Eugene R. Anderson
ANDERSON KILL & OLICK
1251 Avenue of the Americas
New York, NY 10020-1182
Telephone: (212) 278-1000
Fax: (212) 278-1733

Amy Bach, Esq.
Law Offices of Amy Bach
42 Miller Avenue
Mill Valley, CA 94941
Telephone: (415) 381-7627
Fax: (415) 381-5572

Attorneys for Applicant United Policyholders

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF CALIFORNIA
SAN JOSE DIVISION

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| THE PAUL REVERE LIFE INSURANCE COMPANY,<br><br>Plaintiff,<br><br>vs.<br><br>MILES CAMERON TAYLOR aka WHITNEY P. TAYLOR, and DOES 1-50, inclusive,<br><br>Defendants. | Case No. C 99-21104 JF<br><br>UNITED POLICYHOLDER'S BRIEF AS AMICUS CURIAE |
| MILES CAMERON TAYLOR<br><br>Counter Claimant,<br><br>vs.<br><br>THE PAUL REVERE LIFE INSURANCE COMPANY and DOES 1-50, inclusive,<br><br>Counter Defendants. | Date: N/A<br>Time: N/A<br>Courtroom: 4<br><br>Hon. Jeremy Fogel |

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## MEMORANDUM OF POINTS AND AUTHORITIES

### INTRODUCTION

Policyholders buy disability coverage to protect themselves if and when they find themselves at the most helpless extremes of human experience. Like all insurance policyholders they reasonably expect that they can rely on the words in the policy to inform them of their rights and obligations. Everyone concerned also recognizes that when disability claims are made, the policyholders are in no position to fight a wrongful denial of coverage. At that point, they are dependent upon coverage benefits for their basic existence. Being forced to litigate coverage denies them most of the benefit they sought in the first place, the ability to pay for food, shelter, clothing, etc. when they cannot provide for themselves. In fact, such an unexpected battle adds to the often overwhelming problems they already face. It is commonly known and well supported by court findings, in California and elsewhere across the U.S., that such claimants are often driven to settle for less than that to which they are entitled, forced to abandon their claims altogether, or lose for lack of adequate legal assistance and the resources to fight these grueling battles. Disability insurers and the California legislature are both well aware of this situation.

### THE WISDOM BEHIND TAYLOR'S ARGUMENT THAT THE SPECIFIC WORDS OF THE POLICY MUST CONTROL THE DUTIES AND OBLIGATIONS OF EACH PARTY – HIS SO-CALLED "TWO PIECES OF PAPER" ARGUMENT

We understand that at trial Taylor has proven, through uncontroverted evidence that at all times pertinent he was and is Totally Disabled, as those words are defined in the policy. Despite this, he has also argued that he was not actually required to do so under the terms of the policy.

Somewhat surprisingly, he argues that all he should have been required to prove, for the payment of his benefits to have been triggered, was the fact that he had complied with the conditions stated by the words in the policy - no more, but no less, i.e. that he had submitted a notice of claim and a written proof of loss, informing the insurer that because of sickness, he was unable to perform the important duties of his occupation, and he was receiving physician's care, as those words are defined in the policy.

Taylor makes an important distinction that we will expand upon here.

When policyholders buy disability policies, they naturally expect: (1) that their policies do not amount to a guessing game, designed to get them to pay premiums with only an elusive and uncertain prospect of receiving benefits; (2) that they can rely on the words in the policy to inform them of their rights and obligations; (3) that any condition to, limitation on, or exclusion from coverage will be fully, clearly, unambiguously, explicitly and unmistakably expressed by the words in their policy; (4) that they will be covered if they are disabled unless the disability in question is clearly and explicitly excluded and (5) that they will actually receive the policy benefits when they are disabled.

Certainly, without clear, explicit, unambiguous and unmistakable policy language to the contrary, they would not expect that their claims would only be payable at the discretion of the insurer – whose reason for being, making the maximum profit for the corporation and its owners, is directly and adversely affected by the payment of their claim. Yet, that is precisely what Paul Revere argues in Taylor's case.

