

By Barry Zalma

GROUNDNS FOR DENYING CLAIMS

Every fraud investigator or lawyer advising an insurer on a potentially fraudulent claim is faced, at the end of an investigation, with the need to determine whether there is sufficient grounds to deny the claim. It is not enough to believe that the insured has committed fraud. It is necessary that sufficient evidence exist to establish, beyond a preponderance of the evidence, that fraud occurred.

Two grounds upon which a denial may be effective are misrepresentation or concealment of a material fact, and false swearing.

Misrepresentation

To constitute fraud, an insured must have concealed or misrepresented a material fact with the intention of inducing an insurer to pay a claim. Because the facts that are deemed to be "material" for purposes of denying claims or voiding policies are not clearly defined, each case must be evaluated separately.

Generally, a fact is material to the application for insurance if it might have influenced a reasonable insurer in deciding whether to accept or reject the risk. See, for example, *Centrust Mortg. Corp. v. PMI Mortgage Insurance*, 800 P. 2d 37 (Arizona 1990), particularly Part II The Claim. Material facts concealed or misrepresented with intent to mislead the insurer are fraud, which, at the option of the insurer, void the policy.

A misrepresentation after a loss as to a single material fact will forfeit the entire insurance contract. An insured cannot commit a small fraud any more than he can be just a little dead. Once caught in a small fraud, the insured cannot demand that he be paid the legitimate part of the claim.

As the following case demonstrates, however, determining misrepresentation is not always straightforward. In *Suggs v. State Farm Fire and Casualty Co.*, 833 F.2d 883 (10th Cir.1987), an initial investigation by an insurer and the state fire marshal concluded that a residential fire was the result of arson. The fire marshal further concluded that it was the insured who had set the fire.

With criminal charges pending, the insured hired experts who concluded that the fire was probably caused by an electrical malfunction. Criminal proceedings were dismissed. Another expert retained by the insurer later concluded that the fire was not of electrical origin, and the insurer denied the insured's fire damage claim on the grounds that the insured had set the fire intentionally. The insured responded by suing for benefits under the policy, as well as for bad faith. A jury found in favor of the insured on both causes of action.

On appeal, the Tenth Circuit reversed the bad faith judgment. The termination of the arson prosecution was found to be immaterial

because the disposition of criminal cases involves different criteria than civil cases. In any event, substantially conflicting evidence existed regarding the nature of the fire. Based on this conflict, the *Suggs* court held that the only reasonable conclusion the jury could have reached was that the insurer had not acted in bad faith. The insurer had good reason to believe that the insured, Suggs, misrepresented facts material to the claim by denying he set the fire. The insurer was unable to convince the jury that the insured lied, but was able to convince the Tenth Circuit Court of Appeal that the denial was made in good faith.

Although this case resulted in a beneficial or partially beneficial verdict on behalf of the insurer, it reveals the need to deal fairly and in good faith with all insureds and especially with insureds suspected of fraud. If the insurer treats the suspected fraud with the utmost good faith, it will avoid unnecessary litigation, will have sufficient facts to deny a claim, and can explain to the insured all of the reasons for the denial.

In some states, such as California and New York, when misrepresentations as to material facts are made in an application for insurance, existence of fraudulent intent to deceive is not essential to the avoidance of the policy. In these states, a policy can be rescinded for an innocent misrepresentation or concealment of a material fact.

In the presentation of a claim, however, the insured's act must have been intended to defraud the insurer. Even a gross overvaluation of a claim will not permit an insurer to deny the entire claim or declare the policy void, unless the insurer can prove that the overvaluation was not an honest mistake.

Courts in different states have difficulty with the concept of fraud and fraudulent intent. In *Auto-Owners Ins. Co. v. Hansen Housing, Inc.*, 604 N.W. 2d 504, 514 (S.D. 2000), the Supreme Court of South Dakota confirmed that exaggerated claims for purposes of gaining advantages in settlement negotiations are considered attempts to defraud, even if insureds do not expect to ultimately obtain more than their actual loss. On the other hand, the court recognized that honest misstatements of fact may occur and that although, as a general rule, fraud and false swearing will void the policy, mere mistakes in stating facts that do not in themselves annul its conditions and do not appear to be willful misrepresentations will not defeat the action. It is up to the jury, with instructions from the court, to determine whether the misrepresentation is a "mere mistake" or an intentional attempt to deceive. The insurer can prove reliance in the application process by showing that it issued a policy based on the insured's fraud that it would not otherwise have issued.

In a Massachusetts case, the court found that an insured furnished insurers with a schedule wherein he "knowingly exaggerated the sound value of the property in order to be in a more advantageous position to be paid for the real loss suffered, but not with the intent to defraud the insurers." The judges held:

When it is established ... that the insured has not only made false statements, even in such a matter as value, for the purpose of influencing the adjustment of the loss, public

policy demands that the contract be so construed as to discourage such conduct and to give full protection to the insurer. (*Gechjian v. Richmond Insurance Co.*, 11 N.E. 2d 478 [Mass. 1937]; and *Bennie Bockser v. Dorchester Mutual Fire*, 1951.MA144, 99 N.E. 2d 640, 327 Mass. 473 [1951].)

Materiality of false statements is not determined by whether the statements deal with subjects later determined to be unimportant. If, for example, false statements are made about factors other than those that caused a loss, the false statements are, nevertheless, material. False sworn statements are material if they might have affected the attitude and action of the insurer. They are equally material if they were calculated to discourage, mislead, or deflect the company's investigation in any area. A fact is material to a claim if it concerns a subject relevant and germane to the insurer's investigation of the claim.

