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Chapter 1: Philosophy of Law

Purpose of the Law

Every adult has probably been a party to an insurance contract in some point in his or her life. Be it for an automobile, health, life or a homeowner's policy, insurance touches many aspects of our day to day lives. Odds are that most people do not read their insurance policies. Even if they did, they would have a hard time understanding the coverages provided. You might say that the insurance agent comes in by explaining the coverages. Insurance agents must be competent and well grounded in legal principles surrounding their industry in order to educate and serve the public.

Insurance contracts are complex legal documents that reflect both general rules of law and insurance law. When a person buys insurance, they expect to be paid for a covered loss. The amounts paid and if it can be collected are matters covered by insurance law. Agents need some understanding of the legal principles and concepts reflected in insurance contracts.

During an average working day people give little thought to the legal system under which we operate. That system is what makes it possible for you to leave your car in the parking lot, go to work, deal with other people, buy groceries, set out for home and arrive there safely, knowing that tomorrow will be a lot like today. The rule of law makes the commonplace possible. In a society without the rule of law somebody's whim could take away your property, your livelihood, and even your life at any time with no reason or warning. An understanding of our legal system can give individuals "a new appreciation of the protecting net the law has woven between anarchy and us."

An effective teaching method for students being introduced to the study of any topic in a legal framework is to provide some of the basic working materials of the law. Illustrative cases are provided in the various chapters as a means of arousing and (hopefully) retaining the interest of the reader. In this way the architecture of the legal system as it ultimately applies to the insurance industry can be seen. The rules and principles are shown as they apply to specific cases and in the solution to specific problems. This is not the same thing as a student being taught law in a law school. It is a method to illustrate firsthand from decided cases the manner in which controversies between and among insurance industry representatives, consumers, and regulators are decided by the courts

This course is not intended to provide expertise in law but simply to give an overview of the origin, development, and current provisions of laws governing the common transactions that make viable a successful social organization. Every civilized society is founded on law. None has ever survived without it.

These pages contain some of the more common issues and concepts that arise in the areas of insurance coverage and insurance law. Court rulings, common law and statutory law on this topic are always changing, always evolving. The decisions are often subject to many different interpretations. Because of this, the student or insurance professional is advised not to rely on the concepts and principles laid out in this book without additional research. This book is meant to expand the educational horizons of the reader- it does not give legal advice. Consult a legal expert for answers to specific questions about the law.

The Legal System Develops

A legal system is made up of the rules a society has adopted and enforced in order to function. The rules depend on the basic principles under which that society is operating. Democracy in America has as its first premise the liberty of the individual based on the recognition of the right to life, liberty, and the pursuit of happiness. The second promise is equality, the right to equal treatment and the duty not to interfere with the equal rights of others. The third promise is cooperation to insure those rights and duties for all.

Other major premises of democracy are toleration, justice and participation. Tolerant of the rights and beliefs of others is essential to cooperation and to equality of treatment. Justice is a constant and perpetual dedication to the ideal of rendering to every person his or her due. Equality requires that justice be even-handed. To keep a democracy viable and vital, its constituents must not only be vigilant, but they must participate.

The organized form of society known as government is instituted to define and enforce individual rights and duties and to ensure equality and cooperation. The law is a set of rules intended to fit individual and group rights into the framework of its political premises. Law has to be flexible enough to apply under changing conditions without abandoning the basic premises under which it was established. Because of this, the law cannot be set down in one unchanging list of rules. In the most stable society no person can foresee the future. Rules cannot be established to meet all possible situations as they arise. There will always be new economic and social developments never thought of when the original laws were laid down. The courts make it possible to adapt the law to the realities of social, industrial, and political conditions without abandoning the basic principles on which the judicial system was founded.

Primitive Society and Ancient Law

In all societies the historical function of law has been to elaborate, rationalize, and protect the dominant institutions and accredited ways of life (whether "good" or "bad"), and the function of public law has been to apply ultimately the coercion of the state toward maintaining the outlines of those dominant institutions.

The Nature of Law- Law is clearly not an exact science such as the inductive physical sciences. U.S. Supreme Court Justice Benjamin Cardozo (1870-1938) said that "the more we study law in its making, at least in its present stages of development, the more we gain the sense of a gradual striving toward an end, shaped by a logic which eschewing the quest for certainty, must be satisfied if its conclusions are rooted in the probable. An exact science is ‘what is’ and law is ‘what should be.’"

Nevertheless, the methodology of law combines the techniques of the three major sources of learning:
1.) <u>Science and the Inductive Method</u>*:* Insofar as science relies upon experience and inductive reasoning that builds upon experience in reaching tentative conclusions for further testing, the law is a science. Holmes said that "the life of the law has not been logic: it has been experience" and that a "page of history is worth a volume of logic" Cardozo noted that "the effect of history is to make the path of logic clear." The law relies for its knowledge upon experience, history, tradition and custom. It employs the inductive method and to that extent is a science. Cardozo divided the inductive sources into the method of evolution or historical development and the method of tradition
2.) <u>Reason and the Deductive Method</u>*:* The law also employs reason and logic in combination with knowledge learned through observation and study of numerous instances or cases as premises for new deductions. Cardozo termed this technique as the method of philosophy.
3.) <u>Arts and the Intuitive Method</u>*:* Cardozo's final category was the method of sociology, by which he meant that the law was also formed by more or less intuitive forces such as morals, ethics, justice, social welfare, public policy and religion. Within the intuitive category fall such other creative devices as "common sense" and a sense of artistry. Jerome Frank said that, "Judges, like musical performers, are to some extent artists."

The Philosophical Development of Law- Once it is acknowledged that the law is not a pure science based upon immutable and universal truths, but rather a continuous striving to attain a workable set of rules to adjust the individual and group rights of a society within the fixed framework of its political premises and the constant changing and progression of its sociology and technology, and once it is understood that the law is formed by a creative admixture of inductive, deductive and intuitive techniques, then the ultimate question remains: What should the law be?

American democracy and its legal system are derived from "natural law." **Natural law** has been expounded through the centuries by philosophers and jurists such as Sophocles, the Stoics, Aristotle, Cicero, Justinian, St. Paul, St. Augustine, Thomas Aquinas, Bracton, Coke, Grotius, Locke, Blackstone, and Marshall.

Natural law is based upon the assumption that all civilized persons of normal conscience throughout the world can agree that the first principle of human behavior is to do good and to avoid evil. It recognizes that man is a being invested with human dignity in whom reside basic rights, such as the right to existence and life, the right to personal freedom, the right to the pursuit of happiness, the right to keep one's body whole, the right to private ownership of material goods, the right to marry according to one's choice and to raise a family which will be assured of the liberties due it, and the right of association. The above-enumerated rights of each person are inseparable from the correlative duties of every other person.

The precepts of natural law as a basis of individual liberty are embodied in Magna Carta. Natural law concepts cradled the thinking that led to the American and French revolutions and are found in the Declaration of Independence, and the Bill of Rights

Law protects these rights. Down through the ages, man has been considered endowed with natural rights. As science, technology, industry and social institutions change and develop, these fundamental rights remain constant.

The Functional Development of the Common Law- Although the philosophical basis for the American political and legal system is also the basis for other legal systems, there are great differences in the legal institutions within those systems and differences in the procedures and vehicles whereby each system attempts to fulfill its governmental function.

The American legal system has functionally developed from the English **common law**, which, in turn, has roots in Roman law. The common law can be traced back to the blood feuds of primitive societies where private warfare among consanguinial kindred groups such as families, tribes, or clans resulted in a continuing series of killings and counter-killings. Vengeance generated by a feud could be halted only by the exaction of a "blood-fine" against the killer's clan payable to the victim's clan. The buying off of a feud was known as a **composition**. At first the composition was optional with the slain man's kin but later it became compulsory. It was required that the feud terminate upon the payment of the sum determined in some societies by a fixed schedule and in others by disinterested arbitrators. When the state intervened to arbitrate, a portion of the fine was payable to the state, not as a penalty for a crime but as a fee for its time and trouble.

Eventually, crimes were regarded as offenses against the community as evil conduct was considered harmful to everyone, and the state as representative of the people became responsible for imposing penalties upon offenders whose conduct was *contra pacem regis* (against the peace of the king). However, for centuries, individuals have depended for protection against harm and violence upon what has developed as the law of torts (civil wrongs), rather than upon deterrence of wrongful conduct by enforcement of the criminal law.

The common law history of torts is grounded in the old "appeals" of murder, mayhem or larceny whereby the injured party or his kin pursued and captured the wrongdoer, charged him, and engaged him in trial by battle, later supplanted by trial by jury. As in primitive cultures, the motive was vengeance and hence the first compensable torts were intentionally inflicted harms. The victim was originally compensated by the life of the wrongdoer or by the recovery of the property taken by the wrongdoer. In the seventeenth century in Anglo-Saxon England, a schedule of payments was published, not unlike present-day workmen's compensation schedules, fixing the prices for the composition of various kinds of injuries.

It was not until after the Battle of Hastings and the Norman Conquest of Britain by William the Conqueror in 1066, and particularly after the ascendancy to the throne of Henry II in 1154 that the beginning of the common law becomes clearly observable. As the kings undertook to consolidate the administration of their realm, they brought into being a system of law administered by their own justices and known as the common law. The history of the common law of England is the history of the expansion of royal justice, administered by courts of the king, at the expense of the local judicial bodies, the manorial courts that had theretofore adjudicated controversies. This transition was encouraged and abetted by the advantages that litigants had in the king's courts, including trial by jury.

One seeking redress in the king's courts applied for a "writ." Originally, a **writ** was merely any written command given by the king or in his name. Later, it came to be a command to the defendant to appear in court to answer the charges of the plaintiff. It was thus the manner in which a legal action could be started in a royal court. However, the litigant had to find a writ that would fit his case. If there were no writ suitable to the claim he was asserting, his only recourse would be to local tribunals. There was no general law of contract or of tort, administered in the king's courts; rather, there were certain legal remedies or forms of action corresponding to the recognized writs.

The remedy for a direct, intentional harm was by a form of action known as <u>trespass.</u> Such action was available to a person who had been injured by the direct and immediate application of force to himself or to his property. Where the injury or harm was caused by culpable omissions or resulted indirectly from the wrongdoer's act or omission to act, the proper form of action to redress the wrong was known as <u>trespass on the case</u>. The forms of action developed so that trespass became the remedy to recover damages for direct and intentional harms and trespass on the case the remedy to recover damages for injury resulting from the actor's negligence.

The **concept of contract** developed from the background of feud and private vengeance. Once the clan consented to compensation by the payment of a blood price, the paying clan was faced with the problem of making available the agreed upon amount. During this period, the avenging clan demanded a hostage, usually the slayer, as surety to secure performance of the promise of payment. If payment was not made, the hostage was understood to be expendable and was put to death. The secured promise occasionally became an unsecured promise.

At common law, the first form of action sounding in contract was <u>debt</u> for the recovery of a fixed amount of money, followed by <u>covenant</u> for the enforcement of a contract under seal, and finally <u>assumpsit</u> for the enforcement of a simple contract.

Thus, the common law developed in three basic areas:
1.) Crimes, wrongs committed against the state or against society as a whole;
2.) Torts, wrongs committed against an individual's inherent interests which the state protects against infringement by any other person; and
3.) Contracts, individual rights created by agreement and consent of the contracting parties.

Early Common Law Courts- The early common law courts were three in number: Court of Exchequer, Court of Common Pleas, and Court of King's Bench. The Court of Exchequer originally handled only tax matters. The court later became a regular law court. The court of Common Pleas, also called Common Bench, decided ordinary civil actions. The Court of the King's Bench had sole criminal jurisdiction.

Utilizing the writ system, these courts began to develop a body of law resting upon decided cases which came to serve as precedent for the future determination of controversies. The principle of *stare decisis* (to stand by the decisions) whereby past decisions are adhered to and relied upon in the solution of present disputes, is a hallmark of the common law as articulated by these English tribunals. So it is with courts today in this country.

The Insurance Business & the Law

As the law and concept of legal systems developed, so too did the insurance industry. As the industry became more pervasive, disputes naturally arose. During the Middle Ages, European merchants engaged in international commerce desired to govern their own trade and contract disputes rather than submit their controversies to the local courts of continental Europe. They established informal mercantile tribunals that served basically as committees of arbitration. Although these tribunals had no direct way of enforcing their orders, their effectiveness arose from the consent of the parties and from the force of custom.

The first English Insurance Act, passed in 1601, created a special court to hear marine insurance cases. The court was composed of "the judge of the admiralty . . . the recorder of London . . . two doctors of the [European] civil law, two [English] common [law] lawyers, and eight grave and discreet merchants...." This court was not successful, and later died of inaction.

The appointment of Lord Mansfield, the "father of English commercial law," as Chief Justice of the Court of King's Bench in 1756 marked a turning point in the development of the common law. The principles of mercantile law, including those principles relating to insurance law, were finally incorporated into the English common law system during his tenure as Chief Justice. This incorporation rendered the common law courts competent to rule on controversies involving insurance, and by 1788, most merchants turned to the common law courts for the settlement of commercial and insurance disputes.

Kinds of Law

Public Law- is the body of rules in which the government is directly involved. Public law regulates the relationships between individuals and the government. One group of rules in public law defines and limits the powers of the government.

