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The Misrepresentation Defense Strikes Again

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In May of this year, the United States Court of Appeals for the Second Circuit handed down a decision that illustrates, once again, the effective use by insurers of the misrepresentation defense to void their policies on the basis of a purported failure on the part of a policyholder to disclose pertinent facts relating to the insured risks. The result: no coverage.

The case before the Second Circuit, *Fireman's Fund Insurance Co., et al. v. Great American Insurance Co., et al.*, Case No. 14-1346-cv(L) (May 20, 2016), involved an insurance claim for removal and cleanup costs associated with the sinking of a dry dock in Port Arthur, Texas.[1] The dry dock was owned and operated by Signal International, LLC ("Signal"), and Signal was successful in obtaining coverage for the damage to the dock from its marine liability insurer, Fireman's Fund Insurance Company ("Fireman's Fund"). In turn, Fireman's Fund and Signal sought contribution from Signal's pollution liability and property insurers, Great American Insurance Company of New York ("Great American") and Max Specialty Insurance Company ("MSI"), respectively.[2] At the trial court level, the Southern District of New York granted summary judgment to both Great American and MSI finding that their policies were voidable due to Signal's failure to disclose material information about the condition of the dock at the time of obtaining the policies. More specifically, the District Court held that Great American, under maritime law, could rescind its policy because Signal did not satisfy its duty of "utmost good faith," and MSI's policy, under Mississippi law, was voidable because Signal had made a material misrepresentation. The Second Circuit affirmed the District Court decision, agreeing that both Great American and MSI were entitled to void their policies.

Over the course of Signal's ownership of the dry dock, Signal had received a number of reports regarding its condition, some of which provided a relatively favorable assessment and some of which indicated that the dock was deteriorating and that its lifespan was limited.[3] At the time that Signal purchased its policies, and as part of the application process, it shared some of the more favorable reports with its insurers but did not share the less favorable reports. When Great American and MSI learned through discovery of the existence of the less favorable reports, they thereafter sought to void the policies on the basis that this information was material and should have been disclosed.[4]

The two policies at issue were governed by different law. The MSI property policy was governed by Mississippi law[5] and, under Mississippi law, if an applicant "is found to have made a misstatement of material fact in the application, the insurer that issued a policy based on the false application is entitled to void or rescind the policy."[6] An application that

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[1] Fireman's Fund Ins. Co., et al. v. Great Am. Ins. Co., et al, Nos. 14-1346-cv(L) (2d Cir. 2016).
[2] *Id*.
[3] *See id*. at 8–12.
[4] *Id.* at 17.
[5] *See id.* at 57–63.
[6] *Id*. at 64 (quoting *Carroll v. Metropolitan Ins. & Annuity Co.*, 166 F.3d 802, 805 (5th Cir. 1999)).

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contains "false, incomplete, or misleading answers" is a misrepresentation if those answers are "material to the risk insured against or contemplated by the policy."[7] When making a decision to underwrite a policy, "insurers have the right to rely on the information supplied in the application."[8] Accordingly, materiality and reliance are intertwined. Additionally, Mississippi law allows an insurer to void its policy even if the policyholder's material misrepresentation was made unintentionally or negligently.[9]

The court found that Signal made a material misrepresentation on its application when it included information from only those reports that portrayed the dry dock in a positive condition and withheld the reports that expressed concern regarding the dry dock's state of deterioration.[10] Notably, the court reached this conclusion even though Signal never answered a question untruthfully in its application. It was enough that Signal affirmatively provided information that did not paint a complete picture for its insurer. The court also found that MSI was not required to request further information regarding the dry dock. When Signal affirmatively provided information, it was required to do so in a nonmisleading way and MSI was entitled to rely on Signal's representation.[11] The Second Circuit found that the omitted information was "highly relevant" to the insurers' decisions to underwrite the risks involved[12] and, accordingly, found that the omitted information was material information upon which the insurers would have relied.[13]

Turning to the Great American pollution liability policy, the court first made the threshold determination that the policy was a marine contract and therefore subject to maritime law.[14] The court then applied the maritime law doctrine of *uberrimae fidei, or "utmost good faith."*[15] Derived from the assumption that the insured party is in a better position to know the risks involved, the doctrine of *uberrimae fidei* requires the party seeking insurance to "disclose all circumstances known to it which materially affect the risk."[16] Importantly, the prospective insured must disclose this information whether or not the insurer asks for it.[17] Thus, applicants fail the duty of "utmost good faith" by not disclosing all material facts known to them, even if the insurance company does not ask for the information. Furthermore, a failure to disclose material information allows the insurer to void the policy even if the omission "results from mistake, accident, forgetfulness, or inadvertence."[18] As with the MSI property policy, the court held that Signal had violated its duty of "utmost good faith" by not providing

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[7] *Id*. at 65.

[8] *Id*.

[9] *Id*. at 65–66.

[10] *Id*. at 69–70.

[11] *Id*. at 71–74.

[12] *Id.* at 75.

[13] *Id.* at 74–79.

[14] *See id*. at 22–39. Whether or not an insurance policy will be governed by maritime law depends on the subject matter of the contract. Admiralty jurisdiction exists, and maritime law applies, "where the primary or principal objective of the contract is the establishment of 'policies of marine insurance.'" *Id*. at 24 (quoting *Folksamerica Reinsurance Co. v. Clean Water of N.Y., Inc.*, 413 F.3d 307, 311 (2d Circ. 2005)). Essentially, an insurance policy is marine insurance if the risks assumed by the insurer are marine risks. *Id*. The court found that the primary objective of Signal's policy insuring a dry dock was directly related to maritime commerce and, thus, the policy was a marine contract. *Id*. at 29–39.