Another element needed to prove the defense of fraud is reliance. The general rule is that an insurer need not suffer detriment or rely on an insured's fraud before being allowed to declare a policy void. If the insurer is deceived and could incur detriment were the deceit successful, this is sufficient to establish the fraud defense. The insurance company need not wait to be damaged when the deceit itself is the proscribed activity, and the stated penalty is forfeiture of all benefits.

The principle that attempted fraud defeats coverage is necessary as a deterrent to would-be fraud perpetrators. Without this protection in place, even more insureds would try fraud, just in case it might be successful and undetected. After all, they would have nothing to lose by trying. The Tenth Circuit, in *American Diver's Supply*, explained as follows:

Moreover, if the law, out of some misgivings about forfeitures, were to require that the insurer demonstrate that it has been misled to its prejudice by the fraud, the policy provision would be virtually worthless and put a premium on dishonest dealings by the assured. For if, by its own investigation, inspired perhaps by suspicions of the assured's efforts to misrepresent, the insurer satisfied itself that a fraud had been attempted and declined to pay, such a rule would mean that the assured's claim would then stand as though no dishonest acts whatsoever had been practiced. *The mendacious assured, surveying the possibilities and contemplating prospective tactics and strategy in the handling of his claim, would sense immediately that, vis a vis himself and the underwriter, there would be no risk at all in his deceit. If it worked, he would have his money and, at worst, could be compelled to disgorge only by affirmative suit by the insurer if the fraud were discovered in time to be legally or practicably effective. If it didn't work (if, before consummation, fraud was detected), he would suffer no disadvantage whatsoever. It would be an everything-to-win, nothing-to-lose proposition.* *Id.*, 892, 893 and *Chaachou v. American Centennial Insurance Company*, 241 F.2d 889 (5th Cir. 1957). (Emphasis added.)

When fraud has been committed, most courts hold that proof of reliance by the insurer is not necessary, as this would encourage

attempts at fraud.

False Swearing

False swearing is a special category of misrepresentation or concealment because it is made under oath. In criminal law, false swearing is called perjury.

In *Mutual of Enumcalw v. Cox*, 757 P.2d 499 (1988), the Washington Supreme Court was asked to interpret a homeowner policy that stated that the entire policy would be void if "(b) There has been fraud or false swearing." Even though the insured's fraud involved only his unscheduled personal property, the court held that the entire policy was void and the insured was not entitled to any recovery. This appears to be the majority position.

An insured's ulterior motive in misrepresenting material facts to the insurer is irrelevant in determining whether a fraud and concealment provision provides a defense to the insured's claim. In the following case, the insured presented a fraudulent vandalism claim for damage caused intentionally by her son. The insured felt compelled to lie as she had been threatened by her son, who had a previous conviction for violent behavior. The California Court of Appeal stated:

First, plaintiff admits that she knew she was lying to the defendant and did so with the intent that defendant not find out the actual facts. Second, under *Claflin*, the intent to defraud the insurer is necessarily implied when the misrepresentation is material and the insured willfully makes it with knowledge of its falsity. Thus, plaintiff's intent to deceive was established as a matter of law *Cummings v. Farmers Ins. Exchange*, 202 Cal. App. 3d 1407, 249 Cal. Rptr. 568 (Cal. App. 2 Dist. 1988).

This conclusion is, in no way, avoided by the plaintiff's contention that the motivation for the false statements was her very reasonable fear of her son. As expressed by the United States Supreme Court in *Claflin*, an insured's ulterior motive in misrepresenting material facts to the insurer is irrelevant. In the context of the *Cummings* case, the plaintiff's Claims motive of fear of her son's violence was irrelevant to the question of whether she intended to deceive the insurer.

It is dangerous for an insurer to assert that an insured committed fraud without sufficient means of proving fraud to a trier of fact. In *DePalma v. Bates County Mutual Ins. Co.*, 923 S.W.2d 385 (Mo. App., 1996), the insurer denied the insured's claim for proceeds of his policy upon the destruction of his house by a fire set by his wife, also an insured on the policy. The insurer's denial was based on a provision in its policy which states:

"If you or any other insured under this policy has intentionally concealed or misrepresented any material fact or circumstance relating to this insurance, whether before or after a loss, then this policy is void as to you or any other insured."

The court held, however, that although the wife had committed arson, causing the destruction of the insured property, neither she nor her husband committed fraud or concealment, which is all that the specific policy language cited by the insurer prohibited.

Conceding that some courts have held that arson is a fraudulent act, the Missouri court explained its reasoning:

Arson does not equate to fraud - something more is needed. To be entitled to summary judgment based upon the fraud and concealment provision, Bates County Mutual was obligated to establish that DePalma or his wife "intentionally concealed or misrepresented" a material fact or circumstance relating to the insurance.

It seems, therefore, that if one wants to be a successful arsonist in Missouri, all one needs do is admit the crime. The insurer was required to pay, even though the person setting the fire went to jail for arson.

A proper defense must relate the specific facts of the claim to pertinent policy language. The law of the jurisdiction in which the claim occurred must be followed to the letter before an insurer contends that an insured has committed fraud. In some cases, this might mean that insurers should consider revising policy wording.

Barry Zalma is an insurance coverage attorney and insurance consultant in California. He can be reached at www.zalma.com.