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Supreme Court Overrules "Easily Ascertainable" Fraud Rule: Insurer May Assert Defense Of Fraud Even If It Was Easily Ascertainable And Claimant Is Innocent Third Party

By Sidney Klingler

In a decision issued June 15, 2012, the Michigan Supreme Court overruled over 30 years of cases which held that an insurance carrier could not assert fraud in the procurement of the policy as a defense to liability, when the fraud was "easily ascertainable" and the claimant was a third party. In *Titan Insurance Company v Hyten*, the Court held "that an insurer is not precluded from availing itself of traditional legal and equitable remedies to avoid liability under an insurance policy on the ground of fraud in the application for insurance, even when the fraud was easily ascertainable and the claimant is a third party."

In *Hyten*, the insured (Hyten) represented in her insurance application that her household had no drivers with suspended licenses, when in fact Hyten's license was suspended and remained suspended for a month after the inception of the policy. Hyten was then involved in a motor vehicle accident in which the plaintiffs were injured. During the investigation of the accident, the insurer learned that Hyten did not have a valid license when the policy was issued, and sought a declaratory judgment that it did not have a duty to indemnify her in the lawsuit brought by the injured plaintiffs.

Looking to traditional principles governing fraud, the Court noted that "it is clear that an insurer has no duty to investigate the representations of a potential insured." A party asserting fraud need not prove "that the fraud could not have been discovered through the exercise of reasonable diligence." In short, "an insurer has no duty to investigate or verify the representations of a potential insured." Furthermore, fraud in the procurement of a contract "may be grounds to retroactively avoid contractual obligations through traditional legal and equitable remedies such as cancellation, rescission, or reformation."

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Fraudulent insureds may no longer defend their fraud (and enforce their fraudulently procured polices) by arguing that their insurance company should have discovered their fraud.

A debate has arisen whether the "innocent third party" rule remains in effect. The Court did not decide the continued viability of the innocent third party rule on the merits since Titan conceded that it would still owe the minimum $20,000/$40,000 liability coverage required by the No Fault Act. However, the Court did note that the statutory requirements would remain in effect (begging the question of whether statutory requirements, such as the $20,000/$40,000 minimum, would remain in effect if the policy was rescinded for fraud by the purported insured). Since this issue was not contested by the parties in *Hyten*, it is an open question of whether the innocent third party rule is vulnerable to a Supreme Court appeal.

The Court reaffirmed its pre-No Fault Act holding from the 1959 case of *Keys v Pace*, "that an insurer may avail itself of traditional legal and equitable remedies to avoid liability under an insurance policy on the ground of fraud, notwithstanding that the fraud may have been easily ascertainable, and notwithstanding that the claimant is a third party." In the process the Court overruled *State Farm Mut Auto Ins v Kurylowicz*, and its 30 year progeny. The Court found that *Kurylowicz* had erroneously failed to follow *Keys*. Moreover, the Court rejected *Kurylowicz's* public policy rationale for the "easily ascertainable" rule. The Court reasoned that "there is simply no basis in the law to support the proposition that public policy requires a private business in these circumstances to maintain a source of funds for the benefit of a third party with whom it has no contractual relationship." The Court concluded that the No Fault Act did not alter the common law which "enables insurers to obtain traditional forms of relief when they have been the victims of fraud."

It remains the case, however, that "when a provision in an insurance policy is mandated by statute, the rights and limitations of the coverage are governed by statute." Thus, the Court noted that the remedies available to Titan might be limited by statute, specifically citing MCL 500.3009, which contains the requirement for a minimum of 20/40 liability coverage.[1] [2]

The three dissenting justices would have adopted the Court of Appeals reasoning, and decried the overruling of 36 years of authority.

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[1] Indeed, Titan had not sought to avoid all liability, but rather sought a declaration that it was not required to indemnify its insured above the minimum liability coverage requirements.

[2] The Court also noted that the Financial Responsibility Act, MCL 257.501 et seq-., in certain circumstances limits the ability of an insurer to avoid liability by claiming fraud in obtaining the policy, but the Court took care to note that this limitation applies only to insurance required by the Act; that is, it applies only to motor vehicle liability insurance policies that have been certified under MCL 257.518 or MCL 257.519.

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