North Carolina

By William Bulfer, Brian Love and Courtney Britt

What is the required procedure for seeking rescission? If there is no required procedure, what are the acceptable or customary procedures for rescission?

Under North Carolina law, an insurer may avoid its obligation under the insurance contract "by showing that the insured made representations in his application that were material and false." *Bell v. Nationwide Ins. Co.*, 146 N.C. App. 725, 726, 554 S.E.2d 399, 401 (2001). When the terms of an insurance policy are clear and unambiguous, an insurer has a right of rescission if its insured made fraudulent misrepresentations in his policy application. *See Swain v. C & N Evans Trucking Co., Inc.*, 126 N.C. App. 332, 484 S.E.2d 845 (1997); *see also* N.C. Gen. Stat. §58-3-10 (2007) (providing that fraudulent misrepresentations in an insurance policy application may prevent recovery).

The accepted mechanism for seeking rescission in North Carolina is to file a declaratory judgment action. Declaratory relief can be sought through North Carolina's declaratory judgment statute, N.C. Gen. Stat. §1-254, or the federal statutes, 28 U.S.C. §2201 *et. seq.* Rescission can also be an affirmative defense to a breach of contract or declaratory relief claim.

What must an insurer prove to be entitled to rescind a policy?

Is it required that the insured have committed an intentional or fraudulent misrepresentation on the application? Or is it sufficient that there was a material misrepresentation, regardless of intent?

False statements will avoid a policy if fraudulently made, irrespective of materiality; however, absent fraud, the falsity of an applicant's answer must be material to the risk in order to warrant avoidance of the policy on that ground. *Tharrington v. Sturdivant Life Ins. Co.*, 115 N.C. App. 123, 127, 443 S.E.2d 797, 800 (1994). An insurance contract may be avoided by showing that the insured made representations which were material and false. *Hardy v. Integon Life Ins. Corp.* 85 N.C. App. 575, 355 S.E.2d 241, disc. rev. denied, 320 N.C. 631, 360 S.E.2d 85 (1987).

To prevail on the affirmative defense of misrepresentation, the insurer must prove the insured made statements that were: (1) false, (2) material, and (3) knowingly and willfully made. *Bryant v. Nationwide Mut. Fire Ins. Co.*, 313 N.C. 362, 370, 329 S.E.2d 333, 338 (1985). Even where false answers are inserted in the application by an agent through mistake, negligence, or fraud, an insured can avoid responsibility for the false statements "only if [the insured] is justifiably ignorant of the untrue answers, has no actual or implied knowledge thereof, and has been guilty of no bad faith or fraud." *Jones v. Home Security Life Ins. Co.*, 254 N.C. 407, 413, 119 S.E.2d 215, 219–20 (1961) (emphasis in original).

Under N.C. Gen. Stat. §58-3-10, "all statements or descriptions in any application for a policy of insurance, or in the policy itself, shall be deemed representations and not warranties, and a representation, unless material or fraudulent, will not prevent a recovery on the policy."

Is there a separate requisite showing of reliance by the insurer, or is reliance presumed if materiality is found?

The insurer has the burden of proving a misrepresentation as an affirmative defense to the enforcement of an insurance contract. *Bryant*, 313 N.C. at 369, 329 S.E.2d at 338. It is a basic principle of insurance law that the insurer may avoid its obligation under the insurance contract by a showing that the insured made representations in the application that were material and false. *Tolbert v. Mut. Benefit Life Ins. Co.*, 236 N.C.

416, 72 S.E.2d 915 (1952); *Willetts v. Integon Life Ins. Corp.*, 45 N.C. App. 424, 263 S.E.2d 300, disc. rev. denied, 300 N.C. 562, 270 S.E.2d 116 (1980).

