# FOURTH CIRCUIT CONFIRMS INSURER WAIVED RIGHT TO RESCIND POLICY BASED ON PRE-LOSS KNOWLEDGE THAT CERTAIN CONDITIONS TO COVERAGE HAD NOT BEEN MET

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In *Colony Ins. Co. v. Peterson*,[1] the U.S. Court of Appeals for the Fourth Circuit affirmed a jury's finding that an insurer waived its right to rescind coverage where the insurer knew prior to the loss that the policyholder had not met certain policy conditions, yet did nothing to inform the policyholder or to cancel or otherwise change the policy.

## Background

Colony Insurance Company ("Colony") issued a commercial property insurance policy to Evergreen Composite Technology, LLC ("Evergreen") covering a property known as the "501 Building" for, among other things, loss caused by fire. The policy contained a protective safeguards endorsement that required, as a condition to coverage, that the policyholder maintain an operable sprinkler system of specified criteria to protect insured property against fire. The protective safeguards endorsement stated that Colony would "not pay for loss or damage caused by or resulting from fire if, prior to the fire," the named insured "[f]ailed to maintain any protective safeguard … in complete working order" or "[k]new of any suspension, malfunction or impairment in any protective safeguard" and failed to notify Colony.

After issuing the policy, Colony engaged a vendor to inspect the 501 Building at the insured's expense to ensure compliance with the protective safeguards endorsement. The vendor reported that the 501 Building's utilities, including heat, were turned off. The report contradicted information contained in the policyholder's insurance application, in which the policyholder had represented that power and heat would remain on at the 501 Building during any vacancy.

After the policy's issuance, fire damaged the 501 Building and business-related personal property. A forensic inspection of the damaged property revealed that the valves of the 501 Building's sprinkler system had been turned off. Based on that evidence, Colony denied coverage and filed suit, seeking a declaratory judgment and rescission based on alleged misrepresentations about the fire protection equipment. Evergreen and the building's owner, Peterson, counterclaimed against Colony and cross-claimed against the building's mortgagee, Randolph Bank and Trust Company, and the insurance broker. All parties moved for summary judgment, which the court denied.

At trial, Colony's underwriter testified that she received but did not read the vendor's inspection report before the loss occurred. She further testified that if she had read it, she would have "immediately" cancelled the policy. The insured also elicited evidence that in other cases involving alleged application discrepancies, Colony did not rescind the policies, but instead negotiated resolutions with its policyholders, such as "higher premiums" or "remedied conditions."

Based on the evidence presented, the jury found in favor of the policyholder and awarded defendants $2,369,000 in coverage and pre-judgment interest. The jury specifically found that Colony waived its right to rely on the protective safeguards endorsement and was estopped from enforcing it. After Colony unsuccessfully moved for a post-verdict entry of judgment in its favor, Colony appealed the judgment to the Fourth Circuit.

## Appeal & Holding

The Fourth Circuit rejected Colony's position that a failure to maintain the fire protection equipment in operable condition vitiated coverage. The court observed that in North Carolina, policy provisions that effect a forfeiture of coverage may be waived by the conduct of the insurer. The court explained that, while the North Carolina Supreme Court has not explicitly

addressed the waiver issue under facts similar to those in *Colony*, intermediate appellate courts have ruled favorably for policyholders, holding that knowing acceptance of certain risks may estop an insurer from later enforcing a forfeiture provision. Other intermediate appellate courts have similarly held that, an insurer that fails to limit coverage after learning of a policyholder's failure to satisfy a coverage condition is estopped from later enforcing the breached condition. The court further explained that estoppel may apply even where the facts that may otherwise vitiate coverage remain unknown to the insurer, so long as the insurer had a reasonable opportunity to learn of them. Consequently, even though Colony's underwriter testified that she had not actually read the report indicating that the protective safeguards condition had not been satisfied, the jury found that Colony had sufficient information and a sufficient opportunity to understand the risk and accept it.

## Implications

The Fourth Circuit's decision in *Colony* illustrates a disfavor for coverage forfeiture provisions and their draconian enforcement. Rather, as the decision demonstrates, the preferred treatment of forfeiture provisions calls for a practical application that considers, among other things, the insurer's actual or implicit willingness to maintain the policy despite a failure to satisfy supposedly essential conditions to coverage. The decision therefore underscores the importance of communicating all material facts about a risk to the insurer, so that the policyholder is in a position to show that the insurer had the ability to fully evaluate the scope of the risk before any loss occurs.

### Note

[1] No. 13-1033 (4th Cir. Aug. 25, 2014).

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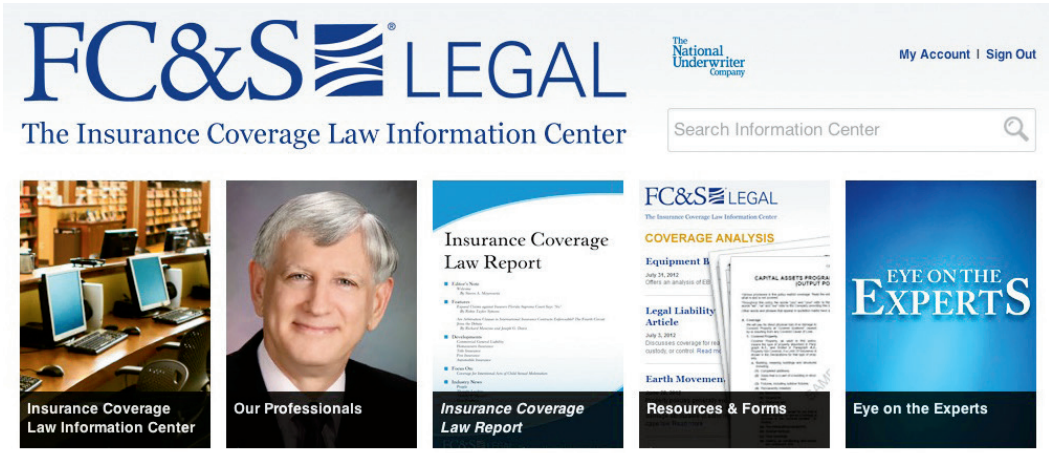


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