APR - ALTERNATIVE MARKETS

DEDICATED TO PUBLIC ENTITY

LESSONS FROM LOSSES – THE IMPACT OF A MATERIAL MISREPRESENTATION

"The only mistake in life is the lesson not learned."— Albert Einstein

DESCRIPTION

A public entity sought to replace current excess coverage. Working through their broker, the City submitted the desired carrier's application attached to the loss run. The underwriter diligently reviewed all details of the application and the open claims inventory. The loss run was six months old. The account premium was quoted subject to receipt of currently valued (valued within 90 days of the policy inception) loss runs.

The broker asked to bind the policy on the effective date and stated that there had not been any changes in the claims history. The broker promised to forward current loss runs immediately. The policy was bound based on the broker's assurances. One month later, after repeated requests, the broker provided the updated loss runs. A claim that had been reserved for $50,000 on the outdated loss run settled for $10 million.

THE RESULT

When the underwriter noticed the change in the loss experience, she notified the carrier. The carrier elected to cancel coverage, citing a "material misrepresentation" in the loss experience. Specifically: (1) the claim against the prior policy was not accurately disclosed; (2) the probable settlement cost was or should have been made known to the City; and (3) had the carrier been aware of the actual loss exposure, they would have either declined to write the policy or charged a premium reflective of the insured's claim experience.

The City received a 60-day notice of cancellation and was obliged to seek coverage with an alternate carrier on short notice.

THE PROBLEM

A "material misrepresentation" is a false statement, including failure to disclose and concealment. The facts misrepresented must be pertinent (in this case, the loss history) to the underwriting decision process, and the underwriter must have relied on the information so that if the carrier would have known, they would have either refused to write the policy or written it under different terms, conditions, or charged a different premium.

Insurance codes established by each state define the elements of material representation and recourse. Most states have codified insurance fraud regulations that require mandatory state reporting of suspected fraud. Many states levy fines, penalties, or criminal charges related to fraudulent acts. Although some states require "intent" to deceive to prove fraud, the majority do not. Note that the consequences of material misrepresentations may be expanded to include the agent or broker, depending on the statute.

If a material misrepresentation is discovered, a carrier may elect to cancel or rescind the policy.

- Cancellation involves a notice to extend coverage for a time certain, at which the policy will terminate. After the policy is canceled, the carrier will return a prorated portion of the premium.
- Policy rescission is the carrier's ability to return the premium and rescind the policy as if it never existed. In a policy rescission, claims incurred during that period between policy inception and policy rescission would not be covered by the policy.

LESSONS LEARNED

- Underwriters rely on loss runs to accurately depict the frequency and severity of the insured's claim history. This is vitally important in adequately pricing the risk.
- Underwriters are only allowed to quote and bind risks that are within their underwriting authority. Failure to adhere to their underwriting authority can result in loss of authority or termination.
- Historical loss experience above a specific loss ratio typically triggers an underwriting referral to the insurance carrier. When an account is referred, the carrier retains the right to determine the terms, conditions, and premium of the quote.
- The loss information must be current and accurate. Ensure all related parties including the TPA, risk manager, insurance manager, and defense counsel have properly evaluated and set the ultimate probable loss amount of all open claims before submitting the claim history as part of the underwriting submission.
- Review the application prior to signing. Ensure that the application is complete and that all questions are answered accurately.
- The authorizing signature is responsible for the verity of the application, whether completed internally or through the agent or broker.

Note: Although the statements above are based on an actual loss, some of the facts may have been altered for the purpose of illustration and education.

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