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Against Insurance Rescission

ABSTRACT. This Note argues that rescission—the traditional remedy for innocent misrepresentations on insurance applications—systematically overcompensates insurance companies. In short, rescission allows insurers to refuse benefits to people who make innocent misrepresentations and suffer losses even while retaining the premiums of similarly situated people who never file claims. The principles of contract law do not compel this result, and courts have made insurance law doctrine less coherent in an effort to avoid it. Given the problems that rescission creates in the innocent misrepresentation context, this Note proposes an alternative remedy called “actuarially fair reformation.” Actuarially fair reformation would avoid rescission’s market-distorting inefficiencies by awarding misrepresenting insureds the amount of insurance that their premiums could have financed.

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INTRODUCTION

Equity abhors a forfeiture,¹ yet in most states the law approves a forfeiture when someone makes an innocent misrepresentation on his insurance application. In such cases courts usually rescind the insurance contract at the option of the insurer. Thus, an insured can answer the questions on his application in good faith, faithfully pay his premiums, and act in reliance on the validity of the insurance contract only to discover after suffering a loss that he is not insured after all. This is a harsh result.

Rescission's severity is as obvious to insurance scholars as it is to anyone else,² so it is surprising that no one has undertaken a comprehensive critique of the traditional remedy. The dearth of scholarship on this subject is all the more surprising given that misrepresentations are "the most litigated issue in life insurance"³ and are extremely important to other types of insurance as well.⁴ This Note aims to fill this gap by criticizing the use of rescission as the remedy for innocent misrepresentations and proposing an alternative remedy called "actuarially fair reformation." I argue that rescission is inefficient, incompatible

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1. See Lynn M. LoPucki, *Legal Culture, Legal Strategy, and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498, 1525 n.132 (1996).
 2. See Eugene R. Anderson, Richard G. Tuttle & Susannah Crego, *Draconian Forfeitures of Insurance: Commonplace, Indefensible, and Unnecessary*, 65 FORDHAM L. REV. 825, 845 (1996); Bob Works, *Excusing Nonoccurrence of Insurance Policy Conditions in Order To Avoid Disproportionate Forfeiture: Claims-Made Formats as a Test Case*, 5 CONN. INS. L.J. 505, 585 (1999); Thomas R. Foley, Note, *Insurers' Misrepresentation Defense: The Need for a Knowledge Element*, 67 S. CAL. L. REV. 659, 659 (1994).
 3. 28 BERTRAM HARNETT & IRVING I. LESNICK, APPLEMAN ON INSURANCE 2D § 176, at 221 (1996).
 4. See KENNETH H. YORK, JOHN W. WHELAN & LEO P. MARTINEZ, GENERAL PRACTICE INSURANCE LAW 108 (3d ed. 1994) (noting the frequency of misrepresentation litigation and that in these cases "a good deal of money and important personal and public interests are at stake"). Litigation over misrepresentations can arise for any type of insurance for which the insurer bases its underwriting decision on the insured's application answers, although it is especially likely in life insurance disputes where the amount in question tends to be larger. See, e.g., *Am. Fire & Indemnity Co. v. Lancaster*, 415 F.2d 1145 (8th Cir. 1969) (auto insurance); *Newman v. Firemen's Ins. Co. of Newark, N.J.*, 154 P.2d 451 (Cal. Ct. App. 1944) (fire insurance); *Golden Rule Ins. Co. v. Schwartz*, 786 N.E.2d 1010 (Ill. 2003) (health insurance); *Dow Corning Corp. v. Cont'l Cas. Co.*, No. 200143, 1999 Mich. App. LEXIS 2920, at *1, *51 (Oct. 12, 1999) (comprehensive general liability insurance). It is possible that such litigation is less likely to arise in the health insurance context in the wake of the recent health care reform package's prohibition on discrimination on the basis of preexisting conditions. See Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 2704, 124 Stat. 119, 154 (2010).

with general principles of contract and restitution, and responsible for the messy state of much of the relevant doctrine. Actuarially fair reformation, which would grant the insured the amount of coverage that an insurance company could have sold him had he told the truth, has the potential to cure these ills.

After discussing the basics of insurance law's use of rescission in innocent misrepresentation cases, Part I shows how insurers systematically profit from rescission. In short, rescission allows insurers to refuse benefits to people who make innocent misrepresentations and suffer losses even while retaining the premiums of similarly situated people who never file claims. Rescission's tendency to overcompensate insurers is evident from concerns that some insurers engage in post-claim underwriting, a deliberate failure to discourage misrepresentations that rescission makes profitable.

Part II discusses the two conceptual justifications for rescission that courts most often offer in innocent misrepresentation cases. I argue that because rescission systematically overcompensates insurers, it does not return either party to its *ex ante* position. The insurer's right to decide with whom it will contract similarly fails as a justification for rescission. Since the traditional remedy requires that the insurer return some—but not all—of what it receives from the insured, this remedy fails to unwind fully their contractual relationship. Part III argues that rescission is responsible for much of the doctrinal confusion surrounding misrepresentations by insurance applicants. Courts are reluctant to deploy such a harsh remedy against sympathetic policyholders, and the result is a body of case law that is difficult to reconcile with the legal rules it purports to apply.

Finally, in Part IV, this Note advocates a new remedy: actuarially fair reformation. Using this remedy, a court would award the misrepresenting insured the amount of coverage that his premiums could have bought had he accurately completed his application. Thus, rather than making the binary choice between a total loss for the insured and strict enforcement of the insurance contract as written, a court could award the insured a recovery tailored to the degree to which his misrepresentation was material. Lest this remedy give insurance applicants an incentive to lie, courts would need to distinguish good-faith misrepresentations from fraudulent ones and refuse to reform the contracts of people who intentionally deceive insurance companies. While this asks somewhat more from courts than the approach that most states take today, I argue that courts can distinguish good- and bad-faith misrepresentations with enough accuracy to justify replacing rescission.

I. RESCISSION: A SUPERCOMPENSATORY REMEDY OBSERVED

Rescission of the insurance contract is the normal remedy for misrepresentations on an insurance application. Where an insured makes a misrepresentation without the intent to deceive, however, rescission's consequences often seem unduly harsh: the policyholder acts in reliance on the existence of insurance coverage and faithfully pays his premiums only to discover after suffering a loss that he is uninsured. The insured's comparative fault in this scenario might justify a remedy designed to return the insurer to the position it occupied prior to the misrepresentation, but rescission is not so limited. Instead, the remedy allows insurers to profit from customers who make misrepresentations but never file claims. Ongoing concerns exist about whether insurers are doing enough to prevent misrepresentations. These concerns strongly suggest that rescission overcompensates insurance companies. But before making the case against rescission in greater detail, it is first necessary to define the scope of misrepresentation cases with which this Note is concerned.

A. *What Is an Innocent Misrepresentation?*

An insurance applicant makes a misrepresentation when his application asserts "something as a fact which is untrue and affects the risk undertaken by the insurer."⁵ As I use the term here, a misrepresentation can be an affirmative assertion of an untrue fact or a more passive failure to provide a complete answer to an insurer's questions.⁶ In either case, misrepresentations are defined by their consequences; a misrepresentation is any communication by an insurance applicant that induces the insurer to assess inaccurately the risk of loss.⁷

Misrepresentations matter because they disrupt the underwriting process. Underwriters use the information in insurance applications to assess the risk of loss and assign premiums that reflect this risk. More specifically, the underwriter's task is to set premiums at levels such that the payments of those who do not suffer losses will produce at least enough revenue to cover the

5. *Methodist Med. Ctr. of Ill. v. Am. Med. Sec. Inc.*, 38 F.3d 316, 319 (7th Cir. 1994) (quoting *Ratcliffe v. Int'l Surplus Lines Ins. Co.*, 550 N.E.2d 1052, 1057 (Ill. App. Ct. 1990)).

6. 6 LEE R. RUSS & THOMAS F. SEGALLA, *COUCH ON INSURANCE* 3D § 81:6. *But see* KENNETH S. ABRAHAM, *INSURANCE LAW AND REGULATION* 16-19 (4th ed. 2005) (distinguishing between cases of misrepresentation and cases of concealment and noting that concealment poses additional scienter problems).

7. 6 RUSS & SEGALLA, *supra* note 6, § 81:6.

losses of those who do.⁸ Since it must rely on the truth of statements in the application when assessing the risk of loss, misrepresentations “impair[] an insurance company’s ability to price premiums responsibly and fairly based on the actual risk the applicant represents to the insurer.”⁹

It follows that undiscovered or unremedied misrepresentations cause the insurer to underestimate the risk of loss and shift some of the cost of insurance from the applicant to the insurance company. For the insurance company’s policies to remain actuarially sound, it must pass this cost on to other members of the risk pool in the form of higher premiums. As such, an insurance policy underwritten on the basis of misrepresentations is “an instrument of injustice to the [insurer] and all its policy holders.”¹⁰ Because they threaten both the viability and the fairness of any insurance scheme, misrepresentations are a special concern in insurance law.

An insured’s misrepresentations may be fraudulent or innocent. Fraudulent misrepresentations are deliberately false and designed to mislead the insurer into issuing a policy that it either would not have issued or would have issued at a higher premium.¹¹ Such misrepresentations are an attempt to defraud the insurance company and its policyholders. In contrast, an insured commits innocent misrepresentation when he makes a misstatement as a result of “ignorance, mistake, or negligence.”¹² As in other areas of private law, the difference between fraudulent and innocent misrepresentation in the insurance context turns on the good faith of the misrepresenting party.¹³

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8. See TOM BAKER, *INSURANCE LAW AND POLICY: CASES AND MATERIALS* 11-12 (2d ed. 2008) (“The core analytical task of an insurance enterprise is identifying future losses, choosing which of those losses it is willing to insure, estimating their frequency and magnitude, preparing insurance contracts that reflect those choices, and then deciding how much to charge which classes of people in return for this protection.”).
 9. Gary Schuman, *Misrepresentation of Smoking History in Life Insurance Applications*, 30 *TORT & INS. L.J.* 103, 107 (1994); see also *Stipcich v. Metro. Life Ins. Co.*, 277 U.S. 311, 316-17 (1928) (“[E]ven the most unsophisticated person must know that in answering the questionnaire and submitting it to the insurer he is furnishing the data on the basis of which the company will decide whether, by using a policy, it wishes to insure him.”).
 10. *N.Y. Life Ins. Co. v. Hollender*, 237 P.2d 510, 513 (Cal. 1951) (en banc) (quoting *Murphy v. Travelers’ Ins. Co.*, 234 N.Y.S. 278, 280 (N.Y. Spec. Term 1928)).
 11. See 6 *RUSS & SEGALLA*, *supra* note 6, §§ 82:21-:33.
 12. See *id.* §§ 82:34-:39.
 13. See *W. PAGE KEETON ET AL.*, *PROSSER AND KEETON ON THE LAW OF TORTS* § 107, at 741-45 (5th ed. 1984) (discussing how remedies available for the tort of deceit depend on scienter of the misrepresenting party); 7 *JOSEPH M. PERILLO*, *CORBIN ON CONTRACTS* § 28.14 (rev. ed. 2002) (distinguishing between intentional and unintentional misrepresentation).

Though the specific facts of innocent misrepresentation cases vary, most fit into one of two scenarios: either the insured represents a fact about which he is mistaken or he is responsible for a miscommunication with the insurer. Thus, the insured's good-faith misrepresentations may be based on an incorrect assumption,¹⁴ an undiscovered fact,¹⁵ or a forgotten detail.¹⁶ In other cases the applicant misinterprets one of the insurer's questions,¹⁷ fails to mention a fact that he wrongly assumes the insurance company already knows,¹⁸ or does not read the application with care.¹⁹ While the degree of the insured's culpability varies in these scenarios, the common theme is that the insurance contract is predicated on a misstatement, despite the applicant's good-faith attempt to answer the insurer's questions truthfully.

