Insurance Fraud in South Carolina

Potential Pitfalls for Insurers

By Jeffrey J. Wiseman and Joseph W. Rohe

Fraud is big business in South Carolina and, with the recent economic turmoil, it's going to get even bigger. A recent article published by the Coalition Against Insurance Fraud (www.insurancefraud.org), citing data from the National Insurance Crime Bureau, noted that the number of reportedly stolen vehicles being recovered burned or flooded under suspect circumstances increased steadily with rising gas prices and increasing unemployment figures. According to the S.C. Attorney General's office, at least 10 percent of all auto, home and business insurance claims are either fraudulent or highly inflated. Additionally, the S.C. Insurance News Service (www.scinsnews.com) reported that insurance fraud costs Americans more than $85 billion a year, while the effect of insurance fraud costs the average American household more than $1,000 a year in out-of-pocket expense.

In 2006 (the most recent figures available), the three largest insurance sectors affected by fraud in South Carolina were automobile (45 percent), personal/commercial property (14 percent) and workers' compensation (13 percent). According to the S.C. Attorney General, the seven most common types of insurance fraud in the state are:

- Underreporting the number of miles driven on an automobile policy;
- Failing to report an accurate medical history when applying for health insurance;
- Employees faking or exaggerating injuries to avoid work and draw workers' compensation payouts;
- Auto accident victims who falsify or overstate injuries to achieve large settlements or awards;
- Staging automobile accidents that result in inflated injury claims;
- Exaggerating or fabricating injuries or illness to draw accident and/or health insurance benefits; and
- Exaggerating the amount and value of items stolen from a home or business.

S.C. Attorney General's Office (www.scattorneygeneral.org).

South Carolina, however, is at the forefront of the fight to combat insurance fraud. For instance, in 2002, South Carolina was ranked number one in the nation by the Coalition Against Insurance Fraud for convictions per dollar spent fighting insurance fraud. While the pro-activity of the State has greatly increased the ability to combat and deter this fraud, it is the insurance claims professional, their counsel and management that remain best poised to defend against this problem. This is accomplished through careful and calculated claims han-

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dling practices, policy language drafting and legal guidance.

Pleading and Proving Fraud

Pleading a cause of action for fraud under the special pleadings rule of the South Carolina Rules of Civil Procedure requires that "[i]n all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity." Rule 9, SCRCP. Further, failure to plead and prove any one of the nine elements will be fatal to a cause of action for fraud. *Inman v. Ken Hyatt Chrysler Plymouth, Inc.*, 294 S.C. 240, 242, 363 S.E.2d 691, 692 (1988) ("It is well-settled that a complaint is fatally defective if it fails to allege all nine elements of fraud.").

The requisite burden of proof

In South Carolina, the requisite burden of proof in most civil cases is a "preponderance of the evidence" standard. As judges will typically explain to a jury when charging on this burden, one must only "tip the scales" slightly to meet this standard. In contrast, fraud must be proven by the elevated burden of clear, cogent and convincing evidence. *See Brown v. Stewart*, 348 S.C. 33, 42, 557 S.E.2d 676, 680 (Ct. App. 2001).

Further confusing the issue, case law suggests that an insurer can "defend" a claim with a fraud defense in cases of arson and need only to prove the claim with a "preponderance" evidentiary standard. *See Carter v. Am. Mut. Fire Ins. Co.*, 297 S.C. 218, 220, 375 S.E.2d 356, 358 (Ct. App. 1988) ("An insurance company can prevail in an arson defense based solely on circumstantial evidence if it shows that the fire was of *incendiary origin* and that the plaintiff had both the *opportunity* and *motive* to have the fire set."); *see also Brown v. Allstate Ins. Co.*, 344 S.C. 21, 25, 542 S.E.2d 723, 725 (2001) ("To prove arson, an insurer must demonstrate by the preponderance of the evidence the fire was of an incendiary origin, and the insured caused the fire."). As it currently stands, the difference in evidentiary standards between a fraud claim and a fraud defense appears to be limited to cases where an insurer raises arson as a defense to plaintiff's claim. *See Kerr v. State Farm Fire & Cas. Co.*, 731 F.2d 227, 228-29 (4th Cir. 1984) (applying South Carolina law and reversing a jury charge on an insurer's defense of "misrepresentation" that the insurer's burden was "by a preponderance of the evidence"). In the end, this discussion regarding the difference between the preponderance standard and the clear and convincing standard is likely more esoteric than practical. The jury will either believe the evidence or they will not, and a judge is not likely to interfere with the jury's determination of a question of fact.