A representation in an application for an insurance policy is material "if the knowledge or ignorance of it would naturally influence the judgment of the insurer in making the contract, or in estimating the degree and character of the risk, or in fixing the rate of premium." *Goodwin v. Investors Life Ins. Co. of North America*, 332 N.C. 326, 331, 419 S.E.2d 766, 769 (1992)(emphasis omitted).

While materiality is generally a question of fact, *Michael v. St. Paul Fire and Marine Ins. Co.*, 65 N.C. App. 50, 308 S.E.2d 727 (1983), in an application for a life insurance policy, written questions and answers relating to health are deemed material as a matter of law. *See Rhinehardt v. N.C. Mut. Life Ins. Co.*, 254 N.C. 671, 119 S.E.2d 614 (1961); *see also Jones v. Home Security Life Ins. Co.*, 254 N.C. 407, 119 S.E.2d 215 (1961); *Thomas–Yelverton Co. v. State Capital Life Ins. Co.*, 238 N.C. 278, 77 S.E.2d 692 (1953); *Equitable Life Assur. Soc'y of U.S. v. Ashby*, 215 N.C. 280, 1 S.E.2d 830 (1939); *Inman v. Sovereign Camp, W.O.W.*, 211 N.C. 179, 189 S.E 496 (1937); *Gardner v. N. State Mut. Life Ins. Co.*, 163 N.C. 367, 79 S.E. 806 (1913). While there is no authority for this proposition outside of the life insurance context, an analogous argument can be made with respect to other types of insurance coverage.

With regard to life insurance, accident insurance, and other such policies, does your jurisdiction recognize that the policy becomes "incontestable" after a certain period of time? And must an insurer, in turn, prove fraud to rescind the policy?

North Carolina courts follow the rule that "a life insurance policy containing a provision that it shall be incontestable after a specified time cannot thereafter be contested by the insurer on any ground not excepted from the incontestability provision." *Am. Trust Co. v. Life Ins. Co. of Va.*, 173 N.C. 558, 92 S.E. 706 (1917). North Carolina courts also hold that "if the contestable period has run the insurer may not assert any defense barred by the incontestability clause, whether such defense arose out of the original contract or out of the application for reinstatement." *Chavis v. Southern Life Ins. Co.*, 318 N.C. 259, 263, 347 S.E.2d 425, 428 (1986).

Can an insurer rescind based on the insured's failure to volunteer material information that was not requested by the application? That is, does the insured have a duty to volunteer material information?

The elements of fraud in the inducement supporting a fraudulent misrepresentation defense to the enforcement of a contract are: (1) a false representation or concealment of a material fact; (2) reasonably calculated to deceive; (3) made with the intent to deceive; (4) that does in fact deceive; and (5) results in damage to the injured party. *Whisnant v. Carolina Farm Credit*, 204 N.C. App. 84, 94 693 S.E.2d 149, 157 (2010). While the issue of an affirmative duty has not been specifically addressed by North Carolina courts, the "reasonably calculated to deceive" element of fraud in the inducement may serve as an argument for rescission where the insured's failure was to volunteer rather than to provide requested information. Rescission may be available regardless of whether the information was specifically requested.

If your jurisdiction requires a showing that misrepresentations be material, what constitutes materiality? Does there need to be some sort of causal nexus between the misrepresentation and ultimate loss?

The determining factor regarding materiality and the causal nexus between a misrepresentation and ultimate loss is whether the misrepresentation would have influenced the insurer in deciding the important question of accepting the risk, and what rate of premium should be charged. A misrepresentation is material "if the knowledge or ignorance of it would naturally influence the judgment of the insurer in making the contract, or in estimating the degree and character of the risk, or in fixing the rate of premium." *Tolbert*, 236 N.C. at 418-19, 72 S.E.2d at 917.

What types of proof can or must an insurer rely on to seek rescission?

North Carolina utilizes a subjective standard for evaluating evidence of materiality, recognizing that some businesses are more risk adverse than others. Given this subjective standard, an insurer should be

prepared to address the *Tolbert* standard set forth above with evidence of how its particular underwriting practices are influenced by the insured's representations. *Goodwin*, 332 N.C. at 331, 419 S.E.2d at 769.