Whatever the cause or extent of an innocent misrepresentation, black-letter insurance law provides a single remedy: rescission of the insurance contract at the option of the insurer.²⁰ This remedy permits the insurer to "either opt to void the contract based upon [its] defect, or choose, instead, to waive that defect and ratify the contract despite it."²¹ Thus, when the insurer discovers an innocent misrepresentation after the policyholder suffers an insured-against loss, rescission permits the insurer to avoid paying benefits to which the insured would be otherwise entitled. To secure the benefits of rescission in this context, an insurer must return the insured's past premiums.²² This

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14. See, e.g., *Golden Rule Ins. Co. v. Schwartz*, 786 N.E.2d 1010 (Ill. 2003); *John Hancock Mut. Life Ins. Co. of Bos., Mass. v. Adams*, 107 A.2d 111 (Md. 1954).
 15. See, e.g., *Duren v. Nw. Nat'l Life Ins. Co. of N. Am.*, 581 So. 2d 810 (Ala. 1991); *Rippel v. Metro. Life Ins. Co.*, 24 A.2d 888 (Conn. 1942).
 16. See, e.g., *Lamar Life Ins. Co. v. Culp*, 78 S.W.2d 56 (Tenn. 1935).
 17. See, e.g., *Hyman v. Life Ins. Co. of N. Am.*, 481 F.2d 441, 443 (5th Cir. 1973).
 18. See, e.g., *Am. Fire & Indem. Co. v. Lancaster*, 415 F.2d 1145 (8th Cir. 1969); *Newman v. Firemen's Ins. Co. of Newark, N.J.*, 154 P.2d 451 (Cal. Ct. App. 1944); *Ryan v. Sec. Indus. Ins. Co.*, 386 So. 2d 939 (La. Ct. App. 1980).
 19. See, e.g., *Greber v. Equitable Life Assurance Soc'y*, 28 P.2d 817, 821 (Ariz. 1934); *Kabban v. Mackin*, 801 P.2d 883, 887-88 (Or. Ct. App. 1990).
 20. See 3 ERIC MILLS HOLMES, *HOLMES' APPLEMAN ON INSURANCE* 2D § 10.4 (1996); 6 RUSS & SEGALLA, *supra* note 6, § 82:34.
 21. *Ill. State Bar Ass'n Mut. Ins. Co. v. Coregis Ins. Co.*, 821 N.E.2d 706, 713 (Ill. App. Ct. 2004). See generally 1 BARRY R. OSTRANGER & THOMAS R. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* § 2.07 (14th ed. 2008) (discussing the availability of rescission).
 22. See, e.g., *Borden v. Paul Revere Life Ins. Co.*, 935 F.2d 370, 379 (1st Cir. 1991) (observing that in Rhode Island "the general rule is that when an insurer ventures to rescind a policy on the basis of a material misrepresentation in the application, it must first tender to the insured the premiums paid under the policy"); *McDonald v. N. Benefit Ass'n*, 131 P.2d 479,

requirement illustrates the underlying logic of rescission. Where the insurer opts to rescind, the insurance contract is void ab initio; it is "as if [it] had never existed," and each party must return the other's partial performance.²³

B. Rescission as a Supercompensatory Remedy

Rescission overcompensates insurers in innocent misrepresentation cases because it allows them to retain the premiums of misrepresenting insureds who do not file claims. The result is a legal remedy that forces people who are themselves uninsured to subsidize members of the insurance risk pool. To see why this is so, it is first necessary to recognize that insurers almost always discover innocent misrepresentations *after* the policyholder files a claim.

Both reviews of reported innocent misrepresentation cases²⁴ and the anecdotal experiences of practitioners²⁵ suggest that insurance companies seldom discover innocent misrepresentations until after the insured suffers a

486 (Mont. 1942) ("There is no doubt that a party is entitled to sue and recover money which he has paid by mistake of fact, or of mingled fact and law, and which the receiver ought not, in equity and good conscience, to retain."); see also 5 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1118 (1964) (noting the general duty of an insurer to return premiums not earned); 5 HOLMES, *supra* note 20, § 33.14.

23. Charles M. North, *Remedies for Misrepresentation in Applications in the Presence of Fraudulent Intent*, 29 ATLANTIC ECON. J. 162, 163 (2001); see *State Farm Mut. Auto. Ins. Co. v. Crouch*, 706 S.W.2d 203 (Ky. Ct. App. 1986) (holding that invalidation of insurance agreement was not an impermissible retroactive annulment of insurance where material misrepresentations rendered agreement void ab initio).
24. My own review of innocent misrepresentation cases uncovered very few reported cases in which the insured had not suffered some loss. See also L. William Caraccio, Comment, *Void Ab Initio: Application Fraud as Grounds for Avoiding Directors' and Officers' Liability Insurance Coverage*, 74 CALIF. L. REV. 929, 954 (1986) (making a similar observation with respect to directors' and officers' insurance). Post-claim cases involve larger sums than their pre-claim analogues and are therefore presumably more likely to lead to litigation. Nevertheless, the overwhelming predominance of post-claim disputes in the case law does suggest that these disputes are relatively more common.
25. See, e.g., F. Lane Finch, Jr., *Misrepresentation in the Insurance Application*, 65 ALA. LAW. 309 (2004); Stacey A. Giuliani, *Strategies for Defeating the Material Misrepresentation Defense in Insurance Actions: A Plaintiff's Perspective*, FLA. B.J., Apr. 2003, at 69, 69 (discussing a hypothetical case in which an insurer discovers misstatement after insured files claim as a "typical factual scenario"); Thomas F. Segalla & Carrie P. Parks, *Misrepresentations in Insurance Applications: Dangers in Those Lies*, 73 DEF. COUNS. J. 118, 128 (2006) (discussing claims-handling procedures as one of insurers' principal methods for handling misrepresentations); see also ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES* 567 (2d ed. 1988) (observing that insurers usually request rescission after an insurance buyer suffers a significant loss).

loss. This predominance of post-claim discoveries is in large part the result of the tendency of filed claims to reveal new information about the insured.²⁶ An accident report may uncover the insured's true driving history,²⁷ or arson damage may bring to light undisclosed fire code violations.²⁸ For many types of insurance, claims filed are the only significant source of information about an insured other than the insurance application itself.²⁹ In such situations, it is very unlikely that an insurer will discover misstatements in the application unless the insured files a claim. As a result, in most instances "the insurance company [does] not learn of a misrepresentation until a claim is made under a policy."³⁰

This feature of misrepresentation cases, combined with rescission, enables insurers to make an *ex post* decision about whether to enter into a contract designed to allocate *ex ante* risk. Since the insurer knows that the policyholder suffered a loss during the policy period when deciding whether to rescind for misrepresentation, it is able to identify the insured as a bad bet (i.e., someone who suffered a loss) and to refuse to underwrite his policy. In this way, rescission does more than merely return the insurer to a position from which it can reassess the *ex ante* probability of loss in light of a misrepresentation; it allows the insurer to identify and avoid bad risks *ex post*.

This is important, as not every misrepresenting insured brings a claim or suffers a loss. The insurer may not be able to underwrite insurance contracts accurately based on misrepresentations, but this does not mean that every applicant who makes a misrepresentation is uninsurable. Where it is not certain *ex ante* that the misrepresenting insured will suffer a loss, the *ex post* option to rescind allows insurers to retain the premiums of those who do not suffer losses while withholding benefits from those who do. For this reason, rescission systematically overcompensates the insurer by allowing it to retain premiums paid by people it does not actually insure.

26. See *Matilla v. Farmers New World Life Ins.*, 960 F. Supp. 223, 224 (N.D. Cal. 1997) (observing that insurers routinely investigate any claim filed within the contestability period).

27. See, e.g., *Commercial Union Ins. Co. of N.Y. v. Sec. Gen. Ins. Co.*, 211 So. 2d 477, 484-85 (1968).

28. *Mitchell v. United Nat'l Ins. Co.*, 25 Cal. Rptr. 3d 627 (Ct. App. 2005).

29. See Gary Schuman, *Post-Claim Underwriting: A Life and Health Insurer's Boon or Bane*, 55 FDCCQ. 43, 45 (2004).

30. Kathryn H. Vratil & Stacy M. Andreas, *The Misrepresentation Defense in Causal Relation States: A Primer*, 26 TORT & INS. L.J. 832, 833 (1991).

C. *Rescission in Action: A Case Study*

The recent case of *Chism v. Protective Life Insurance Co.* illustrates this aspect of the rescission remedy.³¹ In connection with their purchase of a new car in 2005, Steve and Karen Chism bought a life insurance policy from Protective that would make the remainder of their car payments in the event of either's death. The Chisms' car dealer, an authorized Protective insurance agent, suggested and sold them the policy with little discussion, and the Chisms signed the agreement without reading it.³²

The insurance contract also included in bold capital letters the words: "WARNING—YOU MUST BE ELIGIBLE TO APPLY FOR INSURANCE."³³ Elsewhere the policy explained that an applicant would be ineligible if he or she had been diagnosed or treated in the past two years for "[a] condition, disease or disorder of the brain, heart, lung(s), liver, kidney(s), nervous system or circulatory system."³⁴ In fact, Steve Chism was suffering from high blood pressure, diabetes, and peripheral vascular disease—multiple conditions that rendered him ineligible under the express terms of the policy.³⁵

When Steve Chism died from a sudden heart attack seven months after the Chisms purchased their car, the Kansas Court of Appeals held that Protective could rescind the policy.³⁶ The Chisms acted with "reckless disregard for the truth" in failing to read the policy before signing it, and the absence of any actual intent to deceive was no bar to rescission.³⁷ The Chisms inadvertently misled Protective into accepting a greater risk than it intended and, under Kansas law, Protective was entitled to rescind the policy.

The Chisms' failure to read the insurance contract is blameworthy, and giving Protective a remedy seems entirely appropriate. But note how systematically granting full rescission in cases like *Chism* allows Protective to profit from its customers' misstatements. No one could have predicted Steve Chism's death with certainty at the time at which the Chisms bought their car, and there are undoubtedly some people with Steve Chism's risk profile who do

31. 195 P.3d 776 (Kan. Ct. App. 2008), *rev'd on other grounds*, 234 P.3d 780 (Kan. 2010) (reversing grant of summary judgment because a material issue of fact existed about whether the alleged misstatements were caused by the Chisms or by the insurance agent).

32. *Id.* at 779-80.

33. *Id.* at 779.

34. *Id.*

35. *See id.* at 779-80.

36. *Id.* at 782-83.

37. *Id.* at 782.

not die during the policy period. For every person like Steve Chism who survives, Protective never discovers any misrepresentation, does not rescind the insurance contract, and retains all premiums paid. While these surviving insureds' premiums undoubtedly would be inadequate to pay for the losses of those who die, they nevertheless represent a source of revenue that Protective does not disgorge as part of the rescission remedy.

