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NEWSLETTER

Professional Liability Policy Rescinded for Failure to Disclose Existence of Cease and Desist Orders

June 2005

The United States District Court for the District of New Jersey, applying New Jersey law, has granted a professional liability insurer's summary judgment motion seeking rescission of a policy issued to a company because the company's president failed to disclose on the policy application that the insured company and several principals had been the subject of cease and desist orders due to illegal insurance sales practices. *TIG Ins. Co. v. Privilege Care Marketing, Inc.*, 2005 WL 994581 (D.N.J. Apr. 27, 2005).

In February 2002, the insurer issued a professional liability policy to a company that sold employee benefit plans to small employers. In the application for insurance coverage, completed by the company's president, the insured responded in the negative to question 21, which asked whether any person had "knowledge or information of any act, error, or omission which might reasonably be expected to give rise to a claim against him/her?" The company also answered in the negative to question 22, which asked whether "any claims have been made against any proposed insured(s) during the past five (5) years?" The company subsequently sought coverage for six claims arising out of the issuance of health insurance to different individuals. The insurer then filed this action seeking to rescind the policy, alleging that the company had "knowingly misrepresented" information on its application with respect to its answers to questions 21 and 22.

The insurer asserted that the policyholder had failed to disclose on the application that the Oklahoma Insurance Department had issued a cease and desist order prohibiting the company from doing business in Oklahoma. The insurer also alleged that, at the time the application for insurance was completed, other state insurance departments had issued cease and desist orders against individuals who were insureds under the policy because of their conduct while associated with a different company that sold similar benefit plans. The insurer also noted that, in 2001, a complaint had been filed against one of the individual insureds in New Jersey state court.

The district court began its analysis by noting that, under New Jersey law, an insurance contract could be rescinded for either legal fraud or equitable fraud based on the policy application. The court indicated that, under a legal fraud theory, the insurer would have to prove that the insured knowingly made material misrepresentations on the application with the intention that the insurer relied on the misrepresentations to its

detriment.

The court then rejected the insurer's contention that the company's answer to question 22 constituted a misrepresentation because of the existence of the cease and desist order. After reviewing the policy definition of "claim," the court held that a cease and desist order issued by an insurance department did not satisfy the definition. The court determined, however, that the New Jersey state court lawsuit against an individual insured should have been disclosed in response to question 22 and it was not. Accordingly, the court concluded that the answer provided in response to question 22 was incorrect.

The court next concluded that the company's answer to question 21 was a misrepresentation. According to the court, as of February 2002, the company's president was "presumably" aware of the Oklahoma Insurance Department's cease and desist order prohibiting the insured from selling insurance in Oklahoma because it had failed to obtain a license and had not provided employers with all details surrounding the plans. Moreover, as of that date, several of the company's principals were subject to cease and desist orders from illegal selling practices at another company. In the court's opinion, it was "clear" that these actions represented "act(s), error(s) or omission(s) which might reasonably be expected to give rise to a claim" and that should have been disclosed in the response to question 21. In doing so, the court rejected the company's contention that question 21 only referred to acts that occurred while the principals were associated with the corporate entity seeking coverage. Instead, the court noted that question 21 "was focused on conduct that could give rise to claims against any of the individuals proposed as insureds, and was not limited to such conduct under the [corporate insured's] rubric."

The court then found that the company's incorrect responses constituted material misrepresentations. Citing to New Jersey case law in which courts have held that a misrepresentation does not have to render an insured "uninsurable" to be material, the court reasoned that this misrepresentation was material because disclosure of the orders would have alerted the insurer to the "increased risk" associated with the company and the insurer would have either charged a higher premium or refused to insure it. The court also concluded that the insurer had relied on the incorrect responses, citing to language in the policy application to that effect. Accordingly, the court held that it would rescind the policy based upon legal fraud.

Finally, the court addressed whether or not the policy could be rescinded for equitable fraud. Noting that under New Jersey law equitable fraud goes further than legal fraud and that "whatever would be fraudulent at law will be so in equity," the court determined that the insurer was entitled to rescind the policy on that theory as well.

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