The part of public law most familiar to many persons is **criminal law***,* which is the body of rules that we are commanded to obey. The government may fine those who do not obey, or even put them in jail. A number of smaller groups of rules also come under the general heading of public law. **International law** is concerned with agreements among nations, problems of boundaries, and other questions arising from the relationships of one country with another. **Constitutional law** deals with the problems that have arisen about various clauses in the United States Constitution. Problems in constitutional law include the organization of the government and the guarantees of our liberties. **Administrative law** is the body of rules made by agencies of government other than the courts. The Interstate Commerce Commission is such an agency.

Private Law or Civil Law. This includes the rules that regulate the relationships among people. Private law includes many smaller groups of rules. Some examples are the rules relating to contracts, personal injuries, and real estate. Many persons think only of criminal law when they hear the word *law.* However, most lawyers and courts spend most of their time dealing with problems of private law. These private law problems include taxation, business affairs, the transfer of property, and the collection of money for persons injured through the fault of others.

Sources of Law

Where do we find the rules that are enforced by the government? They are found in customs, in constitutions, in legislation by lawmaking bodies, in the decisions of judges, in the orders of administrative agencies and, in some countries, in decrees made by dictators.

The Constitution. Many of the basic rules of a country or state are contained in its constitution. The rules in the constitution have force above all other rules of law in the country. To ensure that these basic rules remain in force, it is usually necessary to obtain the agreement of most of the people in order to change a constitution The United States Constitution was written by a constitutional convention. In order to change or amend the constitution, a two-thirds majority of Congress must agree upon an amendment. The amendment must then be ratified by three-fourths of the state legislatures. Alternatively, two-thirds of the states can agree to convene a constitutional convention for the purpose of amending the constitution.

In the United Kingdom the constitution is not written. The rules which make up the British constitution are the traditions of freedom, justice, and human rights that the British people have lived by for centuries. The rules can be changed by Parliament. The right to free speech in Great Britain is considered to be protected as fully by the country's unwritten constitution as it is by the written constitution of the U.S.

Statutes. Many rules are made by persons elected to do the job of lawmaking. A rule that has been enacted by a lawmaking body is called a <u>statute</u>. The legislators of the United States Government are the Senators and Representatives elected to the Congress. Each state also has its own elected legislators.

Common Law. As discussed previously, this is another important source of rules in English-speaking countries. Judges, who enforce the customs of the community as each understands them, make these common law rules. When a court has decided a rule that it considers just, and that agrees with the customs and opinions of the community, that court and the other courts enforce the rule establish in this first case. The case that first sets down a rule of this kind is called a *precedent.* After some time when a rule has been uniformly applied in a number of cases, it becomes a solid part of common law. It is not rejected until a court feels that the rule no longer reflects the beliefs of the community. When a court rejects a precedent, it is said to *overrule* the earlier judgment.

Even though a rule is written in the form of a statute, difficult problems often arise in deciding exactly what the statute means, or to whom it applies. Such questions are decided by the courts in accordance with common traditions, after careful study of the statute. When a court has decided what the statute means, other courts follow its decisions, just as they follow common law rulings.

Administrative Rulings are made by bureaus of the government called *administrative agencies.* An example of such an agency is a local board of health, which regulates such things as standards of cleanliness in restaurants and the purity of drinking water. The Interstate Commerce Commission is a Federal agency that regulates the rates charged by overland transport companies. There is no "per mile" rate system. It is estimated that over six million individual rates exist from point-to-point in the U.S. It takes a huge bureaucracy to administer such a cumbersome rate structure. The rules that these agencies make, and the rules under which they operate are becoming an increasingly important branch of the law.

Decrees- In countries where the government has absolute power, that is, a dictatorship, laws are made without the consent of the people. Law may simply be announced by the dictator as a *decree.* The people do not agree with the law, but they have no way of changing it.

How Laws Change

In a Democracy, the people have the power to determine the rules under which they live. The rules laid down by legislatures, as well as common-law rules, are constantly being changed to reflect changes in the customs and desires of the people. Sometimes the law fails to keep up with the changing society. Some very strange rules remain technically in force, although no one bothers to conform to them. For example, an ancient law about trial by battle was in force in England until 1827, although it had not been enforced for more than three hundred years.

On rare occasions, the government may enforce a rule that is no longer accepted by most of the people. For example, in the early 1900's, many courts in the United States followed an old ruling that said that they could not enforce newer regulations on the number of hours children could work. Many people were dissatisfied with the old rule, and thought that the courts should enforce child labor rules. Finally, the pressure of public opinion caused the courts to abandon the old rule and to enforce new rules which limited child labor. Sometimes courts or legislatures have established a rule with which most of the people have disagreed. When this happens, and when the rule concerns something important, some of the legislators who passed the law may be defeated in elections. Other people will be elected who promise to change the rule. Or the rule simply may not be enforced. Sometimes the rule is one that concerns only a small number of people, such as a requirement that banks make a certain kind of report to a public official. Even then, if most of the people affected by the rule believe that it is out of date or impractical, the legislators and the courts will usually respond by changing the rule.

History of Law

Even before men could write, the laws and customs of each community were passed down from one generation to the next by the older members of the group. Later, some of the laws were written down, for the sake of clarity and permanence.

The Code of Hammurabi. The earliest law that has been preserved is the one developed in the 1900'S B.C. by Hammurabi, a ruler of the ancient Sumerians. The Sumerians lived in the valleys of the Tigris and Euphrates rivers. Hammurabi's code set forth a complete system of law. It set down the kinds of punishment to be used for a variety of offenses. It also established the amounts of payment to be made for various services. The code continued to be used in that part of the world long after Hammurabi's death.

The Law of Moses. About 1200 B.C. Moses, a Hebrew, gave to the world the Ten Commandments. The Ten Commandments stated principles of behavior that had long been recognized as good. These Commandments, in one form or another, can be found stated in law everywhere during all ages of history.

The Law of the Ancient Greeks. The Greeks were among the first to introduce the idea that laws are made by men and can therefore be changed by men whenever the need arises. This idea marked a great step forward in human thought. Before that time, people believed that laws always came from a god or group of gods. They thought that these divine laws were revealed through the rulers or priests and could not be changed by men, even though the laws were unjust.

The Greeks respected law more than any other people had done before. They believed that a country should be ruled by law rather than by men. This does not mean that men were not in governing positions. It means that the power of governing officials was carefully limited by law. All government activities were regulated by law. The Greeks had well-defined laws relating to property and inheritance, to contracts, and to matters relating to trade. In Athens, juries of citizens, or citizens sixty years of age who were called *arbitrators,* tried legal cases. These men were not always well informed on the fine points of the law, but the Greeks believed the spirit of the law to be much more important than its wording.

The proposals made by Solon, who lived about six hundred years before Christ, were a great step in the development of Greek law. Solon persuaded the Athenian nobles to treat all citizens alike in matters of justice and voting in the assembly. One of the famous works on Greek law is by Plato and its title, oddly enough, is *The Laws.*

Law in Ancient Rome. The Romans developed law much beyond the Greeks. Roman law was more complete, and it was in Rome that the first legal profession developed. The first important step in Roman law came in 450 B.C., when the Law of the Twelve Tables was drawn up by a council of ten men. These Tables were based on the Roman religion. They set forth customary ways of behavior. The laws were inscribed on brass tablets. For hundreds of years, many Romans memorized the Twelve Tables, even though they had no other schooling.

In Rome the ministers of justice were called *praetors.* Their duties were in some ways like those of modern judges. The praetors were responsible for administering the Law of the Twelve Tables. In cases not covered by the Tables or by any other statute, the praetors had the power to make decisions that had the effect of law.

After the Roman Republic gave way to the Empire, Roman Emperors made law by decree. Upon the death of each emperor, the senate had the authority to decide whether or not the decrees of the dead ruler should remain in force.

The Law of the Twelve Tables applied only to Roman citizens. The Romans were forced to develop another system of law that would apply to all the conquered peoples within their empire. They tried to develop a system of laws based on the moral instincts of man, which would be common to all civilized men wherever they might be. This system of law was called the *jus gentium,* or *law of nations.* It was based on what the Romans thought was best in the law of all civilized countries.

A great step in the development of law was the *codification,* or classification, of Roman laws by the emperor Justinian. For a long time, jurists had been working to bring all Roman laws together and to present them to the world in a unified and organized group. This compilation of Roman law was completed in Justinian's *Digest* and *Code.* These works had a great influence on later European laws.

Law in Medieval Europe. The influence of Roman law declined after the fall of the Roman Empire. In much of Europe, law developed by the Church, often, called *canon law,* took the place of Roman law. Still, the Roman law was preserved, and finally its influence increased again. As European law developed during the late Middle Ages, it borrowed from both the language and the ideas of Roman law. The first law school was founded at Bologna, in northern Italy, in the 1200's. Its courses consisted of lectures on the Roman laws of Justinian.

Modern European Law. The ideas of Roman and canon law that were worked out in the Middle ages have continued to the present day in Europe. European law was also greatly influenced by the *Code Napoleon.* This was a simple and uniform system of law written by legal experts brought together by Napoleon. The French emperor forced most of Europe to accept this system of laws during his conquests. Napoleon's empire did not last long, but his legal code had great merit. It has had continuing importance in France, Germany, Italy, Spain, and other European countries.

The term *civil law* is sometimes used to refer to the laws of European countries other than the United Kingdom. The term *common law is* sometimes used to describe laws of English speaking countries. When these terms are used in this way, civil law and common law are meant to include all the laws, both public and private.

American Law. When English colonists settled in North America, they brought with them the English common law. Common law is the basis on which both American and Canadian law has grown. Lawyers had to learn the common law by reading what judges had said in deciding various cases. The desire to have law written down became strong in the 1800'S, and today the unwritten common law is often supplemented by comprehensive statutes called *codes.*

English common law is the basis of most of the law in the United States and Canada, but a few states where the early settlers were Spanish, such as California and Texas, still have traces of Spanish law. Louisiana still retains much of the Code Napoleon, which was in force when the state was a possession of France. Similarly, the law of Quebec is largely based on French civil law.

Many of the rules of law that reflected the customs of Spain, France, and England were found to be impractical in this country. Often the older laws were changed somewhat to suit the special needs of the new country. For instance, the common law of England required each man to fence in his cattle. The owner had to pay for any damage if the cattle were not fenced. This law was practical in England, where land holdings were usually rather small. In the western part of the U.S., farms and ranches were larger, more cattle are raised, and wood for fences was hard to obtain. It was more practical for men to fence in their crops and gardens than to fence in the cattle. The courts therefore enforced a rule requiring agrarians to fence in their crops or gardens. If they did not fence in the crops, and they were damaged, the farmer could not collect damages. This rule was more in keeping with American customs. It is an example of how the common law is constantly being changed to meet new conditions.

The Importance of Law. Blackstone, the English jurist whose famous Commentaries influenced the development of the Anglo-American law, firmly believed that, "...a competent knowledge of the laws of one's country is the proper accomplishment of every gentleman and scholar, and is almost an essential part of a liberal education." He bemoaned the fact that whereas in Cicero's time young boys learned the principles of Roman law by heart and in Continental countries no education was complete without considerable study of the laws of one's native land, yet Englishmen were then largely ignorant of the great common law. Two hundred years later finds the average American, who is often knowledgeable in many areas, generally uninformed in regard to the legal system that profoundly affects his everyday life.

The legal system interacts with and influences the political, economic and social systems of every civilized society. When society operates peacefully, efficiently and prosperously, its legal system is a primary cause. When a society appears to break down, it may be the result of the abuse, corruption or malfunction of its legal system requiring change or improvement, but the fact remains that every civilized society is founded upon law and none has ever survived without law or without an efficient legal system. Hence, the beginning of all progress and improvement in any society must be based upon a thorough and complete knowledge of its laws and the system which the totality of its laws comprises.

Understanding the Law- As stated before, the first thing to know about the law is that it is imprecise-not always easy to recognize or apply. Spare yourself the effort of searching for a large tome with the letters L A W unmistakably recognizable on it. There is no such thing. Law in a democracy is, instead, a process of human interaction in which lawbooks, containing statutes, administrative regulations, and reports of court cases, are only beginning points. The clearest thing about the law is that it is often unclear.

Lawyers, administrators, and judges, people all; are at the heart of the process. They draw the legal documents; they make the rules, such as they are; they decide the disputes. These people vary greatly in their abilities and personal characteristics. That those involved in it see, read, hear, and react differently makes law unpredictable. Using the same books, looking at the same documents and papers, sitting in the same courtroom, hearing the same witnesses, people will reach different conclusions.

Judicial decisions have two uses: first, to determine with finality the case decided; and second, to indicate to the public how similar cases will be decided if and when they arise. *Stare decisis* is a guiding principle whereby a court is bound by precedent in deciding the case before it, to follow and apply the rules, principles, and precepts announced and applied by it in former decisions. It is an instrument of stability in our legal system. It also furnishes certainty, predictability, and reliability. It assures all persons of equality and uniformity of treatment. Its strength proceeds from a dedication to long accepted principles and adherence to well-established rules. A court may apply new factors, social or economic, or address itself to new conditions in such a manner as to effect a change in earlier decided case law. In so doing its decision is a departure from precedent. The court, having found no longer valid the reason for the established rule, is not bound by *stare decisis* but is free to establish a new or different rule of law which more accurately and usefully reflects contemporaneous community standards and better serves its requirements.