Holding Protective's profits on these life insurance policies constant, rescission operates as a market-distorting subsidy for nonmisrepresenting insureds. The revenue that Protective collects from people whose policies are invalid but will never file a claim allows Protective to lower its overall premiums, a result that redounds to the benefit of those whose insurance policies are actually valid. This outcome is inefficient since it means that those who do not make misrepresentations do not bear the full cost of their own coverage; misrepresenting insureds pay a portion of everyone else's actuarially fair premiums.³⁸ To the extent that the price of insurance should force the insured to internalize the total cost of his behavior, this type of cross-subsidization is undesirable.³⁹

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38. If innocent misrepresentations were a random event over which insurance applicants had no control, rescission's subsidy for those who do not make misrepresentations would not distort the insurance market. Under this assumption, an applicant has no idea whether he has made a misrepresentation *ex ante*, so the *ex post* subsidy for those who do not make mistakes is no reason to buy extra insurance. In this scenario, rescission is just another characteristic of the insurance product; people buy insurance against the possibility that they will suffer a loss without making an innocent misrepresentation. Once we relax the assumption that the distribution of misrepresentations is random, however, cross-subsidization begins to distort the market. To the extent that people who are more thorough or more sophisticated are less likely to make innocent misrepresentations, they can use this fact to capitalize on the rescission subsidy. While this phenomenon could be used to incentivize an efficient level of caretaking by insurance applicants, Richard R.W. Brooks & Alexander Stremitzer, *Remedies On and Off Contract*, 120 YALE L.J. (forthcoming 2011) (manuscript at 25-32) (on file with the author), some applicants will be more cautious than others. In a world of bounded rationality where few people concern themselves with the subtleties of insurance law, not every insurance applicant is the same. As a consequence, rescission's subsidy for nonmisrepresenting insureds is market-distorting. I am grateful to Alexander Stremitzer for this point.
39. Schuman, *supra* note 29, at 46 ("One of the basic principles of insurance is that each individual insured should pay a premium that is proportionate to the amount of risk the company assumes for that person."). Ironically, concern over this sort of cross-subsidization among insureds motivates many courts' decisions to provide rescission where denying the insurer a remedy would effectively allow the misrepresenting insured to steal from other members of the risk pool. *See, e.g., Paul Revere Life Ins. Co. v. Haas*, 644 A.2d 1098, 1108 (N.J. 1994) (explaining that ordinarily it would be against public policy "to permit a dishonest insured to recover, [since] insurers would include the cost of that risk in premiums charged to honest insureds"). Preventing insureds from shifting the cost of

D. Rescission as an Incentive To Engage in Bad-Faith Underwriting

It is one thing to demonstrate the theoretical possibility that rescission might overcompensate insurers and quite another to show that rescission actually overcompensates in the real world. Indeed, it seems possible that the transaction costs associated with investigating and litigating innocent misrepresentation cases entirely consume the premium payments of misrepresenting insureds who never file claims. Given the competing factors at work, whether rescission is really a supercompensatory remedy is an empirical question. Do insurers systematically profit from innocent misrepresentations? A practice pejoratively known as "post-claim underwriting" suggests that they do.⁴⁰

An insurer engages in post-claim underwriting when it does not make a good-faith effort to assess the risk of loss at the time it issues policies but instead "wait[s] until a claim has been filed to obtain information and make underwriting decisions."⁴¹ An especially attractive approach for types of policies that insure against large and infrequent losses, post-claim underwriting is a way for insurers to profit from rescission by maximizing the number of misrepresenting insureds whose premiums they collect, while avoiding the costs of the normal underwriting process.⁴² Since the profits from post-claim underwriting turn in part on the extent to which rescission overcompensates insurers, the existence of this practice is evidence that rescission is in fact supercompensatory.

insurance onto others has been a major concern from the very beginning of the law of insurance. Richard Epstein, *Do Judges Need To Know Any Economics?*, 1996 N.Z. L.J. 235, 236.

40. See Thomas C. Cady & Georgia Lee Gates, *Post Claim Underwriting*, 102 W. VA. L. REV. 809 (2000) (discussing the insurance industry's practice of conducting an intensive investigation into insurability after a large claim is presented).
41. *Lewis v. Equity Nat'l Life Ins. Co.*, 637 So. 2d 183, 186 (Miss. 1994).
42. Franklin D. Cordell, Note, *The Private Mortgage Insurer's Action for Rescission for Misrepresentation: Limiting a Potential Threat to Private Sector Participation in the Secondary Mortgage Market*, 47 WASH. & LEE L. REV. 587, 598 (1990); see also *St. Joseph's Hosp. & Med. Ctr. v. Reserve Life Ins. Co.*, 742 P.2d 808, 815 n.3 (Ariz. 1987) (noting arguments that post-claim underwriting enables insurers to "place a large number of policies at little cost and realize high profits from the sales" with the knowledge that "the passage of time [will] root out the bad risks"); cf. Cady & Gates, *supra* note 40, at 827 (arguing that the insurer acts in bad faith when it "continues to accept premiums from the insured, knowing that it will later challenge the insured's eligibility for coverage to avoid contract performance").

Though the prevalence of post-claim underwriting is difficult to gauge empirically and undoubtedly varies for different types of insurance,⁴³ many insurance industry observers believe that it occurs. Numerous state supreme courts have identified post-claim underwriting in individual cases and have acted to restrict or ban it outright.⁴⁴ Anecdotal accounts of post-claim underwriting led the House Energy and Commerce Committee to hold hearings on the subject,⁴⁵ and similar concerns emerged during the recent debate over health care reform.⁴⁶ Post-claim underwriting has also garnered considerable academic interest.⁴⁷ Taken together, these authorities suggest that post-claim underwriting is a real phenomenon.

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43. Cf. Schuman, *supra* note 29, at 45-48 (discussing various factors that an insurance company considers when deciding how thoroughly to investigate an insurance applicant before issuing him a policy).
44. See, e.g., *Huff v. United Ins. Co.*, 674 So. 2d 21, 23 (Ala. 1995) (criticizing post-claim underwriting); *Nassen v. Nat'l States Ins. Co.*, 494 N.W.2d 231, 234-36 (Iowa 1992) (permitting expert testimony that insurer was engaged in post-claim underwriting to show fraud by the insurer); *Lewis*, 637 So. 2d at 190 (holding that punitive damages are available where insured proves insurer engaged in post-claim underwriting).
45. See *Terminations of Individual Health Policies by Insurance Companies: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Energy & Commerce*, 111th Cong. (2009), available at http://energycommerce.house.gov/index.php?Itemid=73&catid=133:subcommittee-on-oversight-and-investigations&id=1671:energy-and-commerce-subcommittee-hearing-on-terminations-of-individual-health-policies-by-insurance-companies-&option=com_content&view=article.
46. *On Transparency in Health Insurance: Hearing Before the Subcomm. on Domestic Policy of the H. Oversight & Gov't Reform Comm.*, 111th Cong. (2009) (statement of Karen Pollitz, Research Professor, Georgetown University Health Policy Institute); Nancy West, *In a Health Insurance Bind, Unexpectedly Uninsured*, UNION LEADER (Manchester, N.H.), Nov. 15, 2009, at 1.
47. The leading academic treatments of this subject are Cady and Gates's article in the *West Virginia Law Review*, *supra* note 40, and an older article by Robert Works. See Robert Works, *Coverage Clauses and Incontestable Statutes: The Regulation of Post-Claim Underwriting*, 1979 U. ILL. L.F. 809. Post-claim underwriting has also received cursory treatment in a number of other scholarly works. See, e.g., Spencer L. Kimball & Bartlett A. Jackson, *The Regulation of Insurance Marketing*, 61 COLUM. L. REV. 141, 161 (1961) (observing that insureds may be victims of post-claim underwriting when the insurance agent deliberately inserts misstatements into the insurance contract without the insured's knowledge); Adam F. Scales, *A Nation of Policyholders: Governmental and Market Failure in Flood Insurance*, 26 MISS. C. L. REV. 3, 39 n.123 (2006) (arguing that statutes requiring insurers to pay the full insured value of property upon loss irrespective of actual market value are designed to protect insureds from post-claim underwriting); Benjamin Schatz, Commentary, *The AIDS Insurance Crisis: Underwriting or Overreaching?*, 100 HARV. L. REV. 1782, 1785-86 (1987) (noting the rise of post-claim underwriting of health insurance policies during the AIDS crisis); Works, *supra* note 2, at 570 (arguing that the post-claim underwriting is a form of

Despite the critical role that the supercompensatory remedy of rescission plays in post-claim underwriting, proposals to police or prohibit it have focused on the practice's bad-faith element. Thus, some courts have held that an insurance company is estopped from rescinding a policy where it could have discovered the misrepresentation with minimal effort⁴⁸ or where it did not act promptly to rescind the policy upon discovery of the misrepresentation.⁴⁹ Two commentators have advocated treating evidence of post-claim underwriting as per se bad faith and a basis for refusing to rescind insurance contracts.⁵⁰

However far the law goes on this front, such efforts do nothing to resolve the problem that makes post-claim underwriting profitable in the first place or the ways in which rescission makes the law of insurance doctrinally incoherent.⁵¹ As long as rescission systematically overcompensates insurers, insurance companies will have an incentive to engage in post-claim underwriting. Though courts and commentators have not realized it, worry over this phenomenon is itself a reason to question the wisdom of insurance law's traditional remedy for misrepresentation.

II. RESCISSION'S SHAKY FOOTING IN CONTRACT LAW

Notwithstanding rescission's tendency to overcompensate insurers, courts and commentators often explain this remedy in the insurance context by reference to "the rules and doctrines of contract law" that apply in cases of mistake and misrepresentation.⁵² This appeal to general principles of contract

opportunistic behavior to which the insured is vulnerable due to the sequential nature of performance in insurance contracts).

48. 3 HOLMES, *supra* note 20, § 16.7, at 336; *see also* Utah Power & Light Co. v. Fed. Ins. Co., 983 F.2d 1549 (10th Cir. 1993).
49. 2 STEVEN PLITT, DANIEL MALDONADO & JOSHUA D. ROGERS, COUCH ON INSURANCE 3D § 31:98 (2010).
50. Cady & Gates, *supra* note 40, at 826. Mississippi appears to take this approach. Lewis v. Equity Nat'l Life Ins. Co., 637 So. 2d 183, 188 (Miss. 1994). *But see* Bullock v. Life Ins. Co. of Miss., 872 So. 2d 658 (Miss. 2004) (upholding the insurer's right to rescind based solely on post-claim investigation and implicitly calling *Lewis* into question).
51. *See infra* Parts II-III.
52. KEETON & WIDISS, *supra* note 25, at 571 n.16; *see also* Perkins v. Nationwide Life Ins. Co., 324 N.E. 724, 728 (Ohio 1975) (Stern, J., dissenting) ("An insurance policy is but a form of contract."); McPhee v. Am. Motorists Ins. Co., 205 N.W.2d 152, 155 (Wis. 1973) ("Contracts of insurance rest upon and are controlled by the same principles of law that are applicable to other contracts, and parties to an insurance contract may provide such provisions as they deem proper as long as the contract does not contravene law or public policy."); 6 RUSS & SEGALLA, *supra* note 6, § 81:1 (observing that insurance law's treatment of

law is somewhat misleading in light of the special rules of construction and statutes that apply to insurance contracts.⁵³ Nevertheless, general contract law provides much of the doctrinal and intellectual underpinning for insurance law's use of rescission. *Tingle v. Pacific Mutual Insurance Co.* is illustrative:

The view . . . that a material representation will void the insurance policy, regardless of the good faith of the applicant, appears to be in line with general contract law. Sec. 164(1) of the Restatement, Second, of Contracts, provides [that] . . . “[i]f a party’s manifestation of assent is induced by either a fraudulent or material misrepresentation by the other party upon which the recipient is justified in relying, the contract is voidable by the recipient.”

. . . .

Using [this] rule . . . in the context of an insurance policy, in order to avoid a policy, the insurer must prove that the insured made a fraudulent or material misrepresentation in his application . . . that justifiably induced the issuance of the policy.⁵⁴

As *Tingle* observes, the *Restatement (Second) of Contracts* instructs that where one party’s material misrepresentations induce the other to enter into a contract, the contract is voidable by the nonmisrepresenting party.⁵⁵ This principle is firmly established in the law of contracts.⁵⁶

misrepresentations “can certainly be said to derive from the general law of contracts”); Schuman, *supra* note 29, at 63 (“It is a basic principle of contract law that if one party to a contract has been led to make it by the misrepresentation of the other party, the contract is voidable at the option of the innocent party. This principle is as applicable to insurance policies as other contracts.”).