Does an actionable misrepresentation in a policy application render the policy voidable or void *ab initio*?

Rescission is available at the insurer's option by a showing that the insured made representations in his application that were material and false. *Pittman v. First Protection Life Ins. Co.*, 72 N.C. App. 428, 433, 325 S.E.2d 287, 291 (1985). Misrepresentations on an insurance application are material if "the knowledge or ignorance of it would naturally influence the judgment of the insurer in making the contract and accepting the risk." *Bryant*, 67 N.C. App. at 621, 313 S.E.2d at 807.

Upon a showing of the requisite elements of rescission, is rescission effective as to innocent insureds and third-parties?

North Carolina courts have yet to address this precise issue. Though not in the insurance context, it has been held that a subcontractor's lender could not recover as third-party beneficiary of a modified contract between the subcontractor and contractor to make checks for amounts due the subcontractor payable jointly to the subcontractor and the lender where the modification was not valid and enforceable because it was not supported by new consideration. *Lee v. Paragon Grp. Contractors, Inc.*, 78 N.C. App. 334, 337 S.E.2d 132 (1985). An analogous argument could be made with regard to insurance.

Are there any statutory or regulatory time limits on seeking rescission of a policy? If so, does the statutory or regulatory language override or supersede express policy language allowing for rescission beyond the time limitation?

N.C. Gen. Stat. §58-51-15 requires certain accident and health insurance policies delivered in the State of North Carolina to contain a provision entitled, "Time Limit on Certain Defenses." The mandatory form of this provision states, among other things, that after two years from the date of issue or reinstatement of the policy, "no misstatements except fraudulent misstatements made by the applicant in the application for such policy shall be used to void the policy or deny a claim … commencing after the expiration of such two-year period." This provision "may be used in its entirety only in major or catastrophe hospitalization policies and major medical policies" affording $5,000 or more in coverage for any one sickness or injury; disability income policies affording $100.00 or more per month in coverage for not less than one year; and franchise policies. The statute goes on to state that other policies to which the statute applies "must delete the words 'except fraudulent misstatements.'"

In addition, N.C. Gen. Stat. §58-58-22 mandates the inclusion of the following language similar to the following in every life insurance policy issued in North Carolina: "A provision that the validity of the policy shall not be contested, except for nonpayment of premium, once it has been in force for two years after its date of issue; and that no statement made by any person insured under the policy about that person's insurability shall be used during the person's lifetime to contest the validity of the policy after the insurance has been in force for two years." Such language is required to be included as part of any policy issued in the state and thus overrides any language to the contrary.

What is the requirement for an insurer to be considered to have waived its right to rescind the policy, and what other equitable defenses are available to insureds?

Does an insurer need to have actual knowledge that the insured has made a misrepresentation, or will constructive knowledge be sufficient?

Although an insurer may avoid liability where there has been a material misrepresentation on the part of the insured, it cannot avoid liability on a policy on the basis of facts known to it at the inception of the policy. *Cox v. Equitable Life Assur. Soc'y of the U.S.*,

209 N.C. 778, 185 S.E. 12 (1936). *See also Hardy*, 85 N.C. App. at 575, 355 S.E.2d at 241.

In *Gouldin v. Inter-Ocean Insurance Co.*, 248 N.C. 161, 102 S.E.2d 846 (1958), the court further defined the law of waiver and estoppel as it applies to insurance contracts as follows:

> In general, any act, declaration, or course of dealing by the insurer, with knowledge of the facts constituting a cause of forfeiture … which recognizes and treats the policy as still in force and leads the person insured to regard himself as still protected thereby will amount to a waiver of the forfeiture … and will estop the insurer from insisting on the forfeiture or setting up the same as a defense when sued for a subsequent loss. Such waiver may be inferred from acts as well as from words. Acts of an insurance company in recognizing a policy as a valid and subsisting contract, and inducing the insured to act in that belief and incur trouble or expense, is a waiver of the condition under which the forfeiture arose.