If you are involved in a legal dispute, the lawyer you select may be not very good or very willing. The lawyer for the other side may be far superior. Either can hurt your chances at law. Poorly drawn papers or badly handled negotiations can lead to much trouble for you, and, in court, bad lawyering by your own lawyer can defeat you.

Part of the inescapable uncertainty in court comes from the differences in the way people tell their stories and in their ability to give credence to what they say. This has to do with both their personal credibility and the proof they can muster by means of documents, objects, pictures, and other witnesses. Whoever is to do the judging must believe one side or the other to determine the facts necessary for decision. Judges differ, too, in intelligence, temperament, mood, character, compassion, diligence, understanding, social outlook philosophies, prejudices, and personal preferences. A famous jurist once wrote that what a judge has for breakfast affects his decisions. To this might be added bad stock market news in the morning newspapers and matrimonial arguments after breakfast.

Much of the outcome of a case in court is just plain luck. It can help a poor case and hurt a good one. The chances of getting an inferior judge, a jury impatient to be finished, or missing witnesses are only some of the elements that should persuade people to avoid litigation if it is at all possible.

Risk and Probabilities in Litigation- Given the risks implicit in litigation, no matter how strong a case may seem to one side or the other; all litigation must be considered gambling. The best case can be lost and the worst case can be won. You should always take this into account.

Keeping out of court starts way before you can even see the courthouse steps. The effort begins with preventive conduct at the beginning of your transactions. This means among other things, minimizing conduct that can get you into trouble-that is, restraining greed and taking advantage of others-and being careful of the kind of people with whom you deal. Beware of "sure thing" profits and fantastic bargains; they presage trouble. When disputes do arise, it is invariably best to try to settle them before litigation. Compromise is part of avoiding litigation. Compromise may not result in resounding victory, but it takes away the risk, expense, and emotional distress that goes with litigation.

Most of the uses of the law, as it affects the average person, never get to the courthouse at all, or even to a lawyer's office. In society generally, affairs, even negotiating intricate contracts, leases, and loan papers, are conducted amicably and settled as mutually anticipated. When people do have disputes, in the vast bulk of instances they adjust or forget them before any lawyer is consulted. Even after the parties begin legal consultations, a compromise before trial is the rule and not the exception. In legal usage, a compromise that results in ending a dispute is called a "settlement."

Again, the best time to avoid trouble is before any trouble arises. People should learn the basic rules affecting their rights and duties in the spheres of normal activity. For instance: no agreements will be enforced in court with respect to interests in houses or leases of apartments unless they are in writing; to be effective, a will must be witnessed by at least two people who do not inherit under it and the signer must declare the document to be his will; a person embroiled in separation or divorce problems should not move out of the home without a prior agreement; a person should never admit fault at an accident scene, never sign a release of anything important without consulting a lawyer, and never accept a first settlement offer. Compliance with such simple prescriptions as these, and many more, help people put the law to work for them. These maxims improve results and allow individuals to achieve their objectives.

Law and Morals- Equity developed as a response by the King and his Chancellor to appeals to their moral conscience. Since the common law is based to a great extent upon natural law, it is greatly affected by moral concepts. In a general sense what is or seems to be moral may also be legal and what is or seems to be immoral is often illegal. “Thou shall not kill” and “Thou shall not steal” are both moral precepts and legal constraints. Nevertheless, morality and law are not totally synonymous but must be considered as two circles, one partially superimposed upon the other. The area covered by both the morality circle and the legal circle includes the vast body of ideas that are both moral and legal-that is, the "thou shall's" and the "thou shall not’s."

However, the part of the legal circle not covering the morality circle includes many rules of law that are completely unrelated to morality, such as, you must drive on the right side of the road or you must register before you can vote. Likewise the part of the morality circle not also covered by the legal circle includes moral precepts that are not enforced by law, such as, you should not silently stand by and watch a blind man walk off a cliff or you should not foreclose a poor widow's mortgage. Or, if Brown, a private citizen, while walking along a pier, sees Jones drowning in deep water only ten feet from the pier, the law generally imposes no legal duty on Brown to attempt a rescue. If Brown is an excellent swimmer, the mores of the community may condemn the failure to rescue. Until such time as society insists on the rescue attempt, the law will not require it.

Law and Justice- The law is no guarantee of justice, and these terms are by no means synonymous. Justice is an ideal which good law continually strives to achieve. If the law is regarded as the sum total of the rules enforced and administered by courts and other agencies of government, the disparity between law and justice becomes apparent. Law is inseparable from a politically organized society. In a government by a dictatorship, its laws might be oppressive, harsh, and calculated chiefly to maintain the control and domination of the dictator. A rule, regulation, edict or order is no less a law because it is harsh, unwise, or unjust. Law is ever changing and its change should be in the direction of fair, reasonable, equal and impartial treatment of the competing interests and desires of the individuals in the community to whom it applies. To the extent that it fails to do so, it fails to achieve justice.

On the portico of the Supreme Court Building in Washington, D. C. is inscribed in stone "Equal Justice under Law". These words express not only an ideal, but also the relative position of law and justice. Without law and order there can be no justice. The present and future welfare of mankind depends upon the administration of justice according to law. Here are six arguments for the administration of justice according to the law:

1. Law makes it possible to predict the course which the administration of justice will take.
2. Law secures against errors of individual judgment.
3. Law secures against improper motives on the part of those who administer justice.
4. Law provides the magistrate with standards on which the ethical ideas of the community are formulated.
5. Law gives the magistrate the benefit of all the experience of his predecessors.
6. Law prevents the sacrifice of ultimate interests, social and individual to the more obvious and immediately pressing but less weighty immediate interests."

The Law's Sanctions- The law ensures that those precepts which are both moral and legal are enforced. Sanctions are the means of enforcing the law. Sanctions are most apparent in criminal law that provides fines, imprisonment, or death for certain proscribed conduct. Sanctions are also a vital part of our civil law. A contract would be meaningless in our society if a breach of the contract would afford the innocent party a remedy that was unenforceable. The state provides a means of enforcing that remedy. For example, if money damages are awarded in a breach of contract action, it is possible in the event of failure on the part of the wrongdoer to pay the judgment, to have the appropriate legal officer seize and sell his property and apply the proceeds upon the judgment. In short, to say that the law has sanctions is simply another way of saying that law is based on the physical force of the state.

Laws without sanctions are meaningless. Even as the law adapts itself to find a remedy for every wrong, it also adapts itself to find a sanction for each of its commands. If the law of direct contempt of court as summarily applied does not properly balance the right to a fair trial with the necessity to protect against courtroom disturbances, the law will develop new sanctions to accommodate the right and the need.

Inception of Legal Process. The sources which contribute to the development of a legal system are formalized in three principal ways and appear as the immediate sources of law, namely constitutional law; legislation or statutory law; and case law or precedents established by prior decisions of courts. Underlying all the law in the United States is the U.S. Constitution. No law is valid if it violates the Federal constitution. The final arbiter of constitutionality is the Supreme Court of the United States.

The same pattern exists in every State. The highest law of each State is contained in its written constitution. Subordinate to this is the myriad of statutes passed by the legislatures of the various States. Likewise, State administrative agencies issue rules and regulations having the force of law. In addition, cities, towns and villages have limited legislative powers within their respective municipal areas to pass ordinances and resolutions. The total annual volume of legislative law is enormous.

Case Law- This is the “common law”. The system of jurisprudence that is based on judicial precedent (court decisions) rather than legislative enactment (statutes). It is therefore derived from principles rather than rules. In the absence of statutory law regarding a particular subject, the judge-made rules of common law are the law on that subject. Thus the traditional phrase “at common law” refers to the state of the law in a particular field prior to the enactment of legislation in that field.

Legislation- Whereas case law evolves from the judicial determination of particular controversies, statutory law is the product of a legislative body and, in general, operates only prospectively. Although historically courts were established before legislatures, from an early time the laws enforced are regarded as having always existed. At the beginning of civilization, a time arrived in every culture when the traditional law was reduced to writing. Many ancient codes are of this kind. They do not claim to be declarations of new laws, but a written record of laws already recognized and observed.
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At some point in cultural development there is less weight put upon law as being declarative of that which already exists in the customs of the people and a corresponding emphasis upon changing the law therefore regarded as immutable. In our modern era, we use legislation as an ordinary agency of legal development. Legislative bodies assume an ever-increasing share of the lawmaking. Indeed, a large part of a court's work today is interpretative, that is, construing and applying law promulgated by the legislature The sources of the law of the American legal system are the Federal and State constitutions, the multitude of Federal and State statutes, the ordinances of countless local municipal governments, the rules and regulations of Federal and State administrative agencies, and an increasing volume of reported court decisions.

Classes of Law

Substantive Law and Procedural Law- A common classification divides substantive law from adjective or procedural law. The former includes laws which create, define and regulate legal rights and obligations. Thus, the rule in contracts that an offer must be communicated to the offeree is a statement of substantive law. Adjective law, also called procedural or remedial law, prescribes the methods of enforcing rights that exist by reason of the substantive law. One turns to adjective law, found for the most part in codes of procedure, to ascertain the method by which they are to obtain redress in court. In the standard law school curriculum, contracts, torts, property and agency, are all substantive law courses; adjective law courses are those dealing with civil, criminal, and administrative procedure, and evidence.

Public Law and Private Law- Public law is that branch of law which deals with the rights and powers of the state, in its political or sovereign capacity and its relation to individuals or groups. Public law comprises constitutional, administrative and criminal law. Private law is that which governs private individuals in their relations with one another, or law that is administered between citizen and citizen. Business law is primarily private law.

Tort Law- The word "tort" is derived from the Latin "tortus" meaning twisted or crooked and from the French word for injury or wrong. At the time the common law was developing, "tort" was in common English usage as a synonym for a wrong. Tort and liability will be examined in chapter 3.

Stare Decisis- Judicial decisions have two uses: first, to determine with finality the case decided; and, second, to indicate to the public how similar cases will be decided if and when they arise. *Stare decisis is* a principle whereby a court is bound by precedent in deciding the case before it, to follow and apply the rules, principles, and precepts announced and applied by it in former decisions. It is an instrument of stability in our legal system. It also furnishes certainty, predictability, and reliability. It assures all persons of equality and uniformity of treatment. Its strength proceeds from a dedication to long accepted principles and adherence to well-established rules. A court may apply new factors, social or economic, or address itself to new conditions in such a manner as to effect a change in earlier decided case law. In so doing, its decision is a departure from precedent. The court having found no longer valid the reason for the established rule is not bound by *stare decisis,* but is free to establish a new or different rule of law which more accurately and usefully reflects contemporaneous community standards and better serves its requirements.

This tendency of the courts to follow established precedent is at the foundation of common law. The decision made by a particular court in deciding a dispute serves as authority for the solution of similar cases in the future. One of the strengths of this doctrine is that it affords certainty to the law. Citizens can govern their affairs with certainty in tomorrow when the law is fixed, definite, and known by all. Stare decisis does not preclude correction of erroneous decisions or judicial choice among conflicting precedents. Instead, powerful reasoning will be required to make a court depart from the rules of law set forth in previous cases.

In the United States stare decisis is a flexible doctrine, functioning approximately as follows:

1. The United States Supreme Court has never held itself to be rigidly bound by its own decisions, and lower Federal courts and State courts have followed that course in respect to their own decisions.

2. A decision of the Supreme Court on Federal questions is binding on all other courts, Federal or State.

3. While a decision of a Federal court other than the Supreme Court may be persuasive in a State court on a Federal question, it is, nevertheless, not binding since the State court owes obedience insofar as it has jurisdiction over a case involving Federal law to only one Federal court, namely, the Supreme Court. The converse is also true; a decision of a State court may be persuasive in the Federal courts but it is not binding, except where Federal jurisdiction is based on diversity of citizenship, in which case the Federal courts are required to apply local State law as determined by the highest State tribunal, the Supreme Court of the State, and not by a trial or intermediate appellate court.

4. Decisions of the Federal courts (other than the Supreme Court) are not binding upon other Federal courts of coordinate rank, or of inferior rank, unless the latter owe obedience to the court rendering the decision.

A Remedy for Every Wrong-. The genius of the common law is its ability to create and adopt remedies for each new wrong as it occurs. U.S. Supreme Court Justice Cardozo said, "The inn that shelters for the night is not the journey's end. The law, like the traveler, must be ready for the morrow. It must have a principle of growth." Laws evolve as the needs of society change. This does not mean that reasonable certainty is not possible under the law. The need for certainty is apparent in the field of business law, of which insurance is a part. Economic transactions must be legally defined and enforceable so that commerce can continue.

Chapter 2: The U.S. Legal System

As stated in the last chapter, the legal system of this country developed from English common law, which had its foundation in Roman law. Today most courts administer both law and equity systems. Only actions brought at law are subject to trial by jury. In many cases an equity action seeks relief other than payment of money. Such relief includes obtaining injunctions, accountings, contract cancellation, or specific performance of contracts.

American democracy is based upon certain premises that the founding fathers considered fundamental and essential and with which to this day no substantial group of American citizens has seriously disagreed. The first premise of democracy is liberty in the sense of the recognition of the human dignity of each person and his freedom and right to life, security, property, privacy, family, home, movement, beliefs, honor and reputation.