53. See ROSCOE POUND, *THE SPIRIT OF THE COMMON LAW* 29 (1921) (“[W]e have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth century sought to make them, but are instead relational . . .”).
54. 837 F. Supp. 191, 193 (W.D. La. 1993).
55. RESTATEMENT (SECOND) OF CONTRACTS § 164(1) (1981).
56. See, e.g., *Lincoln Benefit Life Co. v. Edwards*, 45 F. Supp. 2d 722 (D. Neb. 1999); see also 27 RICHARD A. LORD, *WILLISTON ON CONTRACTS* § 70:29, at 298 (4th ed. 2003) (“Rescission, as opposed to damages, may be granted for innocent as well as fraudulent misrepresentations.”); *id.* § 70:31, at 302 (“[T]hough the representation may have been made innocently, it would be unjust to allow the misrepresenting party to retain the fruits of even an inadvertent mistake.”); 7 PERILLO, *supra* note 13, § 28.13, at 72 (“Where a contract requires a party to provide information to the other, . . . a negligent misrepresentation constitutes a breach of contract. If it is material, it is also grounds for avoidance of the contract.”).

But neither the policies that motivate contract law's treatment of misrepresentation nor the specific contours of this doctrine justify insurance law's supercompensatory remedy. Insurance law's use of rescission fails to restore the status quo ante position of either party while systematically awarding the insurer more than its expectation damages. Although there is a sense in which rescission vindicates insurance companies' right to decide with whom to contract, there are good reasons to question the importance of this type of freedom within insurance law's special regulatory framework. Contract law and restitution do not compel but instead counsel against insurance law's use of rescission.

A. Restoring the Parties' Ex Ante Positions

Where one party induces another to enter into an agreement by misrepresentation, contract law offers rescission so as "to restore the parties to *status quo* and therefore to prevent the misrepresenter from gaining a benefit from the transaction."⁵⁷ Courts that deploy rescission in the insurance context often appeal to this general contract principle, emphasizing that rescission is designed to "restore the status quo ante" by requiring each party to return the other's partial performance.⁵⁸ From an ex post point of view that focuses only

57. KEETON ET AL., *supra* note 13, § 105, at 729.

58. *Borden v. Paul Revere Life Ins. Co.*, 935 F.2d 370, 379 (1st Cir. 1991); *see, e.g., Hailey v. Cal. Physicians' Serv.*, 69 Cal. Rptr. 3d 789, 801 (Ct. App. 2007) (explaining the use of rescission in this context as an effort "to restore both parties to their former position as far as possible" (quoting *Neptune Soc'y Corp. v. Longanecker*, 240 Cal. Rptr. 117, 124 (Ct. App. 1987))); *Family Leasing & Fin., Inc. v. Infinity Ins. Co.*, No. CV970060951S, 2000 Conn. Super. LEXIS 2637, at *6 (Oct. 3, 2000) ("The very idea of rescinding a contract implies that what has been parted with shall be restored on both sides, and hence the general rule, which is to be reasonably applied, . . . is that a party who wishes to rescind a contract must place the opposite party in status quo." (quoting *Metcalf v. Talarski*, 567 A.2d 1148, 1152 (Conn. 1989))); *Gonzalez v. Eagle Ins. Co.*, 948 So. 2d 1, 3 (Fla. Dist. Ct. App. 2006) (requiring the refund of premiums in a negligent misrepresentation case because "[r]he insurer must place the insured back in the same position the insured was in before the effective date of the policy" (citing 9 FLA. JUR. 2D Restoration of Parties to the Status Quo § 35 (2004))); *Ill. State Bar Ass'n Mut. Ins. Co. v. Coregis Ins. Co.*, 821 N.E.2d 706, 713 (Ill. Ct. App. 2004) (requiring refund of premiums in a negligent misrepresentation case because "a party seeking rescission must restore the other party to the status quo existing at the time the contract was made" (quoting *Int'l Ins. Co. v. Sargent & Lundy*, 609 N.E.2d 842, 852 (Ill. Ct. App. 1993))); *Mooney v. Nationwide Mut. Ins. Co.*, 822 A.2d 567, 570 (N.H. 2003) (arguing that rescission and the return of premiums ensures that parties "occupy the same positions they occupied before entering into the rescinded contract" (citing *Derouin v. Granite State Realty, Inc.*, 459 A.2d 231 (N.H. 1983))); *Rutgers Cas. Ins. Co. v. LaCroix*, 946 A.2d 1027, 1035 (N.J. 2008) ("The object of . . . rescission is to restore the parties to the

on the individual litigants in a particular case, rescission plus the return of past premiums does this: the insured recovers his prior payments and bears his loss while the insurer disgorges premiums and is not responsible for the loss. These are the positions each party would have occupied in the absence of any contract, and, from this perspective, insurance law's use of rescission seems a straightforward application of more general contract doctrine. Though the logic of this approach is difficult to resist in an individual case, the aggregate effect of rescission in all such cases fails to restore either party to its *ex ante* position. The law of large numbers makes rescission inconsistent with the aims of restitution.

To see why, it is first necessary to observe that rescission is a form of restitution—a mechanism by which the plaintiff forces the defendant to give up the benefits he wrongfully received from the transaction.⁵⁹ The basic function of rescission is manifest in the requirement that one who seeks rescission return any benefits that he received from the misrepresenting party; rescission does not seek to punish the defendant but merely to force him to return his profits.⁶⁰ Thus, where *A* agrees to exchange Whiteacre for Blackacre on the strength of *B*'s misrepresentations, he can only rescind the contract and recover Whiteacre if he also returns Blackacre.⁶¹ Rescission's purpose is "to return the parties, as nearly as is practicable, to the situation in which they found themselves before they made the contract," and the counter-restitution

status quo ante and prevent the party who is responsible for the misrepresentation from gaining a benefit." (quoting *Bonco Petrol, Inc. v. Epstein*, 560 A.2d 655, 662 (N.J. 1989)); *Sabbagh v. Prof'l & Bus. Men's Life Ins. Co.*, 116 N.W.2d 513, 520 (S.D. 1962) (observing that the use of rescission in insurance cases "seeks to restore the status quo" (citing *Ward v. Deavers*, 203 F.2d 72, 76 (D.C. Cir. 1953))).

59. See IAN AYRES & RICHARD E. SPEIDEL, *STUDIES IN CONTRACT LAW* 532 (7th ed. 2008) (explaining that rescission is a form of restitution because it involves "a dissolution or 'undoing' of the contract and a restoration of the parties to their pre-contract position"); 2 DAN B. DOBBS, *LAW OF REMEDIES* § 9.3(2), at 580 (2d ed. 1993) (discussing rescission in the context of cases of innocent misrepresentations).
60. Following the earlier restatements, a comment to the forthcoming *Restatement (Third) of Restitution and Unjust Enrichment* holds that "a rescinding plaintiff becomes subject to a duty of counter-restitution with respect to any benefits received in the nullified transaction." *RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT* § 13 cmt. i (Tentative Draft No. 1, 2001); see *RESTATEMENT OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS* § 65 (1937). See generally *RESTATEMENT (SECOND) OF CONTRACTS* § 384 cmt. a (1981) ("A party who seeks restitution of a benefit that he has conferred on the other party is expected to return what he has received from the other party."); KEETON ET AL., *supra* note 13, § 105, at 730 (observing that "[t]he plaintiff must himself do equity by restoring whatever he had received").
61. *RESTATEMENT OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS* § 65 cmt. b, illus. 1 (1937).

requirement achieves this purpose by fully unwinding the parties' contractual relationship.⁶²

Because rescission is a form of restitution, the plaintiff cannot use it to recover the benefit of his bargain or his reliance interest. Rather, rescission merely returns the plaintiff to the position that he occupied before he contracted with the defendant. As a result, plaintiffs prefer damages to rescission in most cases.⁶³ So long as performance by both parties would have made the plaintiff better off than he was before the contract was formed, his expectation damages will exceed the value of rescission.⁶⁴ For this reason, rescission is "a relatively mild remedy," promising to return plaintiffs to their *ex ante* positions but refusing recovery of any benefits from the contract itself.⁶⁵

Though worth less than damages in most cases, rescission will yield a larger recovery in the subset of cases in which performance of the contract would have made the plaintiff worse off. Where the relative value of Blackacre declines after *A* exchanges it for Whiteacre, *A* will prefer rescission to damages. Most jurisdictions permit rescission in such cases even though it forces the defendant to bear a loss that his breach or misrepresentation did not cause.⁶⁶ Indeed, it is in just this scenario that plaintiffs most often seek—and courts most often award—rescission.⁶⁷ Though the object of sporadic scholarly criticism, most jurisdictions continue to permit recoveries in restitution that exceed the plaintiff's expected returns from complete performance of the contract.⁶⁸

Why does the law deploy the otherwise mild remedy of rescission even when it means that the defendant will have significantly less than he had *ex*

62. See RESTATEMENT (SECOND) OF CONTRACTS § 384 cmt. a (1981).

63. See RICHARD CRASWELL & ALAN SCHWARTZ, FOUNDATIONS OF CONTRACT LAW 126 (1994) ("[T]he restitution and rescission remedies will usually leave the nonbreacher with less than his or her expectation interest.").

64. *Id.*

65. RESTATEMENT (SECOND) OF AGENCY § 260(2) cmt. c (1958); see also 2 DOBBS, *supra* note 59, § 9.1, at 547.

66. See RESTATEMENT (SECOND) OF CONTRACTS § 373 & cmt. d (1981); JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS 782-83, 827-28 (4th ed. 2001); 1 GEORGE E. PALMER, THE LAW OF RESTITUTION § 3.8, at 266 (1978).

67. See DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES 624-25 (3d ed. 2002).

68. For criticism of the still-dominant majority rule, see HANOCH DAGAN, THE LAW AND ETHICS OF RESTITUTION 282-89 (2004); and Mark P. Gergen, *Restitution as a Bridge over Troubled Contractual Waters*, 71 FORDHAM L. REV. 709, 741 (2002). See also 1 PALMER, *supra* note 66, § 4.4(a) at 389 (Supp. 2010) (describing this as the position held by the "overwhelming weight of authority").

ante? Because “the basic idea” of rescission is “to restore to [the] plaintiff whatever [the] defendant received at [his] expense.”⁶⁹ Where a contract shifts the risk of a loss from one party to the other, rescission places this risk of loss back on the original holder.⁷⁰ Respecting the contract’s allocation of risk while rescinding its other elements would work an injustice upon the plaintiff while allowing the defendant to “assert[] a right under the very contract which he himself has discharged.”⁷¹ In the unhappy event that a risk is realized that the contract would have reallocated, the party that originally held the risk must bear the loss. The logic of rescission compels this result: “[E]verything must be returned, and the chips fall where they may.”⁷²

But this risk-shifting rationale for rescission is inapposite when the law of large numbers limits the plaintiff’s possible losses and thus limits the risk shifted between parties. A plaintiff cannot use rescission selectively to avoid only the unprofitable portions of a contract since partial rescission of this sort would not return the parties to their *ex ante* positions.⁷³ For the same reason, a plaintiff should not be able selectively to rescind the unprofitable subset in a series of aleatory contracts. Where multiple contracts between two parties allocate risk, it is the overall allocation of risk that should govern the scope of rescission. In many such situations, the only way to return the parties to their *ex ante* positions would be to make rescission for all contracts a condition of rescission for some contracts.

