Policy Misrepresentations Carry Insurance Rescission Risks

By Alice Weeks, Cary Steklof and Geoffrey Fehling
Published in Law360 | April 11, 2024



No policyholder wants to hear the word "rescission" in the context of an insurance claim.

The reality, however, is that when policyholders complete applications for insurance, they are typically focused on obtaining the best policy terms for the best rate.

Nuances about question wording, the breadth of the applicant's representations, or how a court may analyze the insurer's questions or the policyholder's answers usually take a back seat to the central importance of placing and renewing coverage at a realistic price.

But once a claim is made, insurers look back at applications to assess the accuracy and completeness of all information received during the underwriting process, especially in signed applications. If the insurer discovers a misrepresentation, it can be used to rescind the policy, leaving the insured with no coverage.

**A Lesson on the Importance of Accuracy in Insurance Applications**

This was the scenario faced by the insured in Medical Mutual Insurance Co. of North Carolina v. Gnik in the U.S. Court of Appeals for the Fourth Circuit on Feb. 16.[1]

A medical clinic hired an employee, who devised a scheme to obtain a position as a treating psychologist despite having no medical license to do so.

Shortly after the employee was hired in 2014, she was investigated by Virginia state regulators following complaints that were made to the regulators that she was practicing psychology without a license. The medical clinic founder was aware of the investigations but not their details, source or scope. Regulators dropped the investigations, and the employee continued working at the clinic as a psychologist treating patients until 2017.

In 2017, the clinic, through its founder, sought professional liability coverage by completing and signing an insurance application stating that none of the clinic's employees had been subject to disciplinary investigation proceedings. Based on the statements in the application, the insurer issued a professional liability policy covering the clinic and its practitioners.

The employee was arrested in 2019 for multiple charges stemming from her dishonesty. At the same time, the clinic and its founder were sued by patients in connection with the unlicensed employee's scheme. The clinic sought coverage under its professional liability policy for the patient suits.

**Policy Misrepresentations Carry Insurance Rescission Risks**
By Alice Weeks, Cary Steklof and Geoffrey Fehling
Published in Law360 | April 11, 2024

The insurer filed a declaratory judgment action against the clinic, its founder and the patients, seeking to rescind the policy based on a material misstatement in the application.

The insurer argued that the response on the application stating that none of the clinic's employees had been subject to disciplinary proceedings was a material misstatement because the employee at issue had been investigated in 2014.

The clinic disputed that the 2014 investigations fell within the scope of the application question about disciplinary proceedings, but the U.S. District Court for the Eastern District of Virginia and ultimately the Fourth Circuit disagreed.

Under Virginia law, the court concluded, an applicant's subjective knowledge of the falsity is irrelevant, so the insurer only needed to show that the representations were false, unless the insured qualified that its answer was to the best of their knowledge or another similar limitation.

Here, the answer to the question at issue was not qualified, unlike other responses in the application, so the insurer was not required to show that the founder knew her representation was false.

The court agreed with the insurer that the "No" answer to that question was false, and that the insurer had established a right to rescind the policy. The court also concluded that the application question's undefined phrase "disciplinary investigate proceedings" was unambiguous and included investigations without a formal hearing or action like what occurred with the 2014 state regulatory inquiries.

**Lessons Learned and Takeaways**

Medical Mutual is a clear example of the far-reaching effects of a misrepresentation on an insurance application. Complete and accurate responses to underwriters are always important to obtaining the best pricing or most favorable coverage at the time of policy placement and at each renewal. But those same best practices are equally important to mitigate the risk of potential rescission defenses.

These defenses can undermine recovery for an otherwise covered loss — sometimes weeks, months or even years into litigation. To make matters worse, rescission claims are typically coupled with a demand for repayment of any defense costs or other monies already paid by the insurer under the rescinded policy.

This can amount to a six- or seven-figure insurer demand that policyholders must address while simultaneously defending the underlying claim for which coverage has been rescinded. Thus, in a worst-case scenario, the policyholder may not only lose coverage for its otherwise covered loss, but it may also need to pay all out-of-pocket costs at the same time, all because of one untruthful answer in the application.

Policyholders can employ several relatively straightforward steps to decrease the risk of rescission:

- First and foremost, ensure that all answers are, to the best of the signer's knowledge, honest.
- Carefully review the insurance application to ensure that responses are complete, accurate and appropriate in light of the specific language used in the application and the questions therein. This could include confirming whether a question asks for information going back two years, or five, or

whether the insured needs to disclose what it may consider to be an informal or inconsequential investigation.

- Determine whether a response needs to be qualified. As noted above, if a response is to the best of the policyholder's knowledge, then the response may need to be qualified as such.

- Identify how statements in applications are likely to be analyzed under governing law. Some states require the insurer to show the insured knew the response was false, whereas others only require that the insurer show the response was false.

Applying these steps can help avoid unexpected and troublesome rescission defenses that threaten to negate all coverage for the very risks against which the policy was intended to protect.

**Notes**

1. Medical Mutual Insurance Company of North Carolina v. Gnik , No. 22-1994 (4th Cir. Feb. 16, 2024).

***S. Alice Weeks*** *is an associate in the firm's Insurance Coverage in the firm's Miami office. She represents corporate policyholders in complex insurance disputes and bad faith litigation with experience in handling hurricane claims, commercial general liability insurance disputes including COVID-19 business interruption claims, and cyber breaches. She can be reached at +1 (305) 810-2554 or aweeks@HuntonAK.com.*

***Cary D. Steklof*** *is counsel in the firm's Insurance Coverage group in the firm's Miami office. With experience in the areas of insurance litigation, insurer bad faith and unfair insurance practices, Cary D. Steklof concentrates his practice on advising policyholders in connection with director and officer, error and omission, cyber, commercial general liability and commercial property insurance policies. He can be reached at +1 (305) 810-2463 or csteklof@HuntonAK.com.*

***Geoffrey B. Fehling*** *is a Boston-based partner in the firm's Insurance Coverage group. Geoff dedicates his practice to helping companies and their directors and officers maximize insurance recoveries, especially in the area of directors and officers (D&O), professional liability, and management liability insurance. He can be reached at +1 (617) 648-2806 or gfehling@HuntonAK.com.*