Nothing in Paul Revere's policy, as is the case with many others, expressly alerts the prospective policyholder that Paul Revere reserves the right to exercise its discretion in these claims situations. The question is, then, whether an insurer has this discretion, when the policy does not fully, clearly, explicitly, unmistakably and unambiguously inform the policyholder that it does[1]. Under these circumstances, can an insurer simply disbelieve a claimant and deny coverage after a claim is submitted?

[1] This applies equally to the situations, as Paul Revere asserts is so in this case, in which the denials are based on an insurer's claim that a particular sickness is not supported by "objective" evidence, when there are no words in the policy creating such a condition, limitation or exclusion.

In order to retain such discretion, insurers are required by well-settled existing law to explicitly reserve their right to do so in language in the policy that can leave no doubt in a reasonable policyholder's mind. The law on point in California and the Ninth Circuit is abundant, clear and well-settled. *See, e.g., Galanty v. Paul Revere Life Ins. Co.* 23 Cal.4th 368, 374 (2000); *Montrose Chemical Corp. of Calif. v. Admiral Ins. Co.,* 10 Cal.4th 645, 666-667 (1995); *Bank of the West v. Superior Court (Industrial Indemn.),* 2 Cal.4th 1254, 1265 (1992); *Crane v. State Farm Fire & Cas. Co.,* 5 Cal.3d 112, 115 (1971). See also *MacKinnon v. Truck Ins. Exchange*, 31 Cal.4th 635, 648 (2003); *Waller v. Truck Ins. Exchange, Inc.,* 11 Cal.4th 1, 18 (1995); *Reserve Insurance Co. v. Pisciotta,* 30 Cal.3d 800, 807 (1982); *State Farm Mut. Auto. Ins. Co. v. Jacober*, 10 Cal.3d 193, 201-202 (1973); *Meraz v. Farmers Ins. Exchange,* 92 Cal.App.4th 321, 324 (2001); *Scott v. Continental Insurance Company*, 44 Cal.App.4th 24, 28-29 (1996); and *A.B.S. Clothing Collection, Inc. v. Home Ins. Co.,* 34 Cal.App.4th 1470, 1480 (1995). It is the policyholders' objectively reasonable expectations based on the words in the policy, as those words are understood by an ordinary person, that must prevail. It would be irrational for policyholders to expect that insurers retained discretion to deny their claims whenever the insurer chose to disbelieve them, without having clearly alerted them of this significant limitation on coverage through the words in the policy.

Because of the obvious and inherent conflict of interest between the policyholder's and insurer's economic interests, it would also be an imprudent decision for any potential policyholder to purchase a policy from any insurer, leaving such discretion in the insurer's hands without having been fully apprised of this condition and carefully considering its implications. This is even more apparent in the case of an insurer that has been repeatedly found by the courts to improperly deny and terminate claims, such as is the case with Paul Revere and its related companies. *See, e.g., McGregor v. Paul Revere Life Ins. Co.,* 63 Fed. R. Evid. Serv. 546, 2004 WL 68652 (9th Cir., 2004); *Grosz-Salomon v. Paul Revere Life Ins. Co.,* 237 F.3d 1154, 1157 (9th Cir., 2001); *Hangarter v. Paul Revere Life Ins. Co.,* 236 F.Supp.2d 1069, 1107 (N.D.Cal., 2002); *Galanty v. Paul Revere Life Ins. Co.,* 23 Cal.4th 368, 374 (2000); .

In fact, scholarly insurance industry publications, have explored the consequences upon insurer profits resulting from the loss of consumer certainty as to the scope and effect of coverage under the policy. Such a loss of certainty would inevitably result if potential policyholders were clearly informed that Paul Revere (or any insurer) retained unilateral discretion to deny future claims for benefits.