An example helps to illustrate this point. Consider a scenario in which *A* and *B* bet on one thousand coin tosses by making one thousand contracts. Each

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69. LAYCOCK, *supra* note 67, at 628. See generally Henry Mather, *Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller*, 92 YALE L.J. 14, 29-32 (1982) (arguing that limiting restitutionary remedies to the plaintiff’s expected return from the failed contract would be more consistent with liberal principles of freedom of contract).
70. DAGAN, *supra* note 68, at 284-85; see *Boomer v. Muir*, 24 P.2d 570, 577 (Cal. Ct. App. 1933) (emphasizing contract risk allocation by observing that contract price is set “on condition that the entire contract be performed” and should not therefore control the measure of restitution). Since rescission is a remedy available at the plaintiff’s option, it is only the risk of loss—not the risk of gain—that rescission shifts back onto the defendant. See Andrew Kull, *Restitution as a Remedy for Breach of Contract*, 67 S. CAL. L. REV. 1465, 1472, 1476, 1483-84 (1994).
71. *Philadelphia v. Tripple*, 79 A. 703, 706 (Pa. 1911).
72. LAYCOCK, *supra* note 67, at 629.
73. For example, even if *A* is entitled to rescission of his transaction with *B* in which he exchanged Whiteacre for Blackacre, he cannot choose to rescind only the portion of the contract under which he was to transfer Whiteacre to *B* while asking a court to enforce the portion of the contract under which *B* transferred Blackacre to *A*. Rescission obliges *A* to pay full rescission to *B*, which means returning Blackacre. See *id.* at 627 (“Plaintiff cannot affirm the profitable parts of a contract and rescind the losing parts.”).

contract calls for *A* to pay one dollar to *B* if the coin lands on heads and *B* to pay one dollar to *A* if the coin lands on tails. At the time they formed these contracts, *B* innocently misrepresented that the coin was fair, and, on the strength of this misrepresentation, *A* entered into the contracts believing that his expected return was zero. But unbeknownst to *A*, in fact there was a sixty percent probability that the coin would land on heads with each toss. After *A* and *B* finish tossing the coin and discover *B*'s misrepresentation, should a court rescind the approximately six hundred contracts in which the coin landed on heads? The law of large numbers dictates that there will be relatively little variance in the net outcome from such a large number of coin tosses, and *B*'s profits will be very close to two hundred dollars—the difference between the approximately six hundred times the coin landed on heads and the approximately four hundred times it landed on tails. But allowing *A* selectively to rescind on coin tosses that he lost would guarantee him net profits of approximately four-hundred dollars—the total number of times the coin landed on tails. Although rescission of any individual contract could be said to force *B* to internalize the risk of heads associated with a particular toss, the net effect of selective rescission does not restore either party's *ex ante* position.

For the same reason, rescission in the context of innocent misrepresentations on insurance applications fails to return either party to the status quo ante. Insurers profit from the selective use of rescission because they avoid contracts in which the insured suffers a loss while retaining premiums from contracts in which the insured does not suffer a loss.⁷⁴ Conversely, the insured is worse off than he was *ex ante* since selective rescission is functionally equivalent to giving the insurer an option to retain premiums if the insured does not suffer a loss—an option that has economic value and that the insurer consumes but for which the insured is uncompensated.⁷⁵ Add this conceptual point to the insured's obvious reliance interest in the validity of his insurance policy⁷⁶ and it becomes clear that rescission of the insurance contract fails to return either party to its *ex ante* position.

74. See *supra* Section I.B.

75. Rescission at the choice of the insurer operates as a put option, allowing the insurer to force the insured to purchase insurance at the contract price after learning whether the insured suffered a loss during the relevant period. See IAN AYRES, *OPTIONAL LAW* 13-38 (2005). While Ayres argues that put options are an attractive remedial alternative in a variety of scenarios, the judicial creation of a put option clearly does not return the parties to their *ex ante* positions.

76. See Works, *supra* note 2, at 583-84 (noting that the insured gives up not only the premium but also the opportunity to deal with risk in some other way when he procures insurance); Foley, *supra* note 2, at 662 (explaining how an insured whose policy is rescinded after he

B. Protecting the Insurer's Freedom of Contract

A second justification for the use of rescission in innocent misrepresentation cases is that it vindicates the insurer's right to decide to whom it will sell insurance. Freedom of contract motivates much of the law of contracts, and courts often treat rescission in the insurance context as a specific application of this more general principle.⁷⁷ One who makes a material, unilateral mistake as a result of the other party's misrepresentations will not be bound by the terms of a contract to which he would not have agreed.⁷⁸ In the same way, it is argued, when the insured's misrepresentations induce the insurer to sell him a policy for which he would not otherwise be eligible, the insurer should not be bound. Just as an officious intermeddler cannot compel his unwilling target to contract against his will,⁷⁹ courts should not permit the insured to force someone else to sell him an insurance policy by

suffers a loss is worse off because he is no longer able to obtain insurance on the loss or to take precautionary measures in an effort to prevent an uninsured loss).

77. *Mitchell v. United Nat'l Ins. Co.*, 25 Cal. Rptr. 3d 627, 637 (Ct. App. 2005) ("Freedom of contract and the right of an insurer to make an informed decision whether or not to insure a given risk are strong policy considerations that support more liberal rescission rights for misrepresentations made at the inception of the insurance contract."); *Robinson v. Occidental Life Ins. Co.*, 281 P.2d 39, 42 (Cal. Dist. Ct. App. 1955) (observing that the insurer has "the unquestioned right to select those whom it will insure"); *U.S. Aviation Underwriters, Inc. v. Sunray Airline, Inc.*, 543 So. 2d 1309, 1312 (Fla. Dist. Ct. App. 1989) ("[A]n insurer has a right to decide which risks it will and which it will not insure against."); *Colonial Penn Ins. Co. v. Guzorek*, 690 N.E.2d 664, 672 (Ind. 1997) (observing that rescission "protects the insurer's right to know the full extent of the risk it undertakes when an insurance policy is issued"); see also 10A *RUSS & SEGALLA*, *supra* note 6, § 149:3, at 149-10 (observing that insurance contracts "derive their force and efficacy from the consent of the parties"). Even when courts do not explicitly appeal to freedom of contract, it is often implicitly at work in the application of materiality requirements. See *Dorsey v. Mut. of Omaha Ins. Co.*, 991 F. Supp. 868, 874 (E.D. Mich. 1998) (noting that a misstatement was material and the insurance company could avoid the contract where it "would not have issued the exact same policy had the true facts been revealed"); *Matilla v. Farmers New World Life Ins.*, 960 F. Supp. 223, 225-26 (N.D. Cal. 1997) (concluding that misrepresentation was material because the insurer would not have issued the policy had it known about misrepresentation); see also 3 *HOLMES*, *supra* note 20, § 16.7, at 334-35 (observing that when an insurer seeks rescission for misrepresentation it "effectively claims that the contract never came into effect").
78. See 13 *WALTER H.E. JAEGER, WILLISTON ON CONTRACTS* § 1573, at 489 (3d ed. 1970) (noting that rescission is used in unilateral mistake cases as a means of "relieving any party who has become bound by a contract which he never intended to make, and never would have made but for a mistake he was laboring under in regard to a material fact" (quoting *Hester v. New Amsterdam Cas. Co.*, 268 F. Supp. 623 (D.S.C. 1967))).
79. See *RESTATEMENT (SECOND) OF CONTRACTS* § 50 (1981).

misrepresenting his risk profile. On this view, the insured's misrepresentations prevent a true meeting of the minds, and in the absence of any contract, the insurer is not obliged to pay for the insured's losses.⁸⁰

Though it is a widely accepted justification for rescission in the insurance context, this appeal to freedom of contract is unpersuasive for two reasons. First, it overlooks the countervailing principle that one may have a valid claim in restitution where "the circumstances of the transaction are such as to excuse the claimant from the necessity of basing a claim to payment on a contract."⁸¹ To the extent that it creates liability in the absence of any contract, the law of restitution subordinates the individual's right to decide whether to enter into a particular transaction. From an *ex post* point of view, this means that restitution may compel someone to be party to a transaction against his will.⁸² Such liability is appropriate—and enhances freedom of contract from an *ex ante* perspective—where it is necessary to vindicate the parties' expectations or prevent inequitable forfeitures. People can contract more freely and at a lower cost when they are confident that the courts will use restitution to prevent unexpected, inequitable results.

The innocent misrepresenting insured is a good candidate for this type of recovery in restitution because he is locked into a transaction with the insurer

80. Schuman, *supra* note 9, at 110 ("When the application contains a material misrepresentation, there is no meeting of the minds and no contract results.").

81. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 2(4) (Tentative Draft No. 1, 2001); *see also id.* § 2(4) cmt. c (observing that a "lack of effective consent . . . by one or both parties, furnishes the common analytical theme uniting . . . restitution" (emphasis omitted)); Mary Jane Morrison, *I Imply What You Infer Unless You Are a Court: Reporter's Note to Restatement (Second) of Contracts § 19 (1980)*, 35 OKLA. L. REV. 707, 713 (1982) ("Whether the parties had any subjective or objective intention of contracting is irrelevant for . . . implied-in-law cases."); Works, *supra* note 2, at 585 (assuming that restitution in the insurance contract is limited to rescission and observing that "[b]ecause insurance is aleatory, the rough equivalence between loss and benefit necessary for restitution to be an effective protection against forfeiture simply will not be present").

82. *See, e.g., Somerville v. Jacobs*, 170 S.E.2d 805 (W. Va. 1969) (requiring the landowner to either pay for the building or sell the land where the contractor mistakenly constructed the building on his land); *see also Orleans Onyx, Inc. v. Buchanan*, 472 So. 2d 598 (La. 1985) (permitting the plaintiff to recover the value of renovation to the defendant where the defendant's contract to sell the building to a third party failed as a result of fraud); *Farash v. Sykes Datatronics, Inc.*, 452 N.E.2d 1245 (N.Y. 1983) (permitting the plaintiff to recover in restitution for the cost of renovation to the building carried out pursuant to a contract invalidated by the statute of frauds); *Bradkin v. Leverton*, 257 N.E.2d 643 (N.Y. 1970) (allowing the plaintiff to recover against a corporate officer where the plaintiff had a contract with the corporation entitling him to a finder's fee if the corporation used his information).

that rescission and return of premiums does not fully unwind.⁸³ Like the plaintiff who mistakenly constructed a building on the defendant's land in *Somerville v. Jacobs*,⁸⁴ the misrepresenting insured confers a benefit on the insurer that is not readily returned.⁸⁵ As explained above, the mere restoration of past premiums in the event of a loss does not compensate the insured for what is functionally the insurer's put option to force the insured to buy insurance.⁸⁶ The right to decide with whom to do business provides little guidance when insurer and insured are trapped in an economic relationship that a court cannot undo by simply refusing to enforce the contract. Insofar as it allows the insurer to retain the upside risk associated with the insurance contract, the combination of rescission and return of premiums does not cancel the transaction; it merely changes its terms.

But even apart from the freedom-of-contract argument's dubious basis in general principles of private law, it fails because "insurance is different."⁸⁷ From the need to protect the public from misleading terms over which it cannot bargain to concerns about insurer solvency, a variety of public policy considerations justify insurance-specific regulations that restrict insurers' freedom of contract.⁸⁸ Indeed, the very existence of insurance law as a

83. See Robert H. Jerry, II, *The Insurer's Right to Reimbursement of Defense Costs*, 42 ARIZ. L. REV. 13, 62 (2000) (observing that rescission may not be a viable remedial alternative where it is not possible to unwind a partly performed contract).

84. 170 S.E.2d at 805.

85. See 2 PALMER, *supra* note 66, § 11.5, at 515 (observing that where a "mistaken performance consists of a transfer of nonreturnable goods and services . . . the remedy is in quasi contract to recover the money value of the performance").

86. See *supra* Section I.B.

87. *E.I. Dupont de Nemours & Co. v. Pressman*, 679 A.2d 436, 447 (Del. 1996).

88. For example, state law commonly regulates both insurance rates and contract terms. See, e.g., CAL. INS. CODE §§ 2070-2071 (West 2005) (prescribing standard form for fire insurance and limiting deviations from the standard form); N.Y. COMP. CODES R. & REGS. tit. 11, §§ 160.0-169.1 (2006) (regulating insurance rates). See generally ERIC MILLS HOLMES & WILLIAM F. YOUNG, *REGULATION AND LITIGATION OF INSURANCE: CASES AND MATERIALS* 34-41 (3d ed. 2007) (reviewing various policy considerations that justify regulation of the insurance industry). The justification for special regulation of the insurance relationship has received sustained scholarly attention. For two recent examples, see Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107 (2008), which argues that heavy regulation of insurance contracting and consumer ignorance combine to diminish the value of freedom of contract; and Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389 (2007), which argues that the special nature of insurance contracts justifies treating them as "products" rather than solely as contracts.

substantive area of law distinct from contract reflects this reality.⁸⁹ Given the ways in which state laws governing insurance rates and terms already circumscribe the insurer's freedom to choose with whom to contract and on what terms, freedom of contract provides an ill-fitting justification for insurance law's inequitable use of rescission.