Will an insurer be estopped from rescinding the policy if it waits too long to do so after acquiring actual or constructive knowledge of the misrepresentation?

There is no North Carolina case law which specifically provides for estoppel where an insurer waits too long after acquiring actual or constructive knowledge; however, waiver and estoppel may overcome a material misrepresentation, and such a question is for a jury to resolve. *Cullen v. Valley Forge Life Ins. Co.*, 161 N.C. App. 570, 589 S.E.2d 423, 428 (2003); *Colony Ins. Co. v. Peterson*, 582 F. App'x 156, 164 (4th Cir. (N.C.) 2014). Given that it is an issue for the jury and is, as of yet, unsettled, there remains a possibility that estoppel can be successfully argued under such circumstances.

Additionally, it should be noted that, absent fraud or collusion, knowledge acquired by an agent while acting within the scope of his authority is imputed to the principal. *Thomas-Yelverton Co.*, 238 N.C. at 278, 77 S.E.2d at 692. As such, the knowledge of an agent of a particular insurer of information giving rise to a rescission claim may serve as the basis for an affirmative defense to such an action.

Although an insurer may avoid liability where there has been a material misrepresentation on the part of insured, it cannot avoid liability on a policy on the basis of facts known to it at the inception of the policy. *Cox*, 209 N.C. at 778, 185 S.E. at 12.

When is an insurer required to investigate application answers? If an insurer is so required, does the duty extend only to "easily ascertainable" fraud, or does it go further?

The extent to which an insurer is required to investigate application answers is unsettled in North Carolina. No case law addresses the issue, but language in cases such as *Hardy*, *supra* suggests some investigation may be required. The *Hardy* decision charges the insurer not only with known facts, but also with knowledge of facts which the insurer should have. *Id.* at 582, 355 S.E.2d at 245 (internal quotations omitted). Though the level of required investigation is not explained by *Hardy*, the decision does suggest that some level of investigation, at least with regard to easily ascertainable information, would be required.

If the insured intentionally made the misrepresentation or otherwise acted in bad faith, can there be any waiver by the insurer at all?

Even material misrepresentations in applications for insurance do not void the policy if the insurer knew the facts surrounding the misrepresentations at the time it accepted the application and issued its policy. "It is well settled that an insurance company cannot avoid liability on a policy issued by it by reason of any facts which were known to it at the time the policy was delivered, and that any knowledge of an agent or representative, while acting in the scope of the powers entrusted to him, will, in the absence of fraud or collusion between the insured and the agent or representative, be imputed to the company, though the policy contains a stipulation to the contrary." *Cox*, 209 N.C. at 782, 185 S.E. at 15; *see also*, *Heilig v. Home Security Life Ins. Co.*, 222 N.C. 231, 233, 22 S.E.2d 429, 431 (1942); *Smith v. New York Life Ins. Co.*, 208 N.C. 99, 102, 179 S.E. 457, 459 (1935); *Short v. La Fayette Life Ins. Co.*, 194 N.C. 649, 650, 140 S.E. 302, 303 (1927*); Nat'l Life Ins. Co. v. Grady*, 185 N.C. 348, 353, 117 S.E. 289, 291 (1923); 7 *Strong's N.C. Index* 3d, Insurance §19.1 (1977).

Under what circumstances must an insurer refund the premiums to the insured when rescinding a policy, and when must the refund be dispensed? Does the insurer have to refund the premiums even in situations where the insured procured the policy through willful fraud?

There is no controlling law in North Carolina on the circumstances under which premium must be refunded or the timing of such a refund. It is likely that North Carolina courts would require an insurer to refund the policy premium in the event the insurer elects to rescind the policy. *See Latta v. Farmers Cty. Mut. Fire Ins. Co.*, 67 N.C. App. 494, 313 S.E.2d 214 (1984) (holding an insurer must return premiums where, without fault or fraud by insured, no risk to insurer ever attaches under the policy; in such a case, premiums have been paid under a consideration which has failed).