For example, Richard E. Stewart & Barbara D. Stewart, "The Loss of the Certainty Effect," Vol. 4, No. 2 Risk Management and Insurance Review 29, 29-30 (2001) ("Stewart & Stewart"), a copy of which is attached hereto, explains that the certainty of payment of claims is the central factor in determining whether an insurer can sell its product (insurance policies) and for how much:

> A defining characteristic of insurance is that the product is sold and paid for long before it is delivered. For a certain payment now, the buyer of insurance gets the insurance company's promise to deliver money and services in the future should an uncertain event occur.
>
> . . . .
>
> The buyer's assumption that claims will be paid is the key to the value of what insurers sell.
>
> (Emphasis added.)

Thus, the effect of any reduction in the certainty of payment of claims can have drastic impact on an insurer's bottom line:

> Prospect theory – wherein buyers give disproportionate weight to closing off the last bits of risk – implies that the loss of the certainty effect would cost insurers a great deal more than an amount proportional to the reduction in reliability.[2]
>
> Stewart & Stewart, at 39

Allowing any insurer to exercise the inadequately disclosed discretion that Paul Revere claims to have retained to deny claims would result both in the systematic defrauding of unsuspecting policyholders and possibly irreparable harm to the insurance industry itself. Stewart & Stewart, at 39-45.

[2] See the attached Stewart & Stewart article for a more complete discussion of these factors.

## THE PARTICULAR VULNERABILITY OF INCONTESTABILITY CLAUSE POLICYHOLDERS, LEGISLATIVE INTENT IN REGARD TO THEM, AND THE EFFECT UPON THE LEGAL ISSUES RAISED HEREIN

Disability policy claimants are particularly vulnerable to wrongful denial of their claims by insurers.

First, the claim may be challenged because of some purported omission or misrepresentation on the policy application. To allay policyholder fears regarding this issue (and thereby sell more policies), insurers have historically wanted the option to market at least some disability policies with an Incontestability Clause granting policyholders iron-clad protection against denials for application fraud after the contestability period elapses.

> Incontestability clauses first appeared in life insurance policies in the middle of the 19th century as a feature offered voluntarily by insurers. Such clauses were intended to promote the sale of policies to a public generally distrustful of insurers, and to address the perception that insurers tended to avoid paying benefits because of minor misstatements in applications for insurance.
>
> *Galanty v. Paul Revere Life Ins. Co.*, 23 Cal.4th 368, 379 (2000).

Seeing that this also comported with laudable public policy goals, the Legislature satisfied the insurance industry's desire in 1951 with the enactment of the necessary enabling legislation, Ins. C. § 10350.2.

> Such [incontestability] clauses reflect the legislative policy judgment that it is reasonable and proper to give the insured " ' " 'a guaranty against possible expensive litigation to defeat his claim after the lapse of many years' " ' " while, at the same time, " ' " 'giv[ing] the company time and opportunity for investigation, to ascertain whether the contract should remain in force.' " ' "
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> *Galanty v. Paul Revere Life Ins. Co.*, 23 Cal4th at 388.

It is important to note that this statute also gives insurers the alternative of using a watered down Incontestability Clause in Form A that does allow insurers the ability to assert application fraud as a complete defense to coverage even after the contestability period. In the instant case, however, Paul Revere, like many insurers, consciously elected to use the more pro-policyholder alternative of the two, Form B, that protects policyholders' coverage rights even in the event of outright application fraud.

> In other words, by choosing form B an insurer gives up, after two years, the right to assert the defense of fraud in order to make the policy more attractive to consumers and, thus, more saleable. [footnote 26: " 'Incontestability clauses are generally "included in the policies to affect their saleability." Even when such clauses are required by statute, insurance agents undoubtedly point out the clause to potential buyers and explain that coverage may not be denied after a period of time. Thus, it follows that when given the choice between two clauses, an insurance company would choose the clause that would result in increased sales or in some other benefit to the company. If potential fraud was enough of a threat to the insurance company, the company could have chosen the [form A] option that offered long-term protection against fraud.' " (*New England Mut. Life Ins. Co. v. Doe, supra,* 688 N.Y.S.2d 459, 710 N.E.2d at p. 1064, quoting Note, *Liar's Poker: The Effect of Incontestability Clauses After Paul Revere Life Ins. Co. v. Haas* (1995) 1 Conn. Ins. L.J. 225, 233-234.)]
>
> *Gallanty v. Paul Revere Life Ins. Co.*, 23 Cal.4th at 382.