The second premise is equality in the sense that every person is to be given the greatest possible opportunity to develop his capacity to its utmost extent, limited only by the equal right of every other person to do the same thing. With each person's right to equal treatment is attached a duty not to interfere with the equal rights of other persons.

The third premise is cooperation or what French call fraternity in the sense that all persons cooperate to insure that each enjoys his fullest rights and each observes his duties to protect the equal rights of others.

All three branches in our system of government are there to insure that democracy, the *vox populi* remains the form of government in the United States. The legislature enacts law, the executive carries it out and the judicial branch interprets the law as needed. Courts have developed as an essential element of organized society. They settle controversies among individuals and punish offenses against the peace and dignity of the state. A court usually has one or more judges, a clerk, and an officer to maintain order. A jury may or may not be required.

There are basic or first courts for all legal cases. These are courts of original jurisdiction. What court will be used for which case is determined by the jurisdiction fixed by the Constitution or by statutes. If a case is not settled satisfactorily in the court of original jurisdiction, it may be appealed to an appellate court. An appellate court has no original jurisdiction. It exists to review the judgments of lower courts.

In the United States there are two separate and parallel judicial systems, the state courts and the federal courts. The state system is the one more closely affecting the insurance professional. Each state has its own independent system of courts. Individual state law created the various state systems.

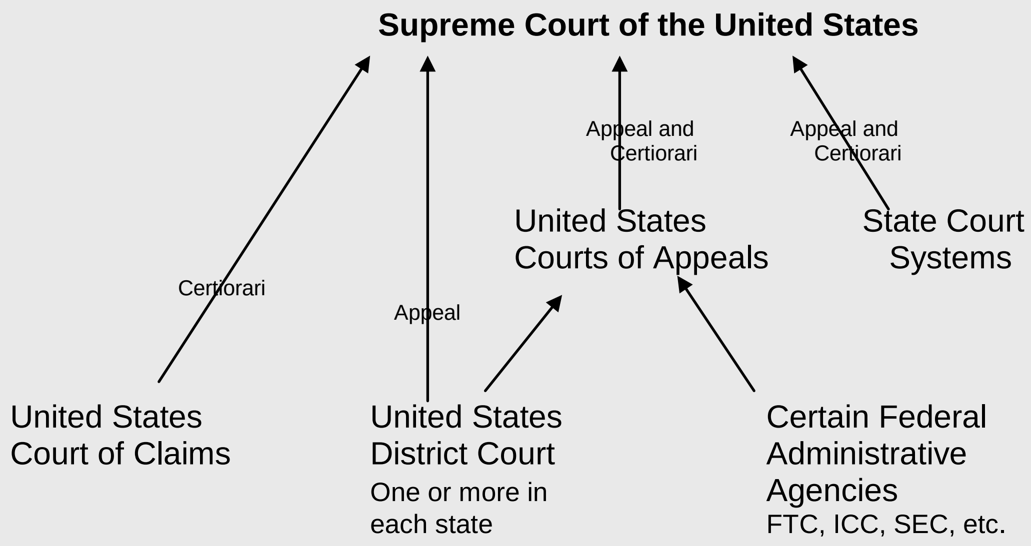
The Federal Court System

The nation's highest court, the Supreme Court of the United States, is made up of nine members appointed for life by the President of the United States. It meets on the second Monday in October each year to consider important cases of national interest or administration interest as well as development of new law. The court decides what cases it will hear. These make up only a tiny percentage of all the judicial proceedings in the country. The bulk of the cases coming before courts in this country involve common law or local statute. These are not appealed to the Supreme Court. Of cases in district courts, less than three per cent reach any court of appeals. The Supreme Court does have original (as opposed to appellate) jurisdiction "in all Cases affecting Ambassadors, other public Ministers and Consuls, and those in which a State shall be a Party," according to the Constitution.

The Supreme Court

Article III of the Constitution provides for a Supreme Court and authorizes such lower federal courts as Congress may from time to time establish. There are federal trial courts (United States District Courts) in each state. Above them are the intermediate appellate tribunals (United States Courts of Appeals), each having jurisdiction to review decisions from district courts within a specified area or "circuit" and from various federal administrative agencies, such as the Federal Trade Commission. Most federal litigation gets no higher than this second judicial level. Only the very special case can go to the Supreme Court. It is crucial that the sole authority that that tribunal gets directly from the Constitution is a very limited original jurisdiction involving states, ambassadors, etc. The appellate authority of the Supreme Court with respect to "inferior" federal courts (and to state courts) is also subject to full congressional control.

Figure 2-1
Diagram Showing the Appellate Authority of
The Supreme Court



A Conflict: Federal v. State Court Systems

It offended some in the early days that the decision of the highest court of a "sovereign state" should be reversible by an "outside" court. Federal courts may decide cases involving certain special parties *regardless of what law is involved.* For example, the ambassador of a foreign country may have his case involving a mere grocery bill tried in a federal court even though no federal law (Constitution, treaty, or act of Congress) is applicable. Obviously in such a case the federal court acts in effect as a special state tribunal. Recognizing this, Congress from the beginning has provided that in litigation of this type the federal courts shall apply state "laws."

By interpreting that word to mean only state legislative (not common) law the Supreme Court in effect authorized courts in "special party" cases to apply their own common law *Swift v. Tyson, 16* Peters (1842) To this extent the states lost a large measure of control of their own admittedly local affairs. Admittedly local, because by hypothesis such cases do not arise under federal law.

If only cases involving ambassadors were involved, the problem would not be serious. Unfortunately, the "special" jurisdiction of the federal court is more extensive. Easily the most common and most troublesome part of it is that which rests on the fact that contending litigants come from different states. As Mr. Justice Frankfurter put it: "the stuff of diversity jurisdiction [as it is called] is state litigation. The availability of federal tribunals for controversies concerning matters which in themselves are outside of federal power and exclusively within state authority, is the essence of jurisdiction solely resting on the fact that a plaintiff and a defendant are citizens of different states. The power of Congress to confer such jurisdiction was based on the desire of the framers to assure out-of-state litigants courts free from susceptibility potential local bias."

However commendable the original motive, and whether or not that motive ever was, or is now, grounded in reality, it is clear that instead of "protecting out-of-state litigants against discrimination by state courts, the effect of diversity of jurisdiction was discrimination against citizens of the State in favor of litigants from without the State." *Lumbermen's Casualty Co. v. Elbert,* 348 U.S. 48, 54-55 (1954). This followed because, as a result of *Swift v. Tyson,* there arose within each state two common law legal systems. Which of the two would apply in a given case depended upon the "accident" of the citizenship of the litigants. Suppose, for example, a Texan was visiting his brother in Iowa. Riding together in an automobile, they were both hurt in a collision with a car driven by another Iowan. The Iowa brother could sue for damages only in a state court, because only state common law is involved and both litigants were citizens of the same state. The Texas brother, however, finding federal common law more favorable than that of the state, might choose to sue in federal court. This he could do because he and the defendant were citizens of different states. Thus, while only one accident was involved, each lawsuit would be governed by a different legal system. Since in the supposed case the one had a lenient, the other a more stringent, test as to what constitutes negligence, one brother might win his case and the other might lose. The difficulties of this strange double legal regime for the same local problems were magnified by another early decision which recognized that, for diversity jurisdiction purposes, a corporation is a "citizen" of the state in which it is incorporated. A Delaware corporation, for example, may enjoy "diversity" privileges in every other state in which it operates.

Possibly the rule that permitted federal courts to create their own independent common law was an expression of Federalist nationalism. Doubtless it arose in the hope, or expectation, that state judges would follow the federal common law so created. Had they complied, the dual law system for non-national matters would not have arisen. We might have had a single, uniform common law for the entire country. The plain fact is state judges did not comply. The result was chaos that had a remarkable tendency to work to the advantage of corporate litigants.

The crux of the difficulty is seen in the *Black* & *White Taxicab* case, 276 U.S. 518 (1928). Two Kentucky corporations wanted to make a contract for the monopolistic conduct of a Kentucky taxi business. Such a monopoly would have been illegal under Kentucky common law, so one of the companies reincorporated in a neighboring state, made the contract, and then by means of a federal injunction in a diversity case was able under federal common law to enforce in Kentucky a trade restriction which violated Kentucky law. This system of operation, where corporations could use the diversity jurisdiction to subvert state law, was overturned by the Supreme Court in 1938. One difficulty remains. The diversity jurisdiction imposes a tremendous burden upon the federal courts. Now that they enforce in such cases the same law that is enforced by state courts is there any reason to continue it? If prejudice against outsiders is a danger in state courts, why is it not equally a danger in federal courts? Like their state counterparts federal trial judges and juries come from the states in which they sit. Where there is state discrimination against outsiders the equal protection clause of the Fourteenth Amendment affords a federal remedy. There was no such provision in the Constitution when diversity jurisdiction was established.

Other Federal Courts

Federal judicial districts are established by Congress. A state may make up a single district or may be divided into several districts depending on its population. No single district may lie within more than one state. The federal district courts are grouped into judicial circuits. Each circuit has a court of appeals to review the decisions of the district courts under it.

These district courts are the trial courts having exclusive jurisdiction over federal criminal cases and over civil cases coming under federal law. Such cases include those involving citizens of different states, as well as anti-trust, patent, trademark, copyright, and securities law cases. Also in the federal judicial system are the Tax Court, Customs Court, Court of Claims, and Court of Customs and Patent Appeals.

The following list summarizes the areas under exclusive federal jurisdiction:
① Cases arising under the Constitution
② The laws and treaties of the United States
③ Cases involving ambassadors, public ministers, and consuls
④ Controversies involving the United States as a unit
⑤ Controversies between states
⑥ Cases of maritime jurisdiction and admiralty. Controversies between a state and citizens of another state
⑦ Controversies between citizens of the same state claiming land under grants of different states
⑧ Controversies between a state and its citizens and foreign states or subjects
⑨ Controversies between citizens of different states

The last item is the only area of federal jurisdiction that includes private civil litigation. It is important to the insurance professional. Federal courts of first instance are district courts. They receive most of the cases within federal jurisdiction and make a final decision for most of them.

Thus the federal legal system may be employed to enforce written agreements to submit existing and future controversies to arbitration provided that the contract is in admiralty or in interstate commerce. With the growing development of congestion and delay in the courts and due to the rising costs of maintaining and defending lawsuits, voluntary arbitration is becoming increasingly popular. Both the Federal and State statutes have been widely used to enforce arbitration agreements in labor disputes and in commercial disputes.

In recent years many States have enacted compulsory uninsured motorists statutes which require automobile liability insurance policies to include uninsured motorist coverage, which provides that if the insured motorist is involved in an automobile accident with an uninsured owner or operator of an automobile, who is liable to the insured motorist, the latter may recover up to a specified amount for bodily injuries from his own insurance carrier. An arbitration clause is customarily incorporated into this type of coverage. The topic of arbitration will be examined in greater detail in another chapter.

State Courts

Each of the fifty states has its individual judicial system. State laws vary but states administer justice under the basic legal system of the United States. Each state has its highest tribunal, usually called the Supreme Court. Under it in most states are intermediate appellate courts. These courts do not hear witnesses but examine the records of cases on appeal from trial courts to determine whether errors have been committed in their judgments. The trial courts are the courts of original jurisdiction to which both civil and criminal cases are brought for hearing. These are called district courts in many states. It is the state court of first instance. This is the court that will receive insurance cases requiring a legal decision. It exercises a general civil jurisdiction in law and in equity and a general criminal jurisdiction.

Below the district courts are other courts such as justice of the peace, county courts or municipal courts. They have jurisdiction limited usually to small civil claims or to misdemeanor cases. Cases from these courts may be taken to appeal. Courts of appeal come between the district court and the state supreme court. Many special courts include probate courts for wills and estates, criminal courts and family law courts. The state supreme court reviews cases that cannot be settled in the lower courts. Few cases involving insurance claims go to supreme courts.

State court systems are revised by laws. The aim is to reduce overlapping jurisdictions, establish central administrative controls, and cut down the timely delays often caused by congested court calendars. Cases involving common law or local statute make up most of those coming under the American judicial system. No appeal is made to the Supreme Court in these cases. Less than three percent of cases in district courts reach the courts of appeals. The percentage of those reaching the Supreme Court of the United States is so small as to be negligible

A Trip Through the Court System

To acquaint the student with the procedure of cases in the courts, it will be helpful to carry a hypothetical action at law through the trial court to the highest court of review in the State. Assume that A, a pedestrian, while crossing a street in Esmerelda City, is struck by an automobile driven by B. A suffers serious personal injuries, incurs heavy medical and hospital expenses, and is unable to work for several months. Naturally, A desires damages from B. Attempts at settlement failing, he brings an action at law against B. Both A and B are represented by counsel. When reference is made to A filing a pleading, it is understood that the pleading is actually filed by his lawyer. In Kansas, where A sustained his injuries, there is no limitation on the amount recoverable. A commences his action against B by filing with the clerk of the circuit court of West county his complaint containing a statement of his cause of action. A is referred to as the plaintiff. The sheriff of the county, or one of his deputies, serves a summons upon B, the defendant, commanding him to file his appearance and answer in the circuit court within thirty days of the day of service of the summons.