Are there any other notable cases or issues regarding an insurer's right and ability to rescind?

An insurer "that denies coverage or rescinds the policy in bad faith risks liability for that action." *United Capitol Ins. Co. v. Kapiloff*, 155 F.3d 488,497 (4th Cir. 1998). North Carolina adheres to a nearly identical rule. *See Robinson v. N.C. Farm Bureau Ins. Co.*, 86 N.C. App. 44, 356 S.E.2d 392, 395 (1987) (vacating summary judgment for the defendant insurer and stating, "An insurance company is expected to deal fairly and in good faith with its policyholders."); *see also Thomas v. Ray,* 69 N.C. App. 412, 317 S.E.2d 53, 57 (1984).

The language of the policy determines the coverage—and, therefore, the insurer's liability—in the event of a loss that occurs following late or irregular reporting. North Carolina law on the doctrines of waiver and estoppel are not available to broaden the coverage of a policy so as to protect the insured against risks not included therein or expressly excluded from coverage. *Hannah v. Nationwide Mut. Fire Ins. Co.*, 190 N.C. App. 626, 631, 660 S.E.2d 600, 604 (2008).

"Knowledge of facts which the insurer has or should have had constitutes notice of whatever an inquiry would have disclosed and is binding on the insurer. The rule applies to insurance companies that whatever puts a person on inquiry amounts in law to notice of such facts as an inquiry pursued with ordinary diligence and understanding would have disclosed." *Hardy*, 85 N.C. App. at 582, 355 S.E.2d at 245 (internal quotations omitted).

False statements will avoid a policy if fraudulently made, irrespective of materiality; however, absent fraud, the falsity of an applicant's answer must be material to the risk in order to warrant avoidance of the policy on that ground. *See 43 Am.Jur.2d, Insuranc*e, §§1035, 1036, 1055 (1982). If fraud is not claimed, the two-part question is whether the insured has proven a material and false representation on the application. A life insurance contract may be avoided by showing that the insured made representations which were material and false. *Hardy*, 85 N.C. App. at 575, 355 S.E.2d at 241; *see also Tharrington,* 115 N.C. App. at 127, 443 S.E.2d at 800.

If the insurer has knowledge of all pertinent facts and if reasonable inquiry would reveal no other information exists, then the insurer waives the right to assert provisions in the insurance contract permitting the insurer to avoid coverage by acting inconsistently with the intent to enforce those provisions. *Cullen*, 161 N.C. App. at 576, 589 S.E.2d at 429.

By signing an insurance application, a plaintiff represents that she read the application "and that the information contained therein [is] true." *Goodwin*, 332 N.C. at 331, 419 S.E.2d at 768. Indeed, "[t]he law presumes that the [insured] knew the contents of the application she signed …" *Id*. Accordingly, "[a]ny false statements contained in the application [are] imputed to the insured and not the insurer." *Ward v. Durham Life Ins. Co.*, 90 N.C.App. 286, 291, 368 S.E.2d 391, 394 (1988). Even where false answers are inserted in the application by the agent through mistake, negligence, or fraud, an insured can avoid responsibility for the false statements "'only if [she] is justifiably ignorant of the untrue answers, has no actual or implied knowledge thereof, and has been guilty of no bad faith or fraud.'" *Goodwin*, 332 N.C. at 330, 419 S.E.2d at 768 (quoting Jones, 254 N.C. at 413, 119 S.E.2d at 219–20).