Moreover, one of the main considerations in favor of other restrictions on insurer freedom of contract—the social desirability of risk spreading—also serves as a reason to reject rescission's harsh consequences in innocent misrepresentation cases. A major theme in the law of insurance is that risk spreading is socially efficient and tends to promote distributive justice.⁹⁰ For this reason, courts and other policymakers seek to make insurance as widely available as possible, even at the expense of insurer freedom of contract.⁹¹ This same policy consideration militates against rescission in innocent misrepresentation cases, a context in which the policyholder's very act of attempting to procure insurance demonstrates that he would find it difficult to bear the loss himself. As one commentator has argued, "The notion that only those policyholders who 'follow the rules' and comply fully with policy conditions should be covered is, in itself, inconsistent with the purpose of insurance."⁹² Irrespective of insurer freedom of contract, courts and legislatures should prefer remedial alternatives that spread risk more broadly without making the insurance markets less efficient.

III. INSURERS' DEFENSES AND THE INEVITABLE INEFFICIENCY OF RESCISSION'S BINARY CHOICE

Part I demonstrated that rescission is inefficient, and Part II argued that broader private law principles do not justify its use. This Part will show that

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89. See EUGENE R. ANDERSON, JORDAN S. STANZLER & LORELIE S. MASTERS, *INSURANCE COVERAGE LITIGATION* § 11.06 (2d ed. Supp. 2009) ("While an insurance policy does represent a contractual commitment, *the attitudes of the general public, the legislatures, and the courts make clear that the insurance agreement is viewed as having broader ramifications than a mere contract.*" (quoting JAMES J. LORIMER ET AL., *THE LEGAL ENVIRONMENT OF INSURANCE* 37-38 (3d ed. 1987))); LAWRENCE M. FRIEDMAN, *A HISTORY OF AMERICAN LAW* 545-49 (2d ed. 1985).
90. See BAKER, *supra* note 8, at 2-4; Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1185-89 (1981).
91. See Robert H. Jerry II, *Insurance*, in *THE OXFORD COMPANION TO AMERICAN LAW* 420, 422 (Kermit L. Hall et al. eds., 2002) (noting that public policy goals are the basis for insurance law's "override of undesirable consumer choices").
92. Anderson et al., *supra* note 2, at 860.

insurance law implicitly recognizes the problems with rescission by deploying doctrines designed to limit its use. While these doctrines deserve praise to the extent that they prevent rescission's most extreme applications, they are no panacea. As Part I showed, courts continue to use rescission in many situations that allow the insurer to profit effectively from its customers' misrepresentations. Moreover, even as courts deploy a variety of doctrines that restrict the use of rescission, they treat rescission as the only possible remedy in innocent misrepresentation cases. Thus, where a court denies the insurer's request for rescission, it denies the insurer any remedy at all. The result is that the misrepresenting insured shifts some of the cost of his risk profile onto the insurer, who passes this cost on to other members of the risk pool in the form of higher premiums. In this way, doctrines that restrict the availability of rescission merely replace one inefficient outcome with another.

A. *Defining Rescission's Limits*

To make any sense of the doctrinal contours of a modern insurer's defense for misrepresentation, one must begin with the old common law doctrine of warranty.⁹³ Under this unforgiving rule, when the insured made a statement deemed "part of the contract," it was "presumed to be material," and its untruthfulness was per se grounds for rescission.⁹⁴ Nineteenth-century insurance law distinguished warranties from "representations"—statements "made to give information to the insurer, and otherwise induce him to enter into the insurance contract" but not essential to the insurance contract itself.⁹⁵ Unlike warranties, the common law required an insurer seeking rescission to show that a representation was relevant to the risk of loss. A "highly technical doctrine" developed to guide courts in determining whether a particular contract provision was a warranty or a representation, but the doctrine of warranty was nevertheless thought to work "substantial injustice" in many cases.⁹⁶

Rescission plays a central role in making warranty an unduly harsh doctrine; that the insurer's remedy constitutes a total loss for the insured leads to warranty's extreme results. Despite rescission's significance, however,

93. See 6 RUSS & SEGALLA, *supra* note 6, § 81:10.

94. WILLIAM REYNOLDS VANCE, HANDBOOK OF THE LAW OF INSURANCE § 106 (1904).

95. *Id.* § 98 (footnote omitted).

96. *Id.* §§ 106-107, at 294-95; see also ROBERT E. KEETON, BASIC TEXT ON INSURANCE LAW 370 (1971) (observing that "pressure developed for amelioration of the law of warranty because its results were often unconscionable, or inconsistent with most policyholders' reasonable expectations").

twentieth-century American insurance law developed substantive rather than remedial solutions to the problems it creates. Even as insurance law came to place less emphasis on the warranty/representation distinction and liberalized the circumstances under which an insured could recover, the law retained rescission as the insurer's only remedy. What a modern insurer must prove to obtain rescission varies among jurisdictions. Even so, a brief survey of the most important limitations on the use of rescission shows not only insurance law's discomfort with the doctrine of warranty but also its failure to look for remedial alternatives.

1. *Construction of Warranties as Representations*

Limits on the doctrine of warranty were among the earliest efforts to restrict rescission's most extreme applications. A variety of state statutes functionally have abolished warranty, either declaring all statements in an insurance application to be representations or otherwise making rescission under the doctrine of warranty contingent on materiality.⁹⁷ In states that have not passed such statutes, a number of judge-made doctrines help to limit warranty's scope. For example, courts narrowly construe warranties and strongly prefer constructions that treat them as "affirmative" rather than "promissory."⁹⁸ The modern presumption against warranty reduces the use of rescission by increasing the number of innocent misrepresentation cases in which courts can deploy demanding materiality requirements.⁹⁹

2. *Heightened Risk of Loss Requirements*

Where a court treats the insured's false statement as a representation rather than a warranty, a variety of risk-of-loss standards may apply. Some states deploy a subjective test, requiring that the insurer show the misrepresented information would have actually changed its decision to provide insurance or

97. 6 RUSS & SEGALLA, *supra* note 6, § 81:51; *see, e.g.*, E.H. Stanton Co. v. Rochester German Underwriters' Agency, 206 F. 978 (E.D. Wash. 1913) (applying the Washington statute).

98. That is, constructions that require that the warranty be true when the insured signs the application but not when he files a claim. *See generally* KEETON, *supra* note 96, at 370-72 (discussing judicial techniques for limiting doctrine of warranty).

99. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part Two*, 83 HARV. L. REV. 1281, 1283 (1970) (arguing that courts construe warranties narrowly "so as to minimize [their] impact").

the premium it charged.¹⁰⁰ Others engage in an objective inquiry as to whether the misrepresentation was material to the insured's risk of loss.¹⁰¹ A few states permit rescission only if the misrepresentation related to the actual loss the insured ultimately suffered.¹⁰² State statutes commonly deploy some combination of these standards,¹⁰³ and, in practice, state courts tend to move freely among them.¹⁰⁴

Whichever standard a particular state's case law adopts, courts implicitly consider the underlying risk of loss and balance the equities of insurer and insured. Thus, a court's assessment of materiality will turn not only on the extent to which the misrepresentation was relevant but also on the court's view of the insured's blameworthiness.¹⁰⁵ Indeed, when courts apply a materiality standard, the question is whether the insured's misrepresentation was sufficiently important to justify rescission, not whether it was material in the technical sense that it had some bearing on the risk of loss.¹⁰⁶ The metaphysical question of whether a particular misrepresentation "contributed to" the insured's loss invites a similarly amorphous judicial inquiry, enabling courts to refuse rescission in many of the cases in which it seems especially severe.¹⁰⁷

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100. See 215 ILL. COMP. STAT. ANN. 5/154 (West 2008) (providing for rescission where a misrepresentation "materially affects . . . the acceptance of the risk . . . assumed by the company"); *Case v. RGA Ins. Servs.*, 521 S.E.2d 32, 33-34 (Ga. Ct. App. 1999) (finding that misrepresentation was material where insurer would "not in good faith have issued the policy, not have issued a policy in as large an amount at the given rate, or would not have provided coverage with respect to the hazard resulting in the loss").
101. See, e.g., *Nw. Mut. Life Ins. Co. v. Iannacchino*, 950 F. Supp. 28, 31 (D. Mass. 1997); *York Mut. Ins. Co. v. Bowman*, 746 A.2d 906, 909 (Me. 2000); *Vt. Mut. Ins. Co. v. Chiu*, 21 S.W.3d 232, 235 (Tenn. Ct. App. 2000).
102. See, e.g., KAN. STAT. ANN. § 40-418 (2000); MO. ANN. STAT. § 376.580 (West 2002); R.I. GEN. LAWS § 27-4-10 (2008); see also 28 HARNETT & LESNICK, *supra* note 3, § 176.02, at 246-47.
103. 28 HARNETT & LESNICK, *supra* note 3, § 176.02, at 239; see, e.g., 215 ILL. COMP. STAT. ANN. 5/154 (West 2008).
104. KEETON, *supra* note 96, at 385.
105. *Id.* at 389 (arguing that the purpose of materiality requirements is "to disallow unconscionable advantages to insurers" and that judicial application of the standard should reflect its purpose); see also ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 102, at 528-30 (1987); cf. 1 PALMER, *supra* note 66, § 3.8, at 266 (observing that as a general matter in the law of remedies, one way to alleviate the harsh consequences of rescission for innocent misrepresentations is by deploying a more exacting materiality standard).
106. KEETON, *supra* note 96, at 381-93 (explaining why a standard that permitted rescission for any marginal increase in the risk of loss would be unworkable).
107. See *id.* at 383-84 (noting ambiguity in the question of whether a particular misrepresentation contributes to a loss).

Even when they must "stretch the facts" to make use of them, these risk-of-loss requirements provide courts with a way out when the uniform use of rescission would yield inequitable results.¹⁰⁸

3. *Categorical Statutory Bars to Insurer Recovery*

In addition to risk-of-loss requirements, many states also categorically forbid rescission under circumstances in which rescission's effects are likely to be especially harsh. For example, a few states permit rescission only if the insurer can demonstrate that the insured's misrepresentation was fraudulent.¹⁰⁹ These states mitigate the practical consequences of this approach by recognizing "equitable fraud,"¹¹⁰ but the doctrine's function is to protect an especially sympathetic group of insureds from the harsh consequences of rescission.

In a similar vein, most states require that at least some types of insurance contracts include incontestability clauses: provisions that create a short (normally one- or two-year) statute of limitations on misrepresentation claims.¹¹¹ These clauses are "a means to protect the public against untimely denials of insurance coverage" by ensuring that one who has maintained an insurance policy for the requisite period will not be forced to defend a misrepresentation suit.¹¹² The breadth of incontestability clause requirements depends on the jurisdiction, and such clauses tend to produce litigation over whether an insurer is attempting to challenge the validity of an insurance policy or its scope.¹¹³ Even so, the incontestability clause provides a means of avoiding the use of rescission where the insured has an especially strong reliance interest.

108. John Dwight Ingram, *Misrepresentations in Applications for Insurance*, 14 U. MIAMI BUS. L. REV. 103, 105-06 (2005).

109. See 28 HARNETT & LESNICK, *supra* note 3, § 176.03, at 251; see also *Vining v. Enter. Fin. Grp., Inc.*, 148 F.3d 1206, 1215 (10th Cir. 1998) (applying Oklahoma law); *Clyde A. Wilson Int'l Investigations, Inc. v. Travelers Ins. Co.*, 959 F. Supp. 756, 761 (S.D. Tex. 1997) (applying Texas law).

