# Fraud Principles Are Never Gone With The Wind: Insurers' Rights To Recover Claim Payments Made On Uncovered Claims In The Wake Of A Disaster

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First-party insurers responding to a natural or man-made catastrophe – whether it is a hurricane that has destroyed a coast, an earthquake, or a terrorist attack – often face an overwhelming volume of claims to adjust and settle. For many reasons, these insurers' adjusters work hard to resolve these claims as quickly as possible. *See, "Storms May Auger Higher Premiums*," National Mortgage News, Oct. 25, 2004 at 55 (quoting Insurance Information Institute representative that "insurers are doing everything possible to pay claims quickly and expedite the rebuilding process" after four hurricanes in Florida, with over 15,000 company adjusters in the state). For one, it makes good business sense. Also, insurance statutes and regulators encourage speedy settlements in some disaster-prone states. In Florida, for example, state law permits "emergency adjusters," who are not licensed by the state, to adjust claims in the event of a catastrophe, to help speed the process along. *Fla. Stat*. 626.859 (West 2004). Moreover, insurers' employees are human like the victims of the catastrophe, and want to help rebuild the victims' lives wherever and however they can.

Unfortunately, the positive impulse to quickly settle catastrophe claims may run headlong into mankind's negative impulse: an impulse to profit from the chaos and confusion arising out of a disaster. For that reason, insurers trying to settle catastrophe claims at a faster pace than usual can find themselves paying claims that later turn out to be beyond the scope of their coverage obligations.

Insurers could "write off" paid, but uncovered, claims as part of the cost of settling claims quickly and assisting their policyholders in the wake of a catastrophe. Paying such claims, though, can ultimately result in increased premiums for those policyholders with legitimate claims. It is thus in the interests of both insurers and the vast majority of policyholders that insurers take steps to recover sums paid on disaster-related claims which, under later, calmer review, turn out to be uncovered. In this paper, we explore three theories under which an insurer might be able to recover such a payment where the payment resulted from the policyholder's misrepresentations or concealment:

1. As a principle of equity and contract law the payment of claims in the wake of disaster is not a waiver of the insurer's right to deny coverage for uncovered claims -- and, therefore, to seek recovery of payments made on uncovered claims;

2. As an equitable principle, a policyholder's "unclean hands" in some circumstances may prevent him, her or it from arguing that by virtue of settling and paying a claim, an insurer is estopped from seeking reimbursement of that payment when the claim is later discovered to be uncovered; and

3. An insurer has, in many jurisdictions, an independent cause of action for fraud against a policyholder, based upon the principles inherent in the insurance contract.

*Common Insurance Contract Provisions Giving Rise To Reimbursement Litigation*

On occasion, contract provisions relating to fraud or dishonesty may permit recovery of uncovered claims. Commercial first-party insurance contracts very often include a condition providing the entire contract will be void in the event of a policyholder's fraud (the "void-for-fraud condition") such as:

**Concealment, misrepresentation or fraud**.

This [first-party] Coverage Part is void in any case of fraud by you as it relates to this Coverage Part at any time. It is also void if you or any other insured, at any time, intentionally conceal or misrepresent a material fact concerning:

1. This Coverage Part;

2. The Covered Property;

3. Your interest in the Covered Property; or

4. A claim under this Coverage Part.

*ISO Form CP 00 90 07 88 ("Commercial Property Conditions").*

With relevance to catastrophic losses arising out of fire, the standard fire policy similarly provides:

> This entire policy shall be void if, whether before or after a loss, the insured has willfully concealed or misrepresented any material fact or circumstance concerning this insurance or the subject thereof, or the interest of the insured therein, or in case of any fraud or false swearing by the insured relating thereto.

ISO Standard Fire Policy, 1987.

A plain reading of either of these conditions suggests that a policyholder's fraudulent claim "at any time" voids the insurance contract, whether or not the insurer has paid the fraudulent claim. Thus, if a policyholder willfully conceals or misrepresents material facts regarding a claim, this provision may permit the insurer to recover any payment made. In the case of fraud discovered after a payment on a fraudulent claim has been

made, policyholders argue, however, that an insurer can not try to recover the payment because it has waived its right to do so, or is estopped from doing so. As explained below, these arguments are not correct.

*Paying A Claim Is Not A Waiver Of The Insurance Contract's Void-For-Fraud Condition*

After an insurer has paid a claim that turns out, on later investigation, to be uncovered, the policyholder will likely argue it has no obligation to return the payment to the insurer because the insurer waived the right to object. Such an argument should not correct. For example, courts have held the exact opposite in connection with concealment, provided that the policyholder's concealment was material to the insurer's determination to cover the claim. Paying the claim does not waive the insurer's right to seek reimbursement of that payment if fraud is later discovered. For example, in *Mutual of Enumclaw Ins. Co. v. Cox*, 757 P.2d 499 (Wash. 1988), the Washington Supreme Court affirmed a grant of judgment notwithstanding the verdict in favor of an insurer which paid a loss to its policyholder under a homeowner's contract, even where it suspected the policyholder of fraud when it did so. Cox, the policyholder in *Mutual of Enumclaw*, purchased a homeowners' contract which included first-party coverage as well as $137,000 worth of unscheduled personal property coverage for his lake house. After his lake house burned down, Cox submitted a proof of loss form claiming over $320,000 in lost unscheduled personal property.