A's complaint sets forth in considerable detail the facts attending his injuries, alleges that he was in the exercise of due and reasonable care for his own safety at the time he was struck by B's automobile, and that, on the other hand, B's negligent driving of his automobile was the proximate cause of A's injuries, and asks damages in the amount of $100,000. B must reply to A's complaint by filing an answer or motion challenging the legal sufficiency of A's statement of a cause of action. In this particular case, we assume that B interposes an answer to A's complaint. By his answer, he categorically denies the allegations of A's pleading and avers, on the other hand, that he, B, was driving his car carefully and in the exercise of caution for the safety of others, but that A dashed across the street without looking in any direction to see whether cars or other vehicles were approaching, and that, in short, A's injuries were occasioned by A's own negligence and, accordingly, that he should not be permitted to recover any damages. An issue of fact is thus made by the pleadings as to whether A and B, respectively, were exercising reasonable care or, instead, were negligent. Reference has been made to the pleadings of A and B as the complaint and answer. In some States A's pleading still bears the common-law designation of declaration, and B's reply is called a plea. An issue of fact having been made, the cause is now ready for trial.

In the course of preparing for the trial, the attorneys for A and B may each decide to take the depositions of the adverse party and of other occurrence witnesses. A deposition consists of the sworn testimony of a person taken upon interrogatories propounded by counsel in the presence of a notary public or other official. The taking of depositions is an effective pre-trial discovery procedure that permits the parties to evaluate their cases and, possibly, to settle their dispute before trial.

The testimony taken in the course of the deposition is of further value for impeachment purposes, i.e., the testimony given by a deponent may be used to contradict any conflicting story he may tell from the witness stand during the trial of the case. Modern rules of procedure provide for the taking of depositions as well as other pre-trial discovery procedures, e. g., demand for admissions of fact, and written interrogatories. Implementing these procedural rules of discovery is the pretrial conference held before one of the trial judges of the court. At this conference the attorneys seek to further narrow the disputed issues to expedite the trial of the case and, again, an effort to settle the case may be made. In due course, absent any intervening settlement, the case will be assigned for trial. When the day of the trial arrives, the attorneys, the parties, and the witnesses are all present in the courtroom ready to proceed. The case is called by name, and if either party has at the initiation of the suit demanded a trial by jury, their attorneys first examine prospective jurors. Upon the selection of a jury, the attorneys make an opening statement of what they expect to prove upon the trial. Plaintiff and his witnesses then testify upon direct examination. Each is subject to cross-examination by defendant's attorney. Plaintiff and his witnesses all testify to the fact that A looked in every direction before proceeding across the street at the time of his injury. Defendant and his witnesses then testify, also upon direct and cross-examination. In each instance there may be redirect examination and further recross-examination. Defendant and his witnesses testify that he was in the exercise of reasonable care and was driving his car at a low rate of speed when it struck and injured A. When the parties and their witnesses have concluded their testimony, the plaintiff's attorney makes his final argument to the jury, reviewing the evidence and urging a verdict in favor of his client.

Defendant's attorney next argues to the jury, summarizing the evidence in the light most favorable to his client. A short rebuttal is then available to plaintiff's attorney. The attorneys have previously tendered instructions on the law of the case to the trial judge who gives those instructions to the jury which he deems correct and refuses to give those which he considers incorrect. The judge may also give the jury instructions of his own choosing. These instructions (called "charges" in some States) are for the purpose of aiding the jury in reaching its conclusion upon the conflicting testimony. They cover such matters as credibility of the witnesses, the weight of the evidence, and the fact that a greater number of witnesses may have testified for one party is not to be considered unfavorably against the other party. The jury then retires to the jury room to deliberate and to reach its decision on the facts. This decision is its verdict. If it finds the issues in favor of the defendant, its verdict is "not guilty." If, however, it finds the issues in favor of the plaintiff, it finds the defendant guilty and fixes the plaintiff's damages at a specified amount, in this case, $65,000. The jury returns to the jury box, and the foreman announces the verdict. Most likely, the defendant's attorney will file a written post-trial motion, seeking a new trial or a judgment notwithstanding the verdict, upon the grounds that errors were committed during the trial, or that despite the facts found by the jury, the law requires a judgment for the defendant. Upon the denial of the post-trial motion, the judge enters judgment on the verdict for $65,000.

If the defendant does not prosecute an appeal to a court of review, the task of collecting the judgment remains. Briefly, an execution is issued to the sheriff who, in turn, demands payment of the judgment and, if it is not paid, proceeds to seize or levy upon property belonging to B, the defendant, and causes it to be sold to pay or satisfy the judgment. If, however, the sheriff finds no property belonging to B, he returns the execution unsatisfied. Plaintiff's (A's) attorney may then bring the defendant into court in a supplementary proceeding in an attempt to locate money or other property belonging to him, in an effort to find a means of collecting the judgment. If these efforts fail, and if A knows of money owing to B by C or property belonging to B in the hands of C, a third party, he may institute a garnishment proceeding against C in an attempt to collect his judgment.

Thus far we have proceeded on the assumption that B did not appeal his case. Assume instead that B directs his attorney to appeal. An appeal lies to the intermediate court of review, the Kansas Appellate Court. A notice of appeal is filed with the clerk of the trial court within the prescribed time. Later, within the time fixed, a transcript of the record is filed in the reviewing court. This record contains the pleadings previously described, a transcript of the testimony, the arguments of counsel to the jury, the instructions, the verdict, the motions thereafter, and the judgment rendered on the verdict. B, who files this record, is required to prepare a condensation of it, known as an abstract or pertinent excerpts from the record. He is required to file his brief and abstract or excerpts with the Appellate Court. His brief contains a statement of the facts, the pleadings, the progress of the case through the trial court, the reasons why he claims the verdict and judgment are erroneous, a statement of the law applicable to the facts, and his argument applying the law to the facts.

B, the unsuccessful party, is now designated as the appellant. A, the successful party, is the appellee. He files a brief answering B's brief. If A deems the abstract or excerpts supplied by B inaccurate or insufficient, he may file an additional abstract or excerpts of the record. B may, but is not required to, file a reply brief. The case is now ready for the consideration of the Appellate Court. This court does not hear any evidence. It takes the case upon the record, abstracts and briefs. The court may also have the benefit of oral argument by the attorneys. The court then assigns the case to one of its members to prepare a written opinion. If the opinion which the judge submits meets with the approval of the majority of the court, it is filed as the opinion of the court. The opinion states the essential facts, the questions of law presented, and the judgment of the Appellate Court. This judgment may be an affirmance of the judgment of the trial court. On the other hand, if the court finds that the verdict is against the weight of the evidence, or that certain instructions given were prejudicial to B, the appellant, or that certain instructions which were refused should have been given to the jury, or that any other reversible error was committed by the trial court, the judgment will be reversed and the cause remanded for a new trial.

If the Appellate Court affirms, B, the defeated appellant, may decide to seek a reversal of the judgments of the circuit court and of the Appellate Court by appealing the case to the Supreme Court of Kansas. B may file a petition for leave to appeal with the Supreme Court. His petition contains a copy of the Appellate Court opinion, a short statement of the facts, and the alleged errors of the Appellate Court. The abstract or excerpts are also filed with the Supreme Court. A petition for leave to appeal, which corresponds to a petition for a writ of certiorari in the United States Supreme Court and some State Supreme Courts, must be filed within the time prescribed. A may, if he so elects, file an answer to the petition for leave to appeal. The Supreme Court will first decide, upon the basis of B's petition and A's answer, whether to permit a further review. The great majority of petitions are denied, and the litigation thus comes to an end. If the Supreme Court decides to allow the petition for leave to appeal, B, the petitioner, again becomes the appellant and A the appellee.

The parties file new briefs with the Supreme Court. These briefs are of the same character as those filed in the Appellate Court, but usually are somewhat enlarged in the statement both of the facts and of the law. Oral argument is permitted if the parties desire it, and the case is then taken under advisement, as in the Appellate Court. The case is assigned to one of the justices to prepare a written opinion and, if the opinion written by him meets with the approval of a majority of the court, it is adopted and filed as the court's opinion. If the Supreme Court concludes that the judgment of the Appellate Court was correct, it affirms that judgment. If, however, it reaches the conclusion that the Appellate Court judgment was erroneous, a judgment is entered reversing the judgments of both the Appellate Court and the circuit court, and, in some instances, remanding the cause for a new trial.
In either event, the unsuccessful party may file a petition for a rehearing. The assumption will be made here, as in the Appellate Court, that such petition was filed and denied. The case of A against B has reached its terminus upon an affirmance, or is about to start, upon a remand, its second journey through the courts, beginning, as originally, in the trial court. There is a remote possibility of an application for a still further review to the United States Supreme Court. In that case, as far as which the pleadings are concerned, I don’t believe we’re in Kansas anymore.

While the foregoing illustration of the trial and appeal of a case has been centered in the courts of Kansas, it will give some understanding of the trial and appeal of cases generally. It is true that there are some technical differences in trial and appellate procedure in different States. On the whole, however, this story of a lawsuit should serve to give some knowledge of the technique of the litigation of a case from the beginning of the cause of action (B's automobile striking A) to its final disposition by the Supreme Court.

Business and Commercial Law

The entire body of laws pertaining to commercial dealings is commonly referred to as business or commercial law. The broad scope of this category appears from the mere naming of the legal subjects considered in detail: contracts, agency, bailments, statutory liability, property, waiver and estoppel, real estate, and insurance. Before the advent of common-law courts, a system of mercantile courts existed in England that administered a law known generally as Lex mercatoria, the “law merchant.” This law, predicated on the customs of the merchants, was not completely brought within the common-law tradition until the eighteenth century.

The law merchant was important particularly at the time of a fair, when men came with their merchandise from all over Europe. In the Magna Charta (1215) special provisions were made respecting merchants, including Section 41 which provided that all merchants "shall have safe and secure conduct, to go out of, and to come into England, and to stay there, and to pass as well by lands as by water, for buying and selling by the ancient and allowed customs." The English Chief Justice, Lord William Mansfield was mentioned in the preceding chapter. He provided impetus for the combination of the law merchant and the common law. In the mid 18th century, the Chief Justice examined the operation of the merchant courts. They often acted as little more than arbitrators in commercial disputes. After gaining an understanding of their procedures, he facilitated the referral of merchant cases to the regular court system. Employment of the rules and power of the common law courts helped secure a sense of stability for commercial and insurance contracts. Wide recognition is given to Lord Mansfield as founder of both commercial and insurance law.

A characteristic of the merchant courts was the dispatch with which they adjudicated disputes. Adapted to the needs of the litigants, the courts sought to prevent undue delay for the itinerant merchants. The law merchant courts were in operation from hour to hour, and one common type of mercantile court known as the Piepoudre Courts were courts of record incident to every fair and market having jurisdiction over all commercial injuries and minor offenses committed at that particular fair or market, which took its name from this characteristic of rendering immediate decisions. The words "pied poudre" are of French derivation, and mean "dusty feet." The designation indicates that justice was rendered so swiftly that the suits of wandering merchants were tried before the dust could fall from their feet.

Commercial Law Codification

Eventually, the law merchant was absorbed into the common law, and thus it became a part of American law. A significant development in this country has been the codification of large parts of commercial law. The impetus for this movement came from the National Conference of Commissioners on Uniform State Laws, which from time to time drafted uniform statutes and recommended their adoption by State legislatures. The first was the Negotiable Instruments Act, approved in 1896. Other laws with similar goals were enacted over the next 40 years. Codification of commercial law offering equal protection for those doing business in the various states of the Union was the object. The laws were based on nineteenth century law concepts. Many were inadequate for twentieth century commercial practices. Courts nevertheless were compelled to apply these older concepts to rights and obligations of parties.

In 1940 it was proposed that a new code should be adopted to bring statutory commercial law up to date rather than amending the various previous codes in effect. Work on drafting the Uniform Commercial Code began in 1942 and a finished draft was published in 1952 for submission to the states. The code was prepared under the direction of the National Conference of Commissioners on Uniform State Laws and the American Law Institute. The Uniform Commercial Code was adopted with minor changes by the legislatures of all states except Louisiana. A permanent editorial board for the Code was also established. This 11-member board is charged with keeping track of the way in which the code, as reflected in judicial decisions and amended by legislative bodies, is fulfilling its purposes. The editorial board may suggest clarifying amendments to the code when necessary. It is required to keep informed on new commercial practices that may cause code provisions to need changing. In practice, amendments which are merely a change of language and not of substance, which might introduce doubt and uncertainty, are discouraged.

Commerce Clause- The commerce clause of the U.S. Constitution gives Congress the power to regulate commerce with foreign nations and among the several states. It provides the basis for determining those aspects of commerce that the federal government and state governments may regulate and tax. "Commerce" has been broadly construed under this provision to include any commercial activity, whether interstate or intrastate, if it has any appreciable effect upon interstate commerce, whether that effect is direct or indirect. Federal antitrust laws have been upheld by the U.S. Supreme Court as an exercise of the commerce power. Trade or commerce as used in these laws is held to include the distribution of movies, real estate, gathering of news, professional sports (except baseball), and insurance underwriting. The modern view of the commerce clause would apply the power of the federal government to any commercial activity that has an effect on interstate commerce, and this construction is referred to as the Affectation Doctrine.

