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Avoiding Rescission of Insurance Coverage: An Insured's Worst Nightmare

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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.

***Medical Mut. Ins. Co. of North Caroline v. Gnik*: A Lesson on the Importance of Accuracy in Insurance Applications**

This was the scenario faced by the insured in *Medical Mutual Insurance Company of North Carolina v. Gnik*, No. 22-1994 (4th Cir. Feb. 16, 2024). 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 investigate 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. 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 district court, and ultimately the Fourth Circuit, disagreed. Under Virginia law, the court concluded that an applicant's subjective knowledge of the falsity is irrelevant, so the insurer needed only show that the representations were false, unless the insured qualified that its answer is 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 the insurer had established a right to rescind the policy. The court also concluded that the application's question 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 & 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 even more critical to fend off potential rescission defenses, which 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 contend while simultaneously defending the underlying claim for which coverage has been rescinded.

Given the outsized impact of rescission defenses, policyholders will benefit from careful review of all aspects of their insurance applications to ensure that responses are complete, accurate, and appropriate in light of the specific language used in the application. This includes understanding (1) the breadth of the signor's representations on behalf of itself and all insureds, (2) whether and how responses should be qualified, and (3) how statements are likely to be analyzed under governing law. Working with brokers and coverage counsel during the underwriting process can help to avoid unexpected and troublesome rescission defenses that threaten to negate coverage for the very risks against which the policy was intended to protect.

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