110. In New Jersey, for example, a court will infer the insured's fraudulent intent from a misrepresentation of a fact about which he could not have plausibly been mistaken. *Formosa v. Equitable Life Assurance Soc'y*, 398 A.2d 1301 (N.J. Super. Ct. App. Div. 1979).

111. 28 HARNETT & LESNICK, *supra* note 3, § 176.01, at 233.

112. *Anderson et al.*, *supra* note 2, at 845.

113. JERRY, *supra* note 105, at 506. For a useful overview of the use and function of incontestability clauses, see *Works*, *supra* note 47, at 809.

4. *Imputation of Knowledge of the Insured's Misstatement*

In some jurisdictions, courts can avoid rescission by imputing knowledge of the insured's misrepresentation to the insurer. Where an insurance company conducts an investigation prior to issuing a policy, discovers a misrepresentation, and decides to issue the policy anyway, the company "is deemed to have waived the misrepresentation."¹¹⁴ Similarly, a court may refuse to rescind a policy where the insurer failed to conduct a reasonable investigation after the insured's statements put it on notice of a possible misrepresentation.¹¹⁵ Courts are especially likely to make use of this doctrine where they believe that the insurer is engaged in post-claim underwriting¹¹⁶ or suspect that an insurance agent induced the insured to make a misrepresentation.¹¹⁷ By imputing knowledge of the policyholder's misrepresentation to the insurer in such cases, courts refuse to rescind policies that they believe the insurer should not have issued.

B. *Rescission's Limits Are Inefficient*

Every state observes a variety of doctrines designed to rein in rescission in the interest of creating a more equitable body of insurance law—an end that these doctrines attain through the exercise of judicial discretion. Ex post assessments of the risk of loss, the insured's intent, and whether a particular kind of loss is outside the scope of the insurance policy make many innocent misrepresentation cases fact-driven and ad hoc.¹¹⁸ Numerous commentators

114. 28 HARNETT & LESNICK, *supra* note 3, § 176.05, at 278; *see, e.g.*, *Trawick v. Manhattan Life Ins. Co.*, 447 F.2d 1293, 1294 (5th Cir. 1971).

115. *Cox v. Am. Pioneer Life Ins. Co.*, 626 So. 2d 243 (Fla. Dist. Ct. App. 1993) (refusing to rescind policy for misrepresentation where applicant told insurance agent about his wife's congenital heart condition but failed to disclose it on the application); *Golden v. Nw. Mut. Life. Ins. Co.*, 551 A.2d 1009 (N.J. Super. Ct. App. Div. 1988) (refusing to rescind policy where insurance company had reason to suspect the insured had made a misrepresentation because the company's investigation was inadequate).

116. *See supra* note 44 and accompanying text.

117. *See* 28 HARNETT & LESNICK, *supra* note 3, § 176.04, at 256-74 (discussing imputation of agent knowledge to the insurance company).

118. *See* KEETON & WIDISS, *supra* note 25, at 569 (observing that commentators have variously described this area of law as "confused," "erroneous," "misleading," and "inconsistent" (citations omitted)); *see also* EDWIN W. PATTERSON, *ESSENTIALS OF INSURANCE LAW* 339 (1935) (describing the case law as "unsettled and confused"); Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 961 (1970) ("[J]udicial

have noted this aspect of insurance law, though few characterize it as a consequence of rescission.¹¹⁹ The law's failure to articulate and follow clear legal standards surely increases litigation costs and is troubling from a rule-of-law standpoint.

Even more troubling, however, are efforts to prevent harsh applications of rescission by denying the insurer any remedy, which merely replace one inefficient outcome with another. As explained in Part I, misrepresentations shift the risk of loss from the misrepresenting insured to the insurer and, ultimately, onto other members of the risk pool. The cost of restricting the use of rescission is "borne by the diligent or lucky insurance buyers who do not unintentionally misrepresent, or do not have a claim, or whose misrepresentation is not discovered."¹²⁰ When a court denies an insurance company any remedy for a material misrepresentation, the misrepresenting insured does not internalize the full cost of his risk profile. Everyone's insurance premiums go up as a result.¹²¹ For this reason, the various doctrines designed to limit the use of rescission provide no solution to the basic problem. Insurance law gives courts a binary remedial choice when efficiency demands an intermediate result.

IV. "ACTUARIALLY FAIR REFORMATION" AS AN ALTERNATIVE TO RESCISSION

Having observed the myriad problems with rescission, the need for an alternative is clear. This Part argues that actuarially fair reformation would make insurance law's treatment of innocent misrepresentations more efficient and doctrinally coherent. After explaining how courts might use actuarially fair reformation instead of rescission, I deploy my critique of rescission to show why this form of reformation is a better alternative.

opinions in this area are less than ordinarily enlightening about principled bases for decision.").

119. See, e.g., ABRAHAM, *supra* note 6, at 14 (noting that "[b]eginning in the 19th century, both courts and legislatures took action that mitigated the harsh effect of warranty law in contexts such as this"); Keeton, *supra* note 99, at 1294 (arguing that limits on rescission are designed to "bar technical, immaterial defenses" from liability to the insured); Works, *supra* note 2, at 590 (characterizing defenses as "[j]udicial techniques for avoiding the strict common law rule"); Foley, *supra* note 2, at 663 ("[C]ourts often seem sympathetic to the insurance buyer when it appears the insurance buyer simply made an innocent mistake and would be treated harshly [by rescission].").
120. Ingram, *supra* note 108, at 106; see Schuman, *supra* note 9, at 108.
121. See North, *supra* note 23 (developing a game theoretic model showing that the limiting remedy for misrepresentation forces the insurer to charge higher premiums).

A. *The Alternative Remedy Explained*

Courts could avoid the inefficiency and doctrinal incoherence that rescission causes by reforming the insurance contract to award the insured the amount of insurance his premiums could have financed. Under this approach, a court would ask how much coverage an insurer could afford to sell someone like the insured without shifting any of the cost of his insurance onto other members of the risk pool. In this way, the reformation remedy would tailor the misrepresenting insured's recovery to reflect the extent to which the misrepresentation caused the insurer to misjudge the risk of loss. Thus, where a misrepresentation has no impact on the ex ante risk of loss, the insured would recover all of what he would have received under the contract as written. Where the misrepresented fact made the insured's loss certain, the insured would only recover his premiums.¹²² In the many cases between these two extremes, the court would discount the insured's recovery according to the degree to which the misrepresentation bore on the ex ante probability of loss.¹²³

A return to *Chism v. Protective Life Insurance Co.* will help illustrate how actuarially fair reformation would work in practice. Recall that the *Chism* court applied insurance law's traditional doctrinal framework for misrepresentation cases, finding that rescission was the proper remedy because the Chisms had inadvertently made a material misrepresentation on their insurance application.¹²⁴ In contrast to this approach, a court deploying actuarially fair reformation would ask how much insurance Protective could have sold the Chisms without shifting any of the cost onto other members of the risk pool. In other words, the relevant question would be how much insurance the Chisms could have bought with their premiums given the truth about Steve Chism's medical condition.

While it was true in *Chism* that Steve Chism's health made him ineligible for the particular policy he obtained by misrepresentation, this would not

122. Where the probability of a loss is one, the actuarially fair insurance premium is equal to the amount of coverage. For example, \$100 of insurance coverage for a loss that has already occurred will cost \$100 to finance.

123. The structure of this remedy is similar to proportional liability in the torts context, where courts apportion damages according to the probability of causation. See Alexander Stremitzer & Avraham D. Tabbach, *Insolvency and Biased Standards: The Case for Proportional Liability* 4 (Yale Econ. Dep't, Working Paper No. 75R, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1507871.

124. *Chism v. Protective Life Ins. Co.*, 195 P.3d 776 (Kan. Ct. App. 2008), *rev'd on other grounds*, 234 P.3d 780 (Kan. 2010) (reversing grant of summary judgment because a material issue of fact existed about whether the alleged misstatements were caused by the Chisms or by the insurance agent).

preclude his partial recovery under actuarially fair reformation. Rather than asking how much insurance Protective would in fact have sold the Chisms, the relevant inquiry would be how much insurance it could have sold them without forcing someone else to subsidize their coverage. Irrespective of the specific terms of the insurance that Protective underwrites, the Chisms would recover as much insurance as their premiums could finance.

My proposal builds on the ideas of several other commentators, who have variously advocated some form of "reformation,"¹²⁵ "reliance damages,"¹²⁶ or a "substantial performance" standard¹²⁷ that would give courts a remedial option between rescission and full recovery for the insured. The details of these suggestions vary,¹²⁸ but their proponents all focus on the ways in which a "less severe remedy" would allow courts to reach more equitable results in cases in which rescission is overly harsh or unavailable.¹²⁹ Despite their merit, these suggestions have failed to gain traction in the literature. Having made the case against rescission, my aim here is to show that actuarially fair reformation deserves a closer look.

B. *The Merits of a Middle Way*

Other reformation proposals have focused on how such a remedy would have less extreme consequences for the insured and might allow insurers to circumvent statutory bars to rescission.¹³⁰ Though the fact that actuarially fair reformation is a less severe alternative to rescission is without question an important part of its appeal, the problems with rescission suggest another set

125. Vratil & Andreas, *supra* note 30, at 854 (advocating use of reformation to reduce the insured's recovery where state law prevents the insurer from obtaining complete rescission for the misrepresentation); *see also* Abraham, *supra* note 90, at 1177-78 (discussing reformation as a means of conforming insurance contracts to the insured's reasonable expectations).

126. Keeton, *supra* note 99, at 1313-14.

127. Anderson et al., *supra* note 2, at 857-59.

128. Vratil and Andreas would have courts reform the insurance contract where the insured has committed a misrepresentation but state law prevents full rescission. Vratil & Andreas, *supra* note 30, at 854. Keeton suggests permitting the insured to recover reliance damages if he can show that if he had known his insurance contract was void he would have procured insurance through some other means. Keeton, *supra* note 99, at 1313. Anderson et al. make the proposal that is closest to the one I advocate here, suggesting that "[t]he policyholder's payment may be reduced by an amount sufficient to compensate the insurance company for any damage it suffers." Anderson et al., *supra* note 2, at 858.

129. Vratil & Andreas, *supra* note 30, at 854.

130. *See supra* Part III.

of reasons for courts to reform insurance contracts in these cases. Actuarially fair reformation would yield a more efficient and doctrinally coherent body of insurance law.

1. *Efficiency*

The most obvious way in which actuarially fair reformation would make insurance markets more efficient is by eliminating the Hobson's choice between allowing the insurer to profit from its customers' misrepresentations and permitting the insured to shift part of the cost of his coverage onto other members of the risk pool. As explained in detail above, the choice between rescission and no remedy at all is a choice between two suboptimal outcomes whenever a misrepresentation induces the insurer to accept a greater risk but not a certainty of loss.¹³¹ In contrast, actuarially fair reformation would allow a court to tailor the insured's recovery to reflect the true risk that the insurer bore; the insured would get all of what he paid for but nothing more.¹³²

Actuarially fair reformation would also promote efficiency by honoring the insured's manifest desire for insurance. As a general matter, shifting risk from a more to a less risk-averse party promotes economic efficiency, and the fact that the policyholder attempted to procure insurance strongly suggests that he is the more risk-averse party.¹³³ Indeed, the mere existence of an insurance contract tends to promote "broad, diffuse, and pervasive reliance," meaning that a voided insurance contract may itself exacerbate the degree to which the

131. See *supra* Sections I.B-C.

132. It is for this reason that I part with Keeton—as well as Vratil and Andreas—in advocating a version of reformation that would not limit the insured's recovery to the amount of coverage an insurer actually would have been willing to sell him. There is no market for some types of insurance that would nevertheless be possible for an insurer to sell at an actuarially fair rate. One who does not have a valid drivers' license cannot procure auto insurance, for example, even though an unlicensed motorist is not certain to crash. In these types of situations, reformation still outperforms rescission by preventing the insurer from profiting from the insured's misrepresentation.

133. Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 90-91 (1977); see also Foley, *supra* note 2, at 660 (observing that "[i]nsurers are much better able than insurance buyers to spread the risk of a loss by misrepresentation"). This is a key difference between rescission in the insurance context and the more general model of rescission Richard Brooks and Alexander Stremitzer develop in a forthcoming article. Brooks & Stremitzer, *supra* note 38, at 31. Brooks and Stremitzer argue that the threat of rescission promotes efficiency by inducing the parties to take an efficient level of care in fulfilling their contractual duties. Yet where one of the parties is risk averse, the possibility of rescission could lead to overcautious behavior. See *id.*, at 29 (explicitly assuming that parties are not risk neutral).

insured suffers from his loss.¹³⁴ Actuarially fair reformation spreads risk by using the premiums of misrepresenting insureds who do not suffer losses to insure partially those who do. While not the full benefit that the misrepresenting insured expected, actuarially fair reformation spreads risk more effectively than rescission while still preventing insurance applicants from shifting the cost of their insurance onto other people.

An opponent of reformation might object that, notwithstanding actuarially fair reformation's greater remedial precision and improved risk spreading, its more moderate penalty would make insurance applicants more likely to make misrepresentations. Insureds are in the best position to avoid misrepresentations, and one might reasonably worry that reformation would cause them to take less care in their communications with the insurer.¹³⁵

But even if insurance applicants knew enough about insurance law for the change I propose to affect their behavior, actuarially fair reformation would still incentivize an efficient level of care. Actuarially fair reformation forces applicants to bear the full cost of their misrepresentations in the form of reduced coverage; where an applicant induces the insurer to dramatically misjudge the probability of loss, he would receive only a fraction of the coverage he believed he was buying. Unlike this form of reformation, which courts could tailor to reflect the facts of a particular case, rescission is a one-size-fits-all remedy that is almost always supercompensatory. Because rescission overcompensates insurers, it gives the rational insurance applicant reason to take too much care to prevent misrepresentations.¹³⁶ Far from inducing an inefficient number of misrepresentations, actuarially fair reformation incentivizes an efficient level of care at the application stage.

2. Doctrinal Coherence

Beyond promoting efficiency, actuarially fair reformation could also bring greater doctrinal coherence to the law of insurance. From materiality standards to the question of whether a particular misrepresentation bore on the insured's

134. Abraham, *supra* note 90, at 1179 n.95. As Abraham explains, one who mistakenly believes he has insurance will be less likely to take precautions in an effort to prevent a loss or to reserve savings to pay for it.

135. See Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 4 (1978) (arguing that risk should be imposed "on the better information bearer").

136. See CRASWELL & SCHWARTZ, *supra* note 63, at 125 (observing that where rescission permits a greater recovery than expectation damages, it may lead the other party to take too much care to avoid breach).

actual loss, courts already use a variety of doctrinal mechanisms to engage implicitly in the kind of balancing that actuarially fair reformation makes explicit.¹³⁷ The reformation remedy would allow courts to weigh the gravity of the insured's misrepresentation openly, thus providing a more honest account of the factors that motivate judicial decisionmaking in these cases. Rather than framing their arguments within insurance law's formal categories, litigants would be able to appeal directly to the factors that are already most important to courts: was the insured's misrepresentation truly innocent, and to what extent did it cause the insurer to misjudge the risk of loss?¹³⁸ In this way, actuarially fair reformation's straightforward approach to innocent misrepresentation cases would tend to produce better reasoned decisions.

Actuarially fair reformation would also make insurance law better conform to the principle that "[t]he right of a person to restitution for a benefit conferred upon another in a transaction which is voidable for . . . mistake is dependent upon his return . . . to the other party anything which he received as part of the transaction."¹³⁹ Rescission allows the insurer to retain benefits from the insured's mistake,¹⁴⁰ but actuarially fair reformation returns both insurer and insured to their *ex ante* positions. Under the reformation remedy I propose, the insurer neither profits nor loses from the insured's misrepresentations, and the insured receives the equivalent of the value of his premiums in insurance coverage. To avoid its obligations under the insurance contract, general principles of restitution hold that the insurer should return everything of value that it took from the insured. Actuarially fair reformation would accomplish this by forcing insurance companies to use misrepresenting insureds' premiums to cover partially their losses.

C. Actuarially Fair Reformation as a Workable Judicial Standard

Actuarially fair reformation admittedly asks more from courts than rescission, but it nevertheless provides a workable judicial standard that courts

137. See *supra* Part III.

138. See *supra* notes 118-119 and accompanying text; see also KEETON & WIDISS, *supra* note 25, at 567 (noting the conflict between "preserving an insurer's right to assess and accept the actual risk or risks that are to be transferred . . . [and] protecting the expectations or the reliance of an insured").

139. RESTATEMENT OF RESTITUTION: QUASI CONTRACTS AND CONSTRUCTIVE TRUSTS § 65 (1937); see also RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 13 cmt. i (Tentative Draft No. 1, 2001) ("[A] rescinding plaintiff becomes subject to a duty of counter-restitution with respect to any benefits received in the nullified transaction.").

140. See *supra* Section II.A.

could use in practice. For courts to deploy this type of reformation, they would need to distinguish innocent misrepresentations from fraudulent misrepresentations as well as quantify the true *ex ante* risk that a misrepresenting insured would suffer a loss. Neither of these tasks is easy, but very similar inquiries under current doctrine suggest that courts could accomplish them.¹⁴¹ Moreover, the inefficiency of insurance law's use of a supercompensatory remedy suggests that even an imperfectly deployed reformation remedy would be a significant improvement over the status quo.

One of the threshold requirements for actuarially fair reformation in cases where the insured made a misrepresentation on his insurance application would be that the misrepresentation was made in good faith. Without such a requirement, someone who was otherwise unable to procure insurance could lie on his application in the hope that he could partially recover through reformation.¹⁴² The possibility that actuarially fair reformation would incentivize insurance fraud is a legitimate concern, but it should not be exaggerated. The remedy I propose would allow the insured to recover only the amount of coverage his premiums could finance and only when a court believed that the misrepresentation was made in good faith.¹⁴³ Thus, an insurance applicant who intentionally causes the insurer to underestimate

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141. See *supra* Subsection III.A.3 (discussing the practice in some states of only permitting rescission for fraudulent misrepresentations).
142. Someone for whom there is no market for insurance but who is nevertheless insurable would be especially likely to attempt this kind of fraudulent misrepresentation. A person who is unable to obtain a valid driver's license, for example, generally cannot buy auto insurance even though he would not be certain to suffer a loss under the policy. See *Hays v. Jackson Nat'l Life Ins. Co.*, 105 F.3d 583, 590 (10th Cir. 1997) ("If the only consequence of a fraudulent misrepresentation in a life insurance application is to reduce the amount paid under the policy, there is every incentive for applicants to lie." (citing *N.Y. Life Ins. Co. v. Johnson*, 923 F.2d 279, 284 (3d Cir. 1991))); *Schuman*, *supra* note 9, at 123 (expressing the concern that "[a]llowing even a reduced recovery under policies procured [by fraud] would reward the practice of misrepresenting facts critical to the underwriter's task").
143. Discerning when an insurance applicant has acted in good faith has not proved to be unworkable in the states that treat applicant bad faith as a requirement for rescission. See *supra* notes 49-52 and accompanying text. In general, what constitutes an insurance applicant's good faith depends on the particular line of insurance, with greater care expected of more sophisticated applicants. Whatever the scope of the insured's duty to act in good faith, at a minimum it would include a duty not to make knowing misrepresentations on the application and to reveal any misrepresentations to the insurance company upon discovery. Cf. *Indus. Life Ins. Co. v. First Nat'l Bank of Perryton*, 449 S.W.2d 129, 132 (Tex. Civ. App. 1969) (observing that one of the purposes underlying the statutory requirement that a certificate of health be attached to the policy delivered to the applicant is "to furnish the insured an opportunity to correct any error which might vitiate the policy").

greatly the risk of loss could hope to recover little more than his premiums if his fraud was successful; nothing if it was discovered.

Actuarially fair reformation might even discourage fraudulent misrepresentations by freeing states to ease insurers' burden of proof in such cases, perhaps by extending the time within which insurers can raise misrepresentation defenses.¹⁴⁴ As I argued in Part III, state law creates obstacles to insurers' misrepresentation claims because rescission is such an extreme remedy. Adjusting the remedy would make it possible to moderate the standard that insurers must meet to bring a successful claim, and the net result might well reduce a fraudster's chances of success.

But apart from a careful analysis of insurance applicants' incentives to lie, one should not lose sight of the basic asymmetry in the amount of relevant law that insurers and insureds are likely to know. It is surely the case that the typical insurance applicant is ignorant of the nuances of his state's remedy for innocent misrepresentations, and there is thus little concern that these specifics will induce him to commit fraud. Unlike insurance applicants, however, insurance companies are repeat litigants in these cases. Given the companies' greater resources and regular participation in litigation, remedial nuances are much more likely to influence their behavior. Post-claim underwriting and fraudulent misrepresentation are both to be discouraged, but these remedial nuances more effectively reach the former than the latter.

A second challenge for courts applying actuarially fair reformation is that they would need to discern how much insurance the misrepresenting insured's premiums could have financed. To this end, courts could look to prevailing insurance market rates—asking how much insurance the premiums would have purchased in the absence of any misrepresentation. Courts in many jurisdictions already consider such evidence in innocent misrepresentation cases,¹⁴⁵ but the comparison between insurance policies would often be imperfect. For example, life insurance rates tend to be higher when they are tied to the purchase of a vehicle,¹⁴⁶ and a court would need to factor this into its reformation of the policy in *Chism*. This kind of evidentiary problem would increase the cost of litigation and enable only imprecise determinations of the

144. See *supra* Section III.A.

145. See 6 RUSS & SEGALLA, *supra* note 6, § 82:14-15; Segalla & Parks, *supra* note 25, at 127 (noting use of “[p]roof such as underwriting guidelines, rules and regulations, [and] underwriting manuals”).

146. CRL's *First Ever Report on Car Lending Practices*, AM. FOR FAIRNESS IN LENDING, <http://americansforfairnessinlending.wordpress.com/2009/06/02/crls-first-ever-report-on-car-lending-practices/> (last visited Oct. 25, 2010) (suggesting that such policies are overpriced).

insured's proper recovery. Though such difficulties are important to consider when evaluating the efficiency of actuarially fair reformation,¹⁴⁷ my proposed remedy might actually reduce total litigation costs by enabling courts to abandon some of the more ad hoc and unpredictable elements of current doctrine. In any event, the benefits of replacing a supercompensatory remedy surely outweigh the costs.

CONCLUSION

In this Note, I have attempted to make the argument against rescission in innocent misrepresentation cases. The Note's fundamental insight is that rescission systematically overcompensates insurers who are the victims of misrepresentations and that the traditional remedy thereby makes insurance markets less efficient. The general principles of contract law do not justify this outcome; on the contrary, restitution and the internal logic of insurance law suggest a different result. Since state statutes govern much of the underlying law of innocent misrepresentations, legislatures should amend these statutes to authorize the use of actuarially fair reformation. Given rescission's long history and codification by state legislatures, it would be improper for a court to impose the alternative remedy that I suggest by unilateral judicial fiat. Even in the absence of legislative action, however, courts could improve the law at the margin by paying more attention to rescission's inefficient results.

¹⁴⁷ Cf. George L. Priest, *Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach*, 91 HARV. L. REV. 960, 964 (1978) ("A damage remedy entails the calculation of . . . costs—a process which requires the expenditure of resources whether performed by a court or by the parties themselves in settlement negotiations.").

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