Evidentiary issues

There are several significant evidentiary issues that may arise in a fraud case. The issue of whether the insured was criminally prosecuted is often raised. However, evidence of non-prosecution for criminal arson has been held to be irrelevant and inadmissible. *See Brown*, 344 S.C. at 24, 542 S.E.2d at 725. Thus, the insured should not be allowed to testify in his defense that he was not prosecuted for fraud or arson by the local authorities. Likewise, "evidence of criminal charges related to arson is excluded in lawsuits for fire insurance proceeds because such evidence goes to the principle issue before the court and is highly prejudicial." *Id.* at 25, 542 S.E.2d at 725.

Another evidentiary pitfall involves the use of signed statements. Any time a signed statement is taken from an insured, litigant or any other witness, including a proof of loss, our legislature has deemed that a copy of the statement must be provided to that person at the time of its signing. S.C. Code Ann. § 19-1-100 (2008) provides:

> No statement taken from and signed by a witness…shall be used in any civil judicial proceeding for the purpose of contradicting, impeaching or attacking the credibility of such a witness or litigant, unless such party shall have been furnished a copy of said statement at the time of its signing.

This statute has been cited by our courts in cases concerning proofs of loss. In *Varnadore v. Nationwide Mut. Ins. Co.*, 289 S.C. 155, 345 S.E.2d 711 (1986), an insurer was precluded from admitting into evidence a proof of loss statement for the purposes of impeaching the testimony of a witness where the witness had not been furnished a copy of the statement. While the document was permitted to be used for certain evidentiary purposes, it could not be relied upon to impeach the witness. Moreover, the argument that a proof of loss form was not a "statement" was expressly rejected by the Court. *Id.* at 160, 345 S.E.2d at 714.

Clients often raise the question as to what this statute means for the traditional claims practice of taking recorded statements. In *Sullivan v. Davis*, 317 S.C. 462, 454 S.E.2d 907 (Ct. App. 1995), the Court of Appeals refused to reverse a trial verdict on the argument that the trial court should have allowed the use of unsigned recorded statements to impeach three witnesses. In *Sullivan*, the court did not directly address the admissibility of the unsigned statements with regard to § 19-1-100, but rather sidestepped the issue in holding that "[even] if the court erred in excluding the statements for impeachment purposes, we see no prejudice." *Id.* at 465, 454 S.E.2d at 909. Therefore, though our courts have not yet meaningfully addressed this issue, a reasonable practice would be to have the claims professional, while taking the recorded statement, (a) have the witness recognize that a copy of the transcription of the recorded statement will be provided to him or her; (b) agree to sign the transcription when provided, and (c) acknowledge that a copy of the recorded statement transcription will then also be provided at the time it is signed.

Like recorded statements, examinations under oath, or "EUOs," are a helpful and often utilized tool in

investigating suspected insurance fraud. An EUO is an examination of an insured, under oath and before a court reporter, the taking of which is typically provided for under the terms of the policy. Though not yet addressed by the courts, it is very possible that an EUO would be held to constitute a "statement" for the purposes of the statute. Accordingly, it would be reasonable to follow steps similar to that of recorded statements to ensure compliance with § 19-1-100.

Insurance claims professionals should also keep in mind that the process of taking statements, whether that be an EUO or recorded statement, is still part of the claims handling process. Thus, the provisions of the S.C. Improper Claims Handling Statute, S.C. Code Ann. § 38-59-20 (2008), would apply. Because a denial under an accusation of fraud may result in a bad faith claim by the insured, the claims professional should treat every statement as if it will be read in its entirety to a jury and therefore should make every effort to show he is acting reasonably and objectively. This goes for the notes entered into the claims file as well. Even if the insured is suspected of fraud, the investigation should follow all leads and the insured should be given the benefit of the doubt so far as it is possible. Additionally, the claims file should reflect such.

Fraud and Its Impact on Coverage

Impact on the policy

Most insurance policies contain language that provides that any fraud or misrepresentation by an insured will void the entire policy. Although the majority of jurisdictions in the United States recognize that fraud or misrepresentation as to any portion of a policy will void the entire policy, South Carolina's courts have taken a more pro-insured approach. In South Carolina, "fraud will only void provisions [of the policy] tainted by the fraud." *Johnson v. South State Ins. Co.*, 288 S.C. 239, 241, 341 S.E.2d 793, 794 (1986).