Commerce Clause and Insurance- In the case of Paul v. Virginia in 1868, the U.S. Supreme Court held that “issuing of a policy of insurance is not a transaction of commerce.” The contracting parties may be in separate states, but merely being a party to a contract does not involve transactions in interstate commerce. Scholars would point out a court decision such as this as an example of creating and fostering a legal fiction. That is, a fact presumed in law, regardless of its truth, for the purpose of justice or convenience. The business of insurance was therefore not subject to federal regulation. About 80 years later in U.S. v. Southeastern Underwriters (1944), the Supreme Court reversed its previous position by holding that insurance did involve interstate commerce. The case involved a group of fire insurance companies that had been indicted under the Sherman Anti-Trust Act. This time, the question was whether Congress had the power to regulate monopoly and restraint of trade issues under the Sherman Act. The insurance industry was thus subject to federal regulation.

The insurance industry was ready for this turn of events. A draft proposal of a new form of organization had been composed in 1871 following the Paul v. Virginia case. The National Association of Insurance Commissioners was instrumental in providing leadership in the following year. In 1945, Congress enacted the McCarran Act. This act permitted the continued regulation of insurance by the states. The act left open the possibility of federal regulation to the extent that the states did not adequately regulate the insurance business. Numerous state laws were immediately passed in the areas of rate regulation, fair trade practices, and stock acquisitions by insurance companies, to assure that the insurance business was regulated by state law. Where state laws do not provide for unified action by the insurance industry, for example, in the setting of some rates, the industry is still subject to federal antitrust enforcement. Periodically Congress considers repeal of the McCarran Act, to preempt state regulation in favor of uniform federal regulation of insurance. It is the ability of the individual states to adapt regulations to local or regional problems, such as economic conditions impacting business that keeps public opinion and Congress in favor of retention of the McCarran Act.

Criminal Law

Criminal wrongs are wrongs against the public and are punished by fines and imprisonment. Civil wrongs involve unreasonable conduct toward another person. Although the punishment for a criminal wrong may include making restitution to the injured victim, it generally does not. The injured victim, therefore, must begin a civil proceeding in an appropriate court to collect compensation for injury. This court is generically known as a civil trial court. The designation of civil trial courts varies in different jurisdictions. They may be known as "circuit court," "superior court," "court of common pleas," or "district court."

Criminal law defines offenses against the community and provides punishment. In criminal law, the action is brought by the state against the accused. The crime is against society even though the victim is an individual.

The law is enforced by means of sanctions. They are most obvious in criminal law, under which fines, imprisonment, or death are provided as penalties for prescribed conduct. Civil law is also enforced through sanctions. A contract would be meaningless unless the state provided a means of enforcing a remedy for breach of contract. If money damages are awarded in such a case and the damages are not paid, the plaintiff can have a legal officer seize and sell the defendant's property and apply the proceeds toward payment of the judgment. The law is based on physical force. Without sanctions, law is meaningless.

Criminal Action Defined- A crime is any act or omission prohibited by public law in the interest of protection of the public and made punishable by the state in a judicial proceeding. Laws determining the prohibition and punishment of crimes include the protection and safeguarding of government (against treason), human life (against murder), and private property (against larceny).

Many other institutions and interests are protected by criminal law. Newly defined crimes in addition to traditional crimes are prohibited under a wide variety of regulations. Regulations on the licensing and conduct of businesses, anti-trust, securities, and many other areas of business and commerce affect the marketplace.

During the development of common law, individuals depended on what has become the civil tort law for protection against injury from others. Feuds could be settled by the payment of fixed sums. If the state intervened to arbitrate, a portion of the fine was payable to the state not as a penalty for a crime but as a fee for its time and trouble.

Crimes were regarded as offenses against the community. The state, as representative of the people, became responsible for imposing penalties against offenders. Criminal law has increased substantially in its scope with the increased complexity of society. Regulations and laws pertaining to nearly every phase of modern living now have criminal penalties attached. In the business field many facets of licensing and conducting a private enterprise, selling securities, and fraudulent operations in various ways are covered by criminal law.

There is a tendency to think of criminal actions as speedier than civil. When an offense is committed, such as passing a bad check, the district attorney has the legal power to have the wrongdoer arrested and brought into criminal court. Criminal courts may not be as congested as the civil courts. Since many actions are of a criminal and civil nature, both types of actions may be pursued. However, judges frequently dismiss the criminal action when civil restitution is made. Law enforcement officials sometimes take a dim view of being used as collection agencies in such cases.

Criminal Acts- Here is a classification of non-violent criminal acts. Some are so-called “white collar” crimes, the acts most likely to be encountered by insurance agents. They are non-violent crimes, but every year they cost the economy billions of dollars.
① Theft of Property: In early common law the first type of action identified as a crime in order to protect property against theft was called larceny. Larceny was determined to be the taking and carrying away of personal property of another. The wrongdoer would steal, or permanently deprive, the owner of his property.

Enforcement of the law against larceny ran into difficulty in defining "taking" and "carrying away." If the owner of the property had given possession of it to another person who then converted it to his own use, was that "taking"? If a person picked up a piece of someone else's personal property, how far did he have to go with it to be accused of "carrying it away"? New crimes, in addition to larceny, were defined by the English Parliament and by the American legislative bodies for clarification of early criminal law.

Theft or larceny is now defined by statutes covering a wide variety of activities. A person is held to commit theft when he knowingly obtains or exerts unauthorized control over another person's property. Theft is committed when a person obtains control of property by deception or threats. If a person receives stolen property or receives property under circumstances which would reasonably indicate it was stolen theft has been committed. Theft is committed when a person intends to permanently deprive the owner of the use or benefit of the property.

Statutes were added gradually to cover individual crimes under special names. These now have been consolidated into state and federal criminal codes. The crime of theft, or larceny, is differs from the crime of robbery. Robbery involves taking money or personal property from the person of another by force or threat of force.
Burglary under common law was defined as breaking and entering into the dwelling of another with intent to steal. Both robbery and burglary, involve danger to life and limb. They carry heavier penalties than theft without violence.

Crimes constituting larceny are divided into two classes. The classes are determined by the monetary value of the property taken. Theft of property valued at less than the statutory amount is known as petit (petty) larceny. Petty larceny is a misdemeanor offense, punishable by a jail sentence of up to one year. Theft of property valued at more than the statutory amount is known as grand larceny. Grand larceny is a felony offense, punishable by imprisonment in the penitentiary for one year or more.

② Conversion: Converting a person's property to one's own use after having received possession or control of it from the owner constitutes the crime of larceny by bailee. Jones receives Smith's television set to be repaired. Jones sells the television and pockets the money. Jones has committed larceny by bailee.
⅄A bank teller receives a $500 cash deposit from a customer of the bank. The teller keeps the money instead of putting it in the customer's account. The teller has committed a larceny by bailee known as embezzlement.

③ Forgery: A person who knowingly makes, alters, issues, delivers, or possesses with intent to issue a document capable of defrauding and designed to defraud another person commits forgery.
⅄Jones writes a check payable to himself on Smith's bank account. Jones signs the check with Smith's name, endorses the check and cashes it. Jones is guilty of forgery.
⅄Jones receives a check from Smith for $9 in partial payment of a $90 debt. Jones adds a zero to the check. Jones has committed forgery.
⅄A bank official issues a letter of credit to a friend saying he has a $100,000 line of credit with the bank. In fact, he does not have a line of credit. The bank official has committed forgery.

④ False Pretenses: Obtaining money or property under false pretenses by making false representations in order to defraud is a criminal offense. The sale of a cheap watch by a street peddler for $25 with the claim that it was a genuine Rolex may be considered a misdemeanor under this heading.
⅄A man dating a rich widow tells her he can double her money with an investment in a non-existent gold mine. He takes her check and skips the country. He is guilty of making false representations in order to defraud.

⑤ Federal Crimes: Interstate transportation of stolen property and theft of property being transported from one state to another are federal offenses. Theft of property belonging to the federal government, and embezzlements from national banks and other federally insured entities are federal offenses. Burglaries and robberies committed on the premises of federal institution are federal offenses. These actions also may violate state laws, but ordinarily the charges will be brought and tried in federal courts.

A federal statute prohibits anyone who knows of the commission of a felony from concealing such knowledge. All knowledge of felony acts must be reported to federal authorities as soon as possible. The concealment is an offense known as a misprision felony. The penalty for the offense may be a fine up to $500, or imprisonment of not more than three years, or both. The president of a national bank who knows that a teller in the bank has embezzled more than $100 and does not report the matter has committed misprision of felony.

⑥ Property Damage: Arson is the most serious act directed at damage to property. It consists of knowingly causing damage by fire or explosion to real property, or personal property of a stated value, belonging to another person without his consent. Arson also involves damaging any property with intent to defraud an insurance company. Under the old common law, the affected property had to be another person's dwelling. Under modern statutes, the crime is still arson even though the offender may have a total or partial interest in the property and the act is performed to defraud an insurer of the property. If lives are lost as a result of the crime, the offender can be charged with murder. Damage to property with a value below the specified statutory amount may be classified as a misdemeanor. Damage to school property by fire or explosive, however, is classified as arson in some states regardless of the amount involved.

Less serious forms of property damage are sometimes called malicious mischief. Intentional criminal damage to another person's property may include injuries to domestic animals.

⑦. Trespassing: The offense of trespass occurs when a person enters on the land of another immediately after receiving notice from the owner or occupant that entry is forbidden.
Trespassing also occurs when the intruder remains on a person's land after receiving notice to depart. The notice may be oral or written. If written, it must be conspicuously posted or exhibited at the main entrance or other access points to the land.

⑧ Bribery: If an individual's intent is to influence the performance of a public officer, a public employee, or a juror by offering that person property or personal advantage outside of the law, bribery has been committed by the offeror. The offense of bribery also occurs if the offer is made through an intermediary and not directly. The person who accepts or solicits a bribe is also guilty of bribery. The intermediary who accepts or solicits a bribe, whether or not he has the permission or knowledge of that person being bribed is guilty of bribery.

⑨ Usury: Charging more than the legal rate of interest for a loan is known as usury. It is a violation of civil law. The offense may result in an interest rate reduction, or the loss of right to recover the interest. The violation may also result in the loss of both principal and interest. The offense may involve penalty payments to the borrower equal to an amount double or triple the usurious interest charged. Legitimate small loan companies may be allowed to charge higher than standard interest rates under special regulatory statutes.

In an attack on illegitimate loan companies run by organized crime, criminal statutes have been enacted that apply to usury. The statutes are meant to eliminate the organized crime's practice of charging weekly or monthly payments on a loan adding up to 1000 per cent or more interest on an annual basis.

⑩ Income Tax Evasion: A person who is required to file an income tax return, and knowingly fails to file or knowingly files a false or fraudulent return is guilty of the federal crime of income tax evasion. Anyone who knowingly assists or aids a person in preparing a false or fraudulent return is also committing a federal offense.

Criminal Case Defenses & Procedures

Constitutional Defenses- A number of constitutional defenses are available under the Bill of Rights to a defendant in a federal criminal case. The Fifth Amendment prevents self-incrimination, double jeopardy, and deprivation of life or liberty without due process of law. It requires indictment for capital crimes. The Sixth Amendment requires a speedy and public trial by jury. It gives the accused the right to competent counsel, to be informed of the nature of the accusation. It allows the accused to be confronted with witnesses against him, and gives the power to obtain witnesses in his favor.

The Eighth Amendment prohibits excessive bail, excessive fines, and cruel or unusual punishment. The Bill of Rights is not binding on the fifty states. Most state constitutions have provisions similar to those found in the Bill of Rights. Each state has its own criminal code addressing the provisions. The Fourteenth Amendment, added to the Constitution after the Civil War, does specifically apply to the states. It forbids a State to "deprive any person of life, liberty, or property, without due process of law." The meaning of the "due process" provisions of the Fourteenth Amendment varies from the standards imposed on the federal government by the Bill of Rights, which consist of the first ten amendments to the Constitution.

"Unreasonable searches and seizures" of persons and property are prohibited in the Fourth Amendment. Such actions apply to the means of obtaining evidence that can be presented in court. Evidence obtained by unreasonable searches and seizures cannot be presented in either federal or state courts. This "exclusionary rule" however does not apply to evidence presented to grand juries. The grand jury in deciding whether or not a crime has been committed may use illegally obtained evidence as the basis for an indictment. The illegally obtained evidence cannot be presented in court.

Grand Jury Procedure- Serious crimes are prosecuted by an indictment or true bill after being presented to a grand jury. The Grand Jury's only duty is to determine whether or not a criminal action should be brought against an offender. The grand jury is made up of 23 or fewer jurors as determined in each State. The grand jury hears case facts as presented by law officers and other witnesses. The grand jury may request and receive the advice and assistance of judges and of the district attorney. It hears witnesses, examines relevant documents, and may hear the defendant if the defendant requests to be heard. The district attorney summons witnesses to appear before the grand jury when requested to do so. The district attorney, or an assistant, questions the witnesses in front of the grand jury. At least 12 of the grand jurors must agree on an indictment.