It is well established "that one who signs a written instrument, without being induced thereto through fraud or deception, cannot avoid its effect on the ground that at the time [she] signed the paper [she]

did not read it or know its contents …" *Harrison v. Southern Ry. Co.*, 229 N.C. 92, 95, 47 S.E.2d 698, 700 (1948). Unless prevented from doing so, a plaintiff has "[t]he duty to read an instrument or to have it read before signing it." *Id*. The duty to read "is a positive one, and the failure to do so, in the absence of any mistake, fraud or oppression, is a circumstance against which no relief may be had, either at law or in equity." *Id*.

"If reformation be sought solely on the ground of mistake, it must appear that the mistake was mutual and common to both parties. A court cannot create for the parties a contract which they did not both intend to make. A mistake on one side may be ground for rescinding, but not for reforming, a contract." *Floars v. Aetna Life Ins. Co.*, 144 N.C. 232, 56 S.E. 915, 917 (1907). The insurer may avoid its obligation under the insurance contract by a showing that the insured made representations in his application that were material and false. *Tolbert*, 236 N.C. at 416, 72 S.E.2d at 915. Representations made in an insurance application regarding the health of the applicant are material as a matter of law. *Sims v. Liberty Mut. Ins. Co.*, 257 N.C. 32, 125 S.E.2d 362 (1962); *Eubanks v. First Protection Life Ins. Co.*, 44 N.C. App. 224, 261 S.E.2d 28 (1979) disc. rev. denied, 299 N.C. 735, 267 S.E.2d 661 (1980). It is not necessary that the representation be intentional. *Huffman v. State Capitol Life Ins. Co.*, 8 N.C. App. 186, 174 S.E.2d 17 (1970).

There are also some statutory restrictions which can limit the scope of rescission. In *Odum v. Nationwide Mut. Ins. Co.*, 101 N.C. App. 627, 401 S.E.2d 87 (1991), because the coverage amounts in the policy at issue were greater than the statutory minimum, the court held "that as to any coverage in excess of the statutory minimum, the insurer [was] not precluded by statute or public policy from asserting the defense of fraud." *Id*. at 635, 401 S.E.2d at 92. Also, in *Hartford Underwriters Ins. Co. v. Becks*, 123 N.C. App. 489, 494, 473 S.E.2d 427, 430 (1996), the court held the insurer was not precluded from seeking to avoid a claim for UIM coverage where the insureds fraudulently misrepresented or concealed material facts concerning their state of residence on which the insurance company reasonably relied in providing coverage.

AUTHORS

William Bulfer is a partner in Teague Campbell's Asheville, North Carolina office. His practice is focused mainly on both coverage and liability matters. He regularly provides coverage opinions, prosecutes and defends declaratory judgment actions, and provides legal advice on and input with regard to the creation and modification of coverage documents on behalf of insurers, including the drafting of cutting edge policies, including cyber-liability coverage and drone coverage forms. Bill's liability practice focuses on complex matters, including wrongful death, products liability, and professional liability claims.

Teague, Campbell, Dennis & Gorham LLP | 828.254.4515 | wbulfer@teaguecampbell.com

Courtney Britt is a partner in Teague Campbell's Raleigh office. She defends businesses and municipalities in insurance coverage and bad faith litigation as well as complex workers' compensation matters. Her insurance coverage practice focuses on evaluating first party property, general liability, business auto, workers' compensation, excess, and umbrella insurance contracts. She provides coverage opinions, drafts reservation of rights letters, prosecutes and defends declaratory judgment actions, and acts as monitoring counsel.

Teague, Campbell, Dennis & Gorham LLP | 828.254.4515 | cbritt@teaguecampbell.com

Brian Love is an associate in Teague Campbell's Raleigh office. His practice involves civil litigation and insurance coverage issues. Brian has a diverse coverage practice and has provided first and third party coverage opinions, prosecuted and defended declaratory judgment actions and has defended bad faith and other extra contractual liability claims. Brian has also provided legal advice on the creation and modification of coverage forms and endorsements.

Teague, Campbell, Dennis & Gorham LLP | 828.254.4515 | blove@teaguecampbell.com