Mutual of Enumclaw hired a salvor, which found that the ruins of the house contained "no trace of certain items claimed lost." *Id.* at 646. The insurer took Cox's examination under oath, during which he admitted to "making numerous mistakes" on his inventory list. At about the same time, Mutual of Enumclaw paid Cox's lienholders under the building coverage part of the contract, and advanced Cox against his fire loss. Within a month after making many of these payments and taking Cox's EUO, Mutual of Enumclaw filed a declaratory judgment against Cox, asking a Washington State trial court to declare the policy void for fraud. Cox counterclaimed against Mutual of Enumclaw for bad faith and violation of Washington's consumer protection statute.

At trial, the jury found first that Cox committed fraud in listing items on the proof of loss which were not in his lake house when it burned. After that finding, though, the jury proceeded to find that, although Mutual of Enumclaw's partial payments had not waived its right to deny further payments, those same payments estopped the insurer from seeking to void the entire insurance contract and recover its partial payments. The insurer moved for judgment notwithstanding the verdict, arguing that as soon as the jury found fraud on Cox's part, the contract was void because Cox had breached its void-for-fraud condition -- whether or not the insurer had waived its rights, or was estopped, was made irrelevant by virtue of Cox's fraud.

The trial judge agreed, and granted judgment in Mutual of Enumclaw's favor. Cox appealed, arguing that: 1) his fraud was not material enough to breach the void-for-fraud condition in the contract; 2) Mutual of Enumclaw's partial payments under the building coverage part of the contract were not related to his fraud --

which only affected the unscheduled personal property side of the contract; 3) the insurer's partial payments waived its rights to seek to have the contract declared void for fraud; and 4) Cox had relied upon those payments, so the insurer was estopped from now seeking to void the contract.

The appellate court rejected all of Cox's arguments, and affirmed the trial court's entry of judgment in Mutual of Enumclaw's favor. First, the court rejected Cox's argument that his fraud was not material because the amount of his fraudulently claimed loss (over $320,000) well exceeded the $137,000 in coverage available and, therefore, his fraud did not result in Mutual of Enumclaw paying any more than it would have if he had "only" submitted a valid claim. The court rejected this argument, holding that insurers "rely on insureds honestly filling out inventory lists of destroyed property." *Id*. at 650. The court also rejected Cox's argument that his fraud on a personal property claim form could be severed from the building coverage part of his policy.

The court then turned to Cox's waiver argument. Cox argued that Mutual of Enumclaw waived any right to void the contract because it "knew of Cox's false statements by February 1985 [as a result of the salvor's report], but still made partial payments on the policy in [late February and March] 1985." *Id*. Cox further contended the insurer had a duty to tell him it knew of his "misstatements" to avoid waiver by partial payment. The court would not be misled into accepting Cox's argument that Mutual of Enumclaw had a duty to inform Cox of its suspicions, and held the insurer had not waived its right to void the insurance contract. As discussed further below, the court also held Mutual of Enumclaw was not estopped from trying to void the insurance contract after making partial payments on the fraudulent claim.

Other jurisdictions have reached the same conclusion. For example, in *Dale L. Webb v. American Family Mut. Ins. Co.*, 493 N.W.2d 808 (Iowa 1992), the Iowa Supreme Court relied on Mutual of Enumclaw in voiding a homeowners' insurance contract for fraud where the policyholder grossly overstated its losses after a fire. *See also Ofstein v. Nationwide Mut. Ins*. Co., 1999 WL 329642 (Conn. Super). The United States District Court for the Eastern District of Pennsylvania also held that as a matter of Pennsylvania law, an insurer could recover amounts it had paid to a policyholder after a claim later turned out to be fraudulent. *Parasco v. Pacific Indem. Co.*, 920 F.Supp. 647 (E.D. Pa. 1996).

*Mutual of Enumclaw* and these other cases teach that an insurer adjusting claims after a disaster can do so in confidence that it is not waiving its right to void the insurance contract and recover its payment, if its policyholder later turns out to have submitted a claim that would be barred by the concealment provisions. A similar argument should apply as well to other provisions of the contract for insurance.