[15] *Id*. at 6.

[16] *Id*. at 27 (quoting *Folksamerica*, 413 F.3d at 311). This duty applies to information known at the time of the application as well as to information learned after the application. *Id*. at 27.

[17] *Id*.

[18] *Id*. at 28 (quoting 2 Thomas J. Schoenbaum, *Admiralty and Maritime Law* § 19-14, at 405–06).

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Great American with the additional reports discussing the deterioration and limited lifespan of the dry dock.[19]

One argument made by Fireman's Fund on appeal, and a possible defense to the doctrine of "utmost good faith," was that, even if provided, Great American would not have relied on the undisclosed information.[20] The value of this argument, however, assumes that reliance is an independent requirement of the misrepresentation defense, and that was an issue over which the parties in *Fireman's Fund* disagreed.[21] The Second Circuit determined that it need not decide whether subjective reliance was required in all cases, i.e., whether dealing with a nondisclosure as opposed to a misleading disclosure, because the nondisclosure here was "clearly material" for the very reason that it would have been relied upon by the underwriter.[22] The court also found persuasive the unchallenged testimony of Great American's underwriter that the undisclosed information would have affected her underwriting.[23] Unless presented with strong evidence that the insurer would have issued the policy even if it knew of the undisclosed information, a court is unlikely to accept an insured's speculative argument of lack of reliance. Accordingly, because the undisclosed reports detailing the poor condition of the dry dock were both material and would have been relied upon if disclosed, Great American was entitled to void the policy entirely.

The Second Circuit's decision in *Fireman's Fund* provides several important lessons for policyholders seeking to protect the value of their insurance assets to the fullest. First, when a disputed claim arises and leads to litigation, insurers will bring out all the weapons, or defenses, in their arsenal. When possible, this will include the misrepresentation defense, and insurers will raise this defense even when no facts are immediately apparent that support it. Insurers will then use the discovery process to discover facts that arguably allow them to void the policy. This is precisely what Great American and MSI did when they sought to void their policies "on the ground of misrepresentation ***after discovery revealed*** the various reports on the dry dock's poor condition that Signal had not provided to MIS when applying for the policy."[24] Policyholders can avoid this result if, working with their brokers, they are sensitive, during the policy application process, to the extent of their disclosure obligations and act reasonably in providing relevant information to their insurers.

Second, if coverage is secured for any marine-related risks, insureds should be aware that federal maritime law may govern their policy, even if the policy is not explicitly designated a "marine policy" or otherwise states that maritime law shall apply.[25] Moreover, as seen in *Fireman's Fund*, application of maritime law can present serious coverage challenges for policyholders. In particular, the maritime law doctrine of *uberrimae fidei* imposes a high standard of care that may yield harsh results for unsuspecting policyholders. Although the doctrine arose because insurers often "lack[ed] the practicable means to verify the accuracy or sufficiency of facts provided by the insured"[26] — as where marine vessels to be insured

[19] *Id*. at 40–51.
[20] *Id*. at 41.
[21] *Id.*
[22] *Id.* at 44.
[23] *Id*. at 46.
[24] *Id.* at 17 (emphasis added).
[25] According to the Second Circuit, whether an insurance policy "is marine insurance depends on whether the insurer assumes risks which are marine risks." *Id.* at 24 (quoting *Folksamerica*, 413 F.3d at 316).
[26] *Id.* at 26 (quoting 2 Thomas J. Schoenbaum, *Admiralty and Maritime Law* § 19-14, at 404-05 (5th ed. 2011)).

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were out to sea -- *uberrimae fidei* here worked to Signal's disadvantage by depriving it of coverage for a dry dock that the insurers were capable of inspecting, should they have chosen to do so. Further, as a testament to the low level of proof of reliance that is required (assuming it is required at all), the Second Circuit relied on *ex post facto* testimony provided by the underwriter of the Great American policy — namely, that she "was acting on the understanding that Signal was complying with its duty of utmost good faith" — to find that Great American relied upon the absence of undisclosed, material information concerning the deteriorating condition of the dry dock.[27] The court relied on this testimony notwithstanding that the application of maritime law to the Great American policy was disputed such that the policyholder was not even aware at the time it purchased the policy that it was being held to this high standard of care.

Third, and again depending upon the law governing a particular policy, a policyholder may not be able to rebut an insurer's defense of misrepresentation simply by relying on the fact that the policyholder did not provide any false information to the insurer. In *Fireman's Fund*, the Second Circuit faulted Signal's "selective" production of "only positive information about the dry dock's condition, while failing to disclose the substantial and multiple sources of information in its possession that called these positive reports into question."[28] Again, policyholders and their brokers must exercise care when providing information about the insured risk so as not to unintentionally mislead the insurer regarding the nature of the risk.

Finally, the legal standards underlying a misrepresentation defense vary from state to state and, in Signal's case, even as between civil and maritime law. In some states mere negligence in failing to provide material information is insufficient to void a policy while, in other states, like Mississippi, simple negligence may be all that is required. Accordingly, and assuming that the insurance policy at issue does not contain a governing law provision, if choice of law issues exist with respect to a particular loss, consideration should be given to the differences in misrepresentation defense law as between two or more possibly applicable state laws. When supported by the facts, the policyholder should advocate for the less stringent standard. The coverage outcome may depend upon it.

The misrepresentation defense will continue to be a favorite weapon of insurers when insurance coverage claims lead to litigation, but policyholders can take some comfort from the fact that courts continue to view the voiding of a policy as an extreme remedy that they are generally reluctant to allow. Additionally, the success of the misrepresentation defense is governing law- and fact-dependent, and the results are not a foregone conclusion.

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[27] *Id.* at 46–47.
[28] *Id.* at 73.

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