Obviously, the more expansive Form B Incontestability Clause exposes insurers that elect to use it to the risk of deliberate omissions and misrepresentations on policy applications. To protect themselves against this, insurers are allowed to and should thoroughly investigate the applicant's representations, either at the time of application or during the following two-year contestability period following it. (In this case, it appears that Paul Revere chose not to investigate Taylor's misrepresentations on his application, even though those misrepresentations would have been easy enough to discover if it had done so.) And, insurers can be relied upon to charge enough extra in premiums for these policies to cover any remaining risk they have undertaken with its use.

> Moreover, if the insurer chooses to use the other form of incontestability clause (*id.*, form B), the insurer still has two years after issuing the policy to investigate the insured's medical condition and statements in the application. Only an insurer, like Paul Revere in the case before us, that chooses to forgo both contractual protection against fraud and timely verification of the insured's medical condition runs the risk of having to pay a claim that may turn out to be related to a sickness that first manifested itself before the policy's inception date. Under these circumstances, there is nothing unfair in the Legislature's evident policy judgment that any risk of fraud is outweighed, after the period of contestability has run, by the need to protect the value of the policy to the insured and to reduce litigation.
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> *Galanty v. Paul Revere Life Ins. Co.*, 23 Cal4th at 388-389.

Thus, there can be no doubt that those insurers, who like Paul Revere in this case, elect to use the expansive Form B clause do so fully aware that their policyholders will most certainly include "insurance cheats" whose coverage under the policy vests after the contestability period has run. In fact, by the presence of the Incontestability Clause, the policy clearly reflects the very intent to protect these "insurance cheats" after the contestability period. (And, of course, the Legislature for its part fully intended to protect the interests of these policyholders.) As such, disability insurers have the full panoply of responsibilities to these policyholders. And, insurers take their policyholders as they knowingly find them. As always, the insurers' duties here are contextual in regards to who their policyholders are. Just as hospitals have a different duty of care to mental patients with suicidal tendencies than to surgical patients, insurers have a different duty to Form B Incontestability Clause policyholders than they do to Form A policyholders.

(Nor are these Form B policyholders unsympathetic, once one sets aside their application-related misrepresentations. By definition, most of these people are seriously ill. They have misrepresented the nature of their health and health history, correctly anticipating that they will eventually succumb to their disabling illness. Usually, they have no other means of future financial support. Their moral lapse is driven by their desperation.)

Nevertheless, as the Court has seen with Paul Revere's litigation strategy in the instant case, many disability insurers disingenuously express shock and moral outrage, condemning these policyholders as "insurance cheats" and refusing to pay their claims. The fact that these policyholders by definition have a history of making misrepresentations to their insurers leaves them vulnerable to challenges to their credibility and brazen ad hominem attacks. Insurers know they will be able to defeat these policyholders' contract claims in many instances by suggesting to the finder of fact that these "insurance cheats" do not deserve their contractual benefits. And, insurers know that at worst their risk of being hit with a punitive damages award for denying such claims is minimal. In fact, with these factors in mind, insurers are only too willing to have this business and take the substantial premiums these desperate policyholders are willing to pay. (This probably explains Paul Revere's failure to thoroughly underwrite and investigate Taylor's policy application for fraud.)