As South Carolina views coverages as being divisible, the tainted provisions are effectually "severed" from the policy. *See Id.* ("In the absence of fraud or any act condemned by public policy, the contract is divisible, and recovery may be had for the loss of property not affected by the particular warranty broken."). The theoretical foundation for this approach is that South Carolina requires the insurer to prove a "causative link" between the fraud and the recovery sought by the insured before the recovery would be defeated. *Id.* at 241-42, 341 S.E.2d at 794-95. In other words, under this theory, simply because an insured makes material misrepresentations on an application regarding contents of a home or exaggerates a contents claim after a fire loss, coverage for the dwelling (though not the contents therein) remains unaffected because there is no "causative link" between the fraud and the loss to the dwelling. Therefore, under a policy insuring a home, fraud as to Coverage C (typically the contents coverage) would not void Coverage A (the dwelling coverage).

In *Johnson*, the insured submitted a claim following a fire loss that included a sworn "Proof of Loss" claiming the contents of the residence allegedly lost or damaged during the fire. Upon investigation, the insurer discovered fraud as to the contents claim and subsequently denied the entire claim, including the claim for loss to the dwelling. The insurer argued that, pursuant to the terms of the policy, fraud as to one aspect of coverage (the contents) operated to void the entire policy. Notwithstanding the policy's terms, the *Johnson* court found the coverages afforded under the policy to be "severable," and the insured was allowed to recover for the loss to the dwelling and for additional living expenses even in light of his fraud as to contents.

Impact upon an innocent co-insured

The S.C. Supreme Court has held that "in the absence of any statute or specific policy language denying coverage to a co-insured for the arson of anther co-insured, the innocent co-insured shall be entitled to recover his or her share of the insurance proceeds." *McCracken v. Gov't Employees Ins. Co.*, 284 S.C. 66, 69, 325 S.E.2d 62, 64 (1985). Thus the actions of one insured are not necessarily, as a matter of law, imputable upon another insured. *Id.* at 68-69, 325 S.E.2d at 64 (*citing Hildebrand v. Holyoke Mut. Fire Ins. Co.*, 386 A.2d 329 (Me. 1978) and *Howell v. Ohio Cas. Ins. Co.*, 327 A.2d 240 (N.J. Super. 1974)).

In the *McCracken* case, a spouse who was a named insured under the policy made a claim for coverage on a home destroyed by arson committed by the other spouse (also a named insured under the policy). The S.C. Supreme Court declined to find any distinction between property held jointly or severally, as is done in many other jurisdictions. *See McCracken*, 284 S.C. at 68-69, 325 S.E.2d at 63-64. Accordingly, it is within the power of the insurer, by specific policy language, to avoid severance of coverage where one co-insured has committed an act that would itself invalidate coverage. In *S.C. Farm Bureau Mut. Ins. Co. v. Kelly*, 345 S.C. 232, 547 S.E.2d 871 (Ct. App. 2001), an innocent co-insured argued for a finding of coverage under a policy of insurance based on the decision in *McCracken*. Citing the unpublished opinion of *State Farm Fire & Cas. Co. v. Mitchell*, Op. No. 98-UP-100 (Ct. App. 1998), the Court of Appeals held that an innocent co-insured was barred from recovery under the policy where that policy contained specific language denying recovery if any insured caused or procured the loss for the purpose of obtaining insurance benefits. *Kelly*, 345 S.C. at 239-40, 547 S.E.2d at 875.

Issues Concerning Lienholders

In the common case of suspected insurance fraud, it is often discovered that the insured was upside down on his lien and was far behind in payments. This is even more com-

monplace today where recent reports from the Mortgage Bankers Association (www.mbaa.org) claim that 12 percent of U.S. homeowners are either in foreclosure or behind in mortgage payments. According to Bankrate (www.bankrate.com), an even more alarming 40 percent of automobile owners are estimated to be upside down on their auto loans. In cases where the insurer can prove fraud by the insured, the question often arises whether the insurer still has to pay off the lien. Answering this question will always require an examination of the specific "loss payable" or "loss payee" clause in the policy—of which there are two basic types.