*Paying A Fraudulent Claim Does Not Estop An Insurer From Recovering The Payment Under The Insurance Contract's Void-For-Fraud Condition*

A policyholder who has been paid on a uncovered claim is likely to argue that the insurer is, by virtue of making the payment, estopped from seeking reimbursement of the payment. While it is frequently made with

the waiver argument, the argument that an insurer is estopped from raising the void-for-fraud condition to recover the payment is actually different: while waiver requires the insurer's relinquishment of a known right, estoppel requires the policyholder to rely, to its own detriment, on an action the insurer has taken. See, e.g., *Albert J Schiff Assoc. v. Flack*, 51 N.Y.2d 84, 87 (1980); *Touchette Corp. v. Merchants Mut. Ins. Co.*, 429 N.Y.S.2d 952 (N. Y. App. Div. 4th Dep't. 1980). Again, cases in the context of concealment should provide some guidance. A policyholder who has been paid for fraudulent claims often argues that in accepting and spending the payment from the insurer, it has relied on the insurer's investigation and judgment -- and would be damaged if forced to return the claim payment.

As with the waiver argument, policyholders' arguments that insurers are estopped from raising the void-for-fraud clause in these situations are usually rejected by courts. Frequently, the estoppel argument is rejected just after the court rejects the waiver argument, and for similar reasons.

The *Mutual of Enumclaw* case discussed above is a good example. In that case, just after rejecting the policyholder's waiver argument, the court used his own fraud to reject his argument that the insurer was estopped from asserting the void-for-fraud condition by virtue of its payment:

> Moreover, a party claiming estoppel must have proceeded in good faith and with "clean hands"... A person may not base a claim of estoppel on conduct, omissions, or representations induced by his own conduct, concealment, or representations, especially when fraudulent. In this case, Cox's fraud led to [the insurer] voiding his insurance policy. Cox did not have clean hands.

*Id*. at 650-51 (internal citations omitted).

In other words, a policyholder who uses fraud to make a payment -- thus setting up the insurer to have to bring a restitution action later -- can not take advantage of estoppel to protect himself and the proceeds of his fraud. *See also Perovich v. Glens Falls Ins. Co*., 401 F.2d 145, 147 (9th Cir. 1968) (where policyholder misrepresented value of stolen property, it is not entiled to a jury instruction that insurer must be found to have believed misrepresentations because "we believe an insurance company may recover money paid in reasonable reliance on an insured's fraudulent claim").

There may be a time limit to this principle, however. In one older Minnesota case, the court held that an insurer could not seek to recover disability payments it had been making to a policyholder when it discovered the policyholder's possible fraud after making the payments for nine years. *Wold v. State Mut. Life Assur Co*., 270 N.W. 150, 153 ("... [d]efendant by its longcontinued conduct determined that liability on its part existed. It cannot at this late date ... more than ten years after receipt of what it concluded to be adequate proofs of loss, deny liability"). *Wold* is likely in a class by itself, given its age, the type of insurance contract at issue in that case, and the extremely long time the insurer waited to raise the issue of fraud. In practical terms, fraudulent

claims are likely to be discovered within a comparatively short amount of time after the claims are paid -- probably once the "dust settles" after the catastrophes, and adjusters have the opportunity to catch up.

*A Defrauded Insurer Can Sue Its Policyholder For Fraud*

Independent common law fraud claims may provide a further basis for reimbursement. The law governing an insurer's cause of action for fraud against its policyholder varies by jurisdiction. In California, for some time an insurer's fraud action was confused with an insurer's defense of "reverse bad faith." However, in *Kransco v. American Empire Surpllus Lines Ins. Co.*, 2 P.3d 1 (Cal. 2000), the California Supreme Court, while rejecting an insurer's "reverse bad faith" and comparative bad faith claims against its policyholder, clarified that "an insured's fraudulent misconduct is separately actionable and can give rise to tort damages." *Id*. at 14. *See also Agricultural Ins. Co. v. Superior Court*, 82 Cal.Rptr.2d 594, 602-605 (Ct. App. 2d Dist. 1999). Other states have long recognized that an insurer can bring a fraud action against its policyholder after it has paid on a claim it later discovers was fraudulent. *See, e.g., Sterling Ins. Co. v. Chase*, 731 N.Y.S.2d 778 (N.Y. App. Div. 3rd Dep't. 1999).

*Conclusion*

First-party insurers facing a deluge of claims in the wake of a catastrophe should focus first on doing what they do best: settling reasonable, covered claims with their policyholders. Basic principles of equity and contract law -- waiver, estoppel and fraud -- should remain available to protect the carrier. An insurer that discovers it has paid an uncovered claim may be able to use those principles to seek to recover what it paid.

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Lon Berk is a partner in Shaw Pittman's insurance coverage and litigation groups. Mr. Berk has particular experience with insurance coverage and other insurance-related matters, including first-party property, general liability, errors and omissions and fidelity coverages. He was the lead trial lawyer representing St. Paul Fire and Marine Insurance Company in *SR International Business Insurance Co., Ltd. V. World Trade Center Properties, LLC,* 222 F. Supp. 2d 985 (S.D.N.Y.), *aff'd*, 345 F.3d 154 (2d Cir. 2003). He has assisted in the handling of numerous property insurance claims relating to the September 11 al Qaeda attack as well as other complex first-party property and business interruption claims.
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