As recognized by the California Supreme Court in *Galanty v. Paul Revere Life Ins. Co.*, 23 Cal.4th 368, 388 (2000), an Incontestability Clause is nothing more than a contractual, statutorily approved, limitations period:

> An incontestability clause "does not condone fraud but merely establishes a time limit within which it must be raised." (*Amex Life Assurance Co. v. Superior Court*, *supra*, 14 Cal.4th at p. 1237.) Incontestability clauses thus function as " ' "statute[s] of limitations upon the right to maintain certain actions or certain defenses ...." ' " (*Ibid.*) Such clauses reflect the legislative policy judgment that it is reasonable and proper to give the insured " ' " 'a guaranty against possible expensive litigation to defeat his claim after the lapse of many years' " ' " while, at the same time, " ' " 'giv[ing] the company time and opportunity for investigation, to ascertain whether the contract should remain in force.' " ' " (*Id.* at p. 1238.)]

Of course, limitations periods are frequently used by unscrupulous insurers to protect themselves from being held accountable for the fraud and other wrongdoing they perpetrate on claimants. Examples are legion in published cases of insurers whose fraudulent conduct is

absolutely protected by contractual or statutory limitations periods. Thus, insurer outrage when their shoe fits another's foot is more than a little hypocritical.

Tactically, insurers can also enhance their position in resisting these claims by artful claims handling. Knowing that these policyholders have something to hide, namely, their original misrepresentations, insurers re-ask the same or similar questions as those on the original application. Nine times out of ten the policyholder will attempt to cover up his or her original misrepresentations by either repeating them or giving some new misrepresentation that covers for the earlier, application-related misrepresentations in some way. Insurers then argue, as Paul Revere has done herein, that these claims-related misrepresentations are unprotected by the Incontestability Clause and provide an independent basis for voiding the policy.

Among other things, these tactics completely undercut the Legislature's intent to fully protect the contact rights of these Form B policyholders after the contestability period has run. If insurers are allowed to succeed with these tactics, thereby defeating the claims of these policyholders, what is the point of allowing the use of the expansive Form B Incontestability Clause? Unless the otherwise valid disability claims of these Form B policyholders are upheld, it would be far better that the expansive Form B Incontestability Clause is removed from all disability policies. Otherwise, these provisions only encourage desperate people to waste money they should not spend at a time they can least afford it on what is, practically speaking, invalid and illusory coverage.

> " ' " 'To [deny coverage] would be to permit such a clause in its unqualified form to remain in a policy as a deceptive inducement to the insured.' " ' " ([ *Amex Life Assurance Co. v. Superior Court, supra,* 14 Cal.4th] at p. 1246, 60 Cal.Rptr.2d 898, 930 P.2d 1264, quoting *Dibble v. Reliance Life Ins. Co.* (1915) 170 Cal. 199, 206, 149 P. 171.)
>
> *Galanty v. Paul Revere Life Ins. Co.*, 23 Cal.4th at 389.

But, these provisions <u>are</u> in disability policies, and were mandated to be there by a statute designed to protect these policyholders, so it is the insurer claims-handling practices that invalidate them that must be rejected in no uncertain terms.

Among other things, Paul Revere's attempt to void the policy for Taylor's irrelevant and immaterial claims-related misrepresentations must be rejected. This purported affirmative defense is not supported by the policy language, statute, or common law. It should remain that way. In fact, there is a great need for published caselaw specifically repudiating the existence of such an affirmative defense for all the reasons expressed above.

## REQUEST TO PUBLISH THE COURT'S OPINION

The foregoing legal issues are issues of first impression in California. Unscrupulous insurers regularly perpetrate the strategies discussed above owing to the lack of legal authority on point. In the absence of contrary authority, the insurers' position remains in a sense "arguable", and on that basis they are able to escape extra-contractual damages in the rare instances in which they are challenged in court.

For the sake of regularly victimized policyholders, the law in this area needs clarification. Therefore, we urge the Court to not only adopt the positions we espouse herein but also to publish its opinion on these issues.

Dated: April 22, 2004

ANDERSON KILL & OLICK

By _____

Eugene R. Anderson, Esq.
Anderson Kill & Olick, P.C.
1251 Avenue of the Americas
New York, New York 10020
Tel: 212-278-1000
Attorneys for Amicus Curiae
United Policyholders

Of Counsel:

Amy Bach, Esq.
Law Offices of Amy Bach
42 Miller Avenue
Mill Valley, CA 94941