Types of loss payee clauses

South Carolina essentially recognizes two types of loss payable clauses in insurance policies. They are the "simple/open" type clause and "standard/union" type clause (also known as "New York mortgage" clauses). Under a traditional "simple/open" clause, a mortgagee or lienholder (loss payee) cannot recover where the named insured is barred. *Nationwide Mut. Ins. Co. v. Commercial Bank*, 325 S.C. 357, 361, 479 S.E.2d 524, 526 (Ct. App. 1996). Thus, any misconduct by the insured will also serve to bar recovery by the loss payee as, under such a clause, the loss payee stands in the insured's shoes and is typically subject to the same defenses. *See Insurance Law & Practice* § 3401.

Conversely, under the "standard/union" type clause, the loss payee is entitled to full protection, and no act or neglect of the insured can prejudice his rights. *Nationwide Mut. Ins. Co. v. Hunt*, 327 S.C. 89, 94, 488 S.E.2d 339, 342 (1997). However, with the "standard/union" form, the loss payee may become liable to pay the premium to the insurance company on demand, and in return, is freed from policy defenses that the company may have used against the insured. It is this promise to pay premiums upon demand that our courts have held to be the consideration in the "secondary" contract between the insurer and the loss payee (lien holder). *See Fort Hill Fed. Sav. & Loan Ass'n v. S.C. Farm Bureau Ins. Co.*, 281 S.C. 532, 538, 316 S.E.2d 684, 688 (Ct. App. 1984).

Which is which?

The "standard/union" clause uses language similar to the "simple/open" loss-payable clause but further stipulates that, as to the interest of the loss payee (the lien holder), the insurance shall not be invalidated by certain acts of the insured, which continue as grounds for forfeiture against him. *Hunt*, 327 S.C. at 92, 488 S.E.2d at 341. Under the "standard/union" form, the mortgagee is entitled to full protection and no act or neglect of the insured can prejudice his rights. *Id.* at 94, 488 S.E.2d at 342. The following "standard/union" clause was before the court in *Fort Hill*:

> Loss, if any, under this policy, shall be payable to the aforesaid as mortgagee (or trustee) as interest may appear … and *this insurance, as to the interest of the mortgagee (or trustee)… shall not be invalidated by any act or neglect of the mortgagor or owner* … provided, that in the case the mortgagor or owner shall neglect to pay any premium due under this policy the mortgagee (or trustee) shall, on demand, pay the same.

Fort Hill, 281 S.C. at 534-35, 316 S.E.2d at 686 [emphasis added].

It is entirely within the power of the insurer to limit the scope of the "standard/union" clause. In *Commercial Bank*, the loss payable clause stated that "[t]he lienholder's interest will be protected, except from fraud or omissions by the policyholder or the policyholder's representative." *Commercial Bank*, 325 S.C. at 360, S.E.2d at 526. The court held this clause barred recovery by the loss payee in the event of fraud by the insured because the language of the clause was clear and unambiguous. Other policies have attempted to limit this language with only specific types of fraud-like behavior, adding such language as "… provided, however, that the conversion, embezzlement or secretion by the Lessee, Mortgagor or Purchaser in possession of the property insured under a bailment lease, conditional sale, mortgage or other encumbrance is not covered under such policy …" The definitions of "conversion" and "embezzlement" are slightly different legal definitions of stealing. Further, the "legal" definition of "secrete" is "[t]o conceal or secretly transfer (property etc.) esp. to hinder or prevent officials or creditors from finding it." *See* BLACK'S LAW DICTIONARY (8th ed. 2004). Courts have not been receptive to using this type of language to deny payment to the loss payee. *See e.g. Nat'l Cas. Co. v. Gen. Motors Acceptance Corp.*, 161 So. 2d 848, 852 (Fla. Ct. App. 1964) (holding that "[a]n insurer will not be allowed the use of obscure phrases or exceptions to defeat the purpose for which the policy was procured …" and that the insurer's "interpretation of the … exclusionary provision of the policy [based upon a technical consideration of the meaning of "conversion" and "embezzlement"] is inconsistent with its undertaking …"). Therefore, generally determining whether the lienholder must be paid regardless of the fraudulent acts of the insured depends upon the language of the policy as contained in the "loss payee" clause.

In conclusion, insurers and their claims professionals must remain mindful of the intricacies of insurance law in South Carolina, particularly in cases of alleged fraud. South Carolina's case law on these issues requires that insurers carefully tailor their policies and claims handling practices to ensure the fairest result to the claim without unduly exposing the insurer to additional bad faith liability.

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