Arraignment Procedures- The grand jury does not review all criminal cases. Prosecution of less serious crimes begins with the issuance of a warrant and the arrest of the accused. The defendant is then brought before a court in an arraignment. In the arraignment the accused is informed of the charge against him and enter his plea. If the plea is "not guilty" he must stand trial. The defendant can choose to be tried by a jury or by a court sitting without a jury. A sitting without a jury is known as a bench trial with the judge trying the case. In very minor cases there will be a bench trial. The defendant will not have a choice.

A jury trial is always available in felony cases. If the defense and prosecution agree, a jury can be dispensed with or reduced in number in many states. Crimes involving capital punishment are tried by full juries. Some states allow less than unanimous verdicts for conviction in a capital punishment trial. A habeas corpus proceeding may be instituted to expedite the trial, if there is an unreasonable delay in bringing the accused before a magistrate. The Latin phrase "habeas corpus" literally means "You have the body." A habeas corpus is an order by a judge to produce the accused and explain why he is being held. "Speedy trial" laws compel prosecutors to bring defendants to trial within specified time periods.

If the magistrate finds there is probable cause to believe that the accused committed the crime, the accused can be kept in custody. In cases of criminal misdemeanor the next step will be a court trial. In cases of criminal felony, the accused will be held for the grand jury. In either case the accused may be released on bail pending the trial.

Jury Requirements and Procedures- The jury must be an impartial group for the trial to conform to due process of law. If a jury is not selected from a cross-section of the jurisdiction's population, and excludes one major segment or class, the jury may be held to be improperly selected and a new trial ordered.

Once the trial starts, the jury hears testimony, is instructed as to the applicable law, and retires to reach a verdict, which in most states must be unanimous. If the verdict is not guilty, the defendant is acquitted and the state has no right to appeal. The law of double jeopardy, prevents the accused from being tried a second time for the same offense.

If the verdict is guilty, the defendant may make a motion for a new trial on the grounds that prejudicial error occurred at the trial. He can ask for a discharge on the grounds that the evidence was insufficient on which to predicate guilt. He can appeal to a reviewing court alleging error in the trial court. If he pursues none of these options, he may ask for probation.

Burden of Proof- The defendant in a criminal case is presumed to be innocent until he is proven guilty. The burden of proof is on the prosecution, and that proof must show guilt beyond a reasonable doubt. These are basic principles in American law.

A reasonable doubt, as defined in an 1896 New York case, "is such a doubt that a reasonable man has a right to entertain after a fair review and consideration of all the evidence." It is in the minds of the jurors that reasonable doubt is decided. For this reason the judge's charge, giving the jury instructions regarding reasonable doubt, is a vital part of a criminal case.

The judge must properly instruct the jury that the defendant must be acquitted if a reasonable doubt remains in their minds. The judge must properly explain the meaning of reasonable doubt. Lack of proper execution of these two conditions constitutes an error which can result in the reversal of a guilty verdict on appeal.

Confessions- A confession of guilt by a defendant cannot be used against him if it was secured by fear or threats or by a promise not to prosecute. Before making a confession that can be used in court, an accused person must be read his constitutional rights. These rights include the right to have a lawyer present during questioning, the right to remain silent, and the right to be informed that any statement he makes can be used against him. A confession by itself, even if properly obtained, does not sustain a conviction but must be corroborated by evidence.

Plea Bargaining- The practice of plea bargaining is held to be permissible and is often employed, especially in large metropolitan areas where courts are congested. A plea bargain encourages a guilty plea from the accused. The district attorney's office can promise a reduction in the crime charged or leniency in sentencing.

Principals and Accessories- A person who directly commits a criminal act is a principal. Both his intent to commit a crime and the commission of the act itself must be proved. Those who encourage the commission of a crime with full knowledge of the principal's intent and do something in furtherance of the criminal act, whether or not at the scene of the act, are also principals. An accessory is one who harbors, conceals, or aids a criminal after the commission of the crime. The accessory’s purpose is to help the criminal avoid arrest, trial, conviction, or punishment.

An accessory before the fact contributes to the crime by advice, encouragement, or inducement to act without aiding in the act itself. Such an accessory is often treated as a principal. Those who plan an illegal act but do not take part in it can also be found guilty of conspiracy. They are held responsible for anything that occurs during the crime, whether planned or not, if it occurs incidentally to the execution of the plan. A defendant may be found not guilty of a crime if he was coerced into committing it and did not do it of his own will. A defendant also can plead entrapment if he can show that a government agent induced him to act wrongly. He must show that if not for the entrapment, he would not have been disposed to commit the act.

Insurance and Statutory Liability

To this point, this section has dealt with legal principles that find expression in both the judicial common law and the statutory law of most United States jurisdictions; federal, state, and local. The same principles typically underlie all legal obligations, whether they arise from common or statutory law, criminal or civil law. There are, however, some special features of statutory law that merit particular mention. In an insurance or risk management context, there are special challenges not commonly raised by compliance with more traditional and more familiar principles of common law. The following section focuses on the distinguishing characteristics of statutory law and on two very important categories of statutes that create very substantial liabilities for virtually all organizations: statutes defining liability for employee disability.

Sources of Statutory Liability

For every statutory obligation, there is a written document that represents the official enactment of this law by a legislative, regulatory, or executive entity having jurisdiction. A reading of this document indicates conduct that is required, is permissible, or is prohibited under certain circumstances. Unlike common law, statutory law need not be deduced from examples drawn from court cases; statutory law can be read.

The range of documents containing the statutory law governing a particular organization or other entity can be diverse. The primary sources of statutory law are constitutions, statutes and ordinances, administrative regulations, and executive orders. The ultimate source of statutory law, indeed all law applicable in a given jurisdiction, is that jurisdiction's constitution. Each state is governed by the federal Constitution and its own state constitution. The federal Constitution generally contains broad principles; state constitutions tend to be much longer and incorporate both general principles and specific requirements and prohibitions.

Perhaps the greatest portion of statutory law can be found in a variety of statutes and ordinances enacted by legislative bodies, such as the United States Congress having jurisdiction over all states, individual state legislatures, and various county and municipal boards and councils whose enactment carry the force of law only in their local jurisdictions. Some of these statutes require, permit, or forbid quite specific conduct: the anti-noise statute of one state specifies no railroad activity will generate more than 75 decibels of noise (when measured at a distance of 50 feet from the edge of the railroad's property or right of way) for more than two consecutive minutes; another state's comparable statute specifies only that no railroad shall make "unreasonably loud and prolonged" noise. In the latter state, the anti-noise statute is enforced by the administrative agency created by but independent from the legislature. Its regulations detail permissible noise levels for different types of common carriers in various specific situations. Such administrative regulations, developed by these agencies to give specificity to general principles declared by a legislative body, are another important and often quite voluminous source of statutory law.

A final important source of statutory law is known as an **executive order,** which is a directive issued by the United States President, a state governor, a top county official, or a mayor who, acting within his or her general power to "execute" or carry out the intent of a statute or the Constitution, orders that a particular thing be done or not done. While some presidential executive orders make news, many other executive orders issued each day or week by state and local governors and mayors go unnoticed except by those who are directly affected by their content.

Contrasts With Common Law

In general, statutory law tends to differ from common law with respect to its geographical diversity, its hierarchical application, its targeted application, its specificity of content, and the rapidity of its change. Each of these differing characteristics requires special attention in order to recognize and deal with any organization's exposures to liability under statutory law.

A Difference Around the Country- English common law is followed in virtually all jurisdictions within the United States. It derives from English legal tradition and except where modified by state and local statutes, tends to be uniform throughout this country. For example, the general principles of tort law are drawn from English common law and impose uniform duties throughout virtually all the United States. Statutory law, on the other hand, tends to show great geographical diversity. The conduct mandated in one state or locality may not be required in another. What one state or local government requires or permits, another may prohibit.

A key to understanding all the characteristics that tend to set statutory liability apart from common-law liability is the need to be aware of the differences in the laws of the jurisdictions in which an insurance company operates. This awareness must extend beyond the organization's senior management, legal counsel, and risk management department to operating personnel responsible for the activities that are subject to diverse statutory standards.

Authority and Jurisdiction- Most locations within the United States are likely to be within the jurisdiction of not only the federal government and a state but also a particular county and municipality. Therefore, at least four levels of statutory duties are likely to govern virtually every activity of an organization: those imposed by the federal government, by the state, by the county, and by the municipality. In addition, an administrative agency may well have jurisdiction over particular activities, be they farming (subject to the regulations of the federal and state Departments of Agriculture), the manufacture of a consumer product (subject to both federal and state consumer products safety commissions), or the sale of securities (governed by both federal and state securities commissions). Such dual, tripartite, or even quadripartite regulation is characteristic of any form of federal government in which local authorities and administrative agencies regulating particular activities also have jurisdiction. Recognizing that such overlapping jurisdictions are inevitable, and that they may result in differing or conflicting regulatory standards, the federal and state constitutions (and thus many of the laws enacted by the federal and state legislatures) explicitly recognize the hierarchical application of federal, state, and local legislative enactments and administrative regulations.

The requirements of the jurisdiction governing a wider geographical area generally take precedence over those of smaller units. Thus, federal requirements take precedence over state ones, state over county and county over municipal. For the most part, the specific regulations of administrative agencies governing particular industries or activities also take precedence over laws intended to govern the entire population; among these administrative rulings, federal standards take precedence over more local ones. This hierarchical application of statutory law often has important exceptions. With respect to matters deemed to be of special "local concern," a federal statute may authorize each of the states to enact its own legislation with respect to traffic laws, public safety, education, and the like. On such matters, the federal law is likely to stipulate that any state law enacted pursuant to this authorization that is more restrictive than the federal law will take precedence over the federal law. As an illustration, federal highway speed laws apply only where a state or local governmental unit does not impose a lower speed limit; the speed law in each state applies only where a more restrictive local ordinance is not in force. To comply with the applicable law, the organization’s management must know what law applies at each of its locations and to each of its operations.

Specific Utilization- Some statutes, ordinances, administrative regulations, and executive orders apply to virtually everyone in the jurisdiction in which they are issued. Thus, when a state codifies its general criminal law it is often expressing as a statute the principles derived from the common law of crimes. Any entity engaging in the activity that the statute defined as a crime is subject to criminal liability. Many legislative and regulatory enactments, however, specify rather precisely the entities whose activities they are designed to govern. They have a targeted application. Such statutes will apply to specified groups, perhaps those who manufacture a particular product. Such a law might not govern the activities of someone who provided that good or service free of charge.

The organization's management and operating personnel need to know which statutes apply to which of its operations. If the organization is engaged in diverse activities, perhaps being both a common carrier for some customers and a contract carrier for others, a particular statutory requirement may apply to only some of an organization's operations rather than to all of them. Unless operating efficiency and uniformity make it desirable to do so, an organization need not comply with the statutory requirement in all its activities if that requirement applies to only some of its activities. Complying with a statute where applicable, but not going beyond its letter, may be more cost-effective than going beyond the "call of duty" where the law does not require it.

Specificity of Content: Most of the common law generally expresses principles that emphasize results or broad objectives. For example, contracts should embody the expressed wishes of the parties and should be fairly negotiated, one person should take care to avoid unreasonably endangering another through negligent conduct, and one person should not use force to extort or steal property from another. However, the common law generally does not precisely define what should be done to fulfill one's common law duties. Thus, the common law of negligence does not define how to exercise reasonable care to protect another. It merely illustrates by the examples drawn from many cases what constitutes unreasonably careless actions towards others' safety.

In partial contrast, statutes tend to define positive duties (what an organization or other entity is definitely obligated to do under specified circumstances- stances) or to specify what conduct constitutes a breach of a duty. From an insurance standpoint, complying with a specific statutory requirement may or may not be easier than adhering to the more general common-law standard of reasonableness. When the statute is clear, an individual can know what is required, even though the person may not regard this requirement as reasonable.

On the other hand, when the statute is unclear, an entity may face great uncertainty as to what the statute requires of it. As with the common law, they must then look to previously adjudicated cases to see what the administrative agency charged with enforcing the statute and the courts have judged to be permissible competitive practices. If the statute is primarily enforced by administrative regulators who may be pursuing a particular public policy rather than merely following past precedents, an organization may be even more uncertain about how to comply with these regulators' perception of the statute than it would be under common law.

Rapidity of Change. One of the strengths of the common law has been its stability: the same principles applied in resolving past disputes will presumably be applied in similar situations to reach similar resolutions of current and even future disputes. Statutory law can change rapidly. At any rate, as fast as the legislative body, an administrative agency, or an executive at any level of government can enact a statute or ordinance, issue a regulation, or proclaim an executive order.

Furthermore, the direction of change in statutory requirements may be difficult to predict. The rapidity and unpredictability of change in an organization's obligations under statutory law have important implications. Insurance compliance can best be achieved through implementation of regular procedures for (1) keeping abreast of all the statutory requirements to which the organization is subject; (2) defining the activities in which the organization must engage (or those that it must avoid) in order to fulfill its statutory obligations; (3) educating personnel throughout the organization in how they should conduct themselves to comply with these statutes; and (4) monitoring employees' conduct to be sure it is in compliance with all applicable statutes. Compliance management is thus an organization wide effort for which the insurance professional must share general responsibility and specific duties with others.

An Example of Statutory Liability

We now examine an important insurance-related area of statutory liability: workers' compensation. The example is typical of statutory liability that involves insurance professionals, especially those whose organizations operate in several different jurisdictions with varying, sometimes conflicting, statutes.

Workers' Compensation Statutes: Workers' compensation laws are designed to protect employees and their families from the financial consequences of accidental injury, disease, or death arising out of and in the course of employment. Prior to the enactment of these statutes, there were many obstacles to an employee's collecting from an employer for injury on the job. Today, every state has enacted a workers' compensation law.
The laws vary on occupations covered and benefits to be paid. All the laws, however, provide that the employee need not establish the employer's negligence or that the employee was free from negligence. The only requirement is that the injury occurs on the job during the course of employment. If so, the employer is liable. This is an example of strict liability or liability regardless of fault. Some statutes give the employer the option of electing to be sued by employees. In those states, the employee must show employer negligence but is free from the common law defenses of contributory negligence and assumption of risk.

Under workers' compensation acts, employees obtain cash payments for loss of income as well as reimbursement for medical expenses. Some laws provide for the establishment of state workers' compensation funds, and others require private insurance coverage to be obtained by the employer. Under some state laws, employers may "self-insure" if they meet certain qualifying financial standards.

In the past, workers' compensation laws have been criticized because of the number of occupations left uncovered as well as for poor administration of the programs. Because the statutes were designed to remedy recognized defects in the common law, the courts tend to construe the statutes liberally and, whether deciding coverage or the scope of employment, courts tend to find in favor of injured employees. Reform of the benefits has been proposed and the enactment of a federal workers' compensation act may be the ultimate result if all states do not bring their workers' compensation statutes up to a minimum standard.

Safety by Statute- Today, all state workers compensation statutes cover most public and private employment, and the interests protected are those of the workers exposed to work-related illness or injury as well as the members of their families who otherwise would be responsible for medical bills and would suffer loss of income when a worker was disabled or killed. Some statutes include within the scope of their coverage civilian volunteers such as volunteer fire fighters or auxiliary police officers; some statutes specifically exclude domestic servants and farm workers from the operation of the law.

Federal statutes provide similar kinds of benefits to certain types of employees including longshoremen and harbor workers, railroad workers, sailors, and others. The effect of a compensation statute on the employee is to take away his or her common-law rights against the employer and to substitute a remedy that requires the employer to pay certain benefits as specified during disability, awards for permanent disability, and in the case of death, a death benefit to dependents. When workers are excluded from the law, they retain their common-law rights to sue the employer. When afforded, the right to compensation becomes the employee's exclusive remedy (except in states that permit the employee to reject the statute prior to an accident and thus retain the right to sue). Under common law, the injured worker would be subject to the usual delays of litigation and would receive no money unless and until the case was tried or settled in favor of the injured employee.

The effect of a workers' compensation law on the employer is to relieve the employer of the duty to respond in damages that might have otherwise been imposed for failure to meet the common-law duties to the employee. Simultaneously, the employer becomes obligated for the statutory compensation benefits regardless of fault. The statutes require that weekly payments be made promptly, with the first payment usually being due at the end of the second week of disability.

Strict Liability- When an employee sustains injury or illness in the course of employment, the benefits specified in the applicable state workers compensation act becomes a strict liability of the employer. Because the liability is a strict one, there is no requirement on the employee to prove that anything other than injury or illness was sustained and that it arose out of the employment. There is no question of having to prove negligence on the part of the employer or of having to rebut common-law defenses such as contributory negligence.

The vast majority of workers' compensation cases are automatically and routinely processed. It is only when the employer disputes the claim of injury or illness or denies that it arose out of the employment that there is a legal proceeding. Even in such disputed cases, there is no trial (as there would be in a tort action) but rather an informal administrative hearing.

Here is a case that illustrates the concept of liability under the laws of workers' compensation. In it, the insurer has stood in the place of the insured. The concept of **subrogation** is important to this case. Subrogation is the right of the insurer to recover from a third party the amount paid to the insured under the policy. The insurer has no greater rights than those maintained by the insured. As a result, any defenses that are valid against the insured are germane when used against the insurer.

Great West Casualty Co. V. MSI Insurance Co

Court of Appeals of Minnesota
482 N.W.2d 527 (1992)
OPINION
PARKER, JUDGE.

On appeal from summary judgment in an insurance subrogation case, appellants claim the insured's failure to obtain workers' compensation insurance denied Great West Casualty Company any right of subrogation. We agree and reverse the trial court's grant of summary judgment for Great West.

FACTS

In February 1989 Jon Bergan was injured while driving his 1977 Kenworth semitractor north on County Road 14 in Mower County, Minnesota. On the date of the accident, Bergan owned the semi-tractor but was leasing it to Farmers Union Central Exchange, Inc., pursuant to a one-year independent contractor agreement. Farmers Union was given exclusive possession, control and use of Bergan's semi-tractor and assumed complete responsibility for its operation.

The agreement required Farmers Union to carry cargo and public liability insurance on the equipment, as required by the Interstate Commerce Commission. Farmers Union insured the semi-tractor by a policy with MSI Insurance Co., which provided liability and no-fault coverage pursuant to Minnesota law. The policy provided that Farmers Union would pay the first $100,000 of any claim.

The agreement also required that Bergan carry a policy of workers' compensation that would provide coverage to himself. There is no dispute that Bergan failed to purchase the required workers' compensation insurance. He did, however, insure his tractor for "bobtailing," or non-trucking use, with Great West.

After the accident, Bergan submitted his no-fault claims to Great West, which paid him pursuant to its policy. Great West subsequently brought this lawsuit against MSI and Farmers Union for subrogation, claiming that, at the time of the accident, the tractor was being used in the business of Farmers Union, to whom the tractor was leased, and therefore an exclusion in Great West's policy applied. MSI and Farmers Union defended the suit by claiming that Bergan's failure to obtain workers' compensation coverage barred Great West from recovering.

ISSUE

Does an insured's breach of contract, which bars him from seeking indemnity, bar his subrogee derivatively?

DISCUSSION

Appellants claim that Bergan's failure to obtain workers' compensation insurance denied Great West a right of subrogation. We agree. Generally, an insurer can pursue any rights which its insured has against the party causing the loss.... However, an insurer, as subrogee, has no greater rights than those possessed by its insured, the subrogor.... Therefore, as the subrogee of Bergan, Great West is entitled to no greater rights than Bergan and stands in his shoes.

The independent contractor agreement required that Bergan carry a policy of workers' compensation insurance to provide coverage for himself. This is consistent with Minnesota law providing that independent-contractor truck drivers will not be considered employees for the purposes of workers' compensation insurance.... Therefore, Farmers Union was not required to procure workers' compensation coverage.

Although Farmers Union had a mandatory obligation to provide no-fault benefits under I.C.C. regulations, this coverage would have been secondary to the workers' compensation benefits Bergan was required to obtain.... Because **workers'** compensation benefits are primary, MSI and Farmers Union would have had a defense against a claim for no-fault benefits against MSI (as carrier of liability insurance of Farmers Union) by Bergan, based on his breach of the contract.

The Minnesota Supreme Court has determined that a contractual agreement between two parties can extinguish a derivative subrogee's right to subrogation. St. *Paul Fire & Marine Ins. Co. v. Perl,* 415 N.W.2d 663, 665 (Minn. 1987); *see also Great N. Oil Co.,* 291 Minn. at 100, 189 N.W.2d at 407 (insured may defeat subrogation rights of its insurer by executing an exculpatory agreement with the party causing loss). In *Perl* an indemnification agreement entered into between an attorney and his law firm extinguished any subrogation rights of the firm's liability insurer against the attorney for claims paid as a result of the attorney's breach of fiduciary duty where the law firm had agreed to indemnify the attorney for such liability. Similarly, in this case Bergan's failure to purchase workers' compensation coverage, which would bar him from indemnification by Farmers Union's liability carrier (MSI), denies Great West recovery as his subrogee.

Because we have determined this case on the subrogation issue, we need not address whether Bergan was using his tractor in the business of Farmers Union at the time of the accident.

DECISION

The trial court erred in failing to find that Bergan's breach of contract barred Great West from its subrogation claim. MSI and Farmers Union were entitled to summary judgment as a matter of law. The trial court's summary judgment in favor of Great West is reversed and remanded with instructions to the trial court to order entry of summary judgment on behalf of MSI and Farmers Union.

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State Statutes Differ

In the sense that there is no "wrong" usually associated with employee injury, there really is no "wrongdoer," but the obligations of the employer to the worker are outlined in the various statutes and become an absolute or strict liability of that employer. The employer is generally obligated to pay compensation for disability or death and medical expenses. The payment of indemnity is designed to take the place of wages, but in no case is it intended to equal or exceed the amount of wages that the claimant received while working. Statutes provide for a percentage of the average weekly wage (often 66 2/3%). The theory is that the reduced amount will provide some incentive for the injured employee to return to work as soon as possible after the disability ceases.

The amount of compensation is further limited by a maximum rate set forth by statute. The maximum rate differs state by state, and in some states, the duty of establishing the maximum rate is delegated to a state official who will follow a formula directed by the legislature. The formula is usually based on the average wages earned in the state during the preceding year. Thus, in such states, the maximum rate of compensation will change at the end of each calendar year.

Compensation is payable for disability, the inability to work due to injury. The disability may be total or partial, and either of these conditions may be temporary or permanent.

1 Temporary Total Disability- This phrase means that the disablement is such that the injured employee is expected to recover but is unable to do any work for a limited period of time. For such period, the maximum rate of compensation is payable in all states.

2 Temporary Partial Disability**:** This phrase means that the injured employee can do some work but cannot work at full capacity and command the same earnings as when working at his or her regular job. For this type of disability, the injured person is entitled to receive a percentage of the difference between the amount that is currently being earned and wages that were previously earned. It is contemplated that the employee will eventually return to regular work at the usual wages.

3 Permanent Partial Disability- This phrase means that the employee has sustained an injury from which he or she will never recover, but that only partially affects earning capacity. The employee may be able to do his or her former job, but the permanent condition will usually reduce efficiency and will reduce the employee's ability to compete in the labor market in the future. Permanent partial disability compensation payments are designed to pay for the effects of the injury on the employee's future earning capacity. Such payments are made in accordance with the provisions of the particular statute. Most states divide injuries of this type into two groups: scheduled injuries and nonscheduled injuries. Most schedules refer to a number of weeks of disability compensation, which will be paid to the claimant whether working or not. Thus, under a schedule payment, the amount is fixed by statute without reference to the actual influence the injury has on the employee's earning capacity.

Permanent Total Disability- This phrase means that the injured person is totally disabled (not able to do any kind of work) and that the condition will continue for the balance of his or her lifetime. It will not improve under treatment or rehabilitation. Under some statutes, the payment of benefits will continue for the remainder of the injured person's lifetime; under others, the maximum payment is set forth in the statute either by limiting the payments to a number of weeks or to a total dollar amount.

On the Job Death When a worker dies as the result of injuries or an illness sustained, the dependents of such a worker are entitled to receive the reasonable value of the funeral expenses and payment of the compensation benefits set forth in the statute for the benefit of persons defined in that statute as dependents. In the more generous states, payments to the surviving spouse continue indefinitely with a final lump sum (usually the equivalent of two years' benefits) payable on remarriage. Other states limit the period during which this type of compensation will be paid to a number of weeks (for example, 400 to 500) from the date of death. Other dependents, as defined in the particular statute, usually include dependent children, and benefits are paid only during their minority. Legally adopted children also come within this category.

In some states, if there is no surviving spouse or child, an award of compensation is made for the support of grandchildren or brothers and sisters under the age of 18 years. Where there are no persons entitled to death benefits, some states require a payment to a vocational rehabilitation fund or some similar fund. The amount of the payment is set forth in the statute.

Other Compensation Benefits: In addition to the foregoing classes of disability, some statutes provide for a payment to be made in the case of serious facial or body disfigurement, the theory being that the injured person would have a more difficult time finding employment because of the scarring.

Medical Benefits: In addition to the payment of compensation benefits, the injured worker is entitled to such payments for medical surgical, and hospital services as the nature of the injury and process of recovery require, including dental care. Some states allow the injured worker to select a personal physician or dentist, while others require that the employer supply medical and dental attention through its own physicians or dentists. As to what constitutes "medical" treatment, all states are in agreement that services rendered by a duly licensed physician come within this classification. By statute, some states also include treatment rendered by an osteopath, chiropractor, or religious healer.

Most states require the payment of medical expense without any upper dollar limit, while others limit the period of time within which the employer is liable for medical attention and/or impose a dollar maximum. Most states also provide that the employer is liable for the payment for eyeglasses and glass eyes as well as for furnishing of prosthetic devices, such as an artificial arm, hand, or leg.

Major Variations Among State Laws: Although in recent years there has been a trend toward improving benefits, there still remain significant variations among state laws in terms of the level of compensation, the coverage of disease, rehabilitation, employments covered, and other specific provisions. As noted previously, most states have no upper limit applicable to the payment of medical expenses. However, there remains a substantial difference between the states regarding the weekly dollar maximum for disability compensation. The period for which compensation for disability is payable also differs by state. In some states, the maximum period for temporary total disability is as little as 200 weeks; other states are more generous, and still other states pay compensation without limit for the entire period of disability.

Compensation for death is also subject to wide variations. In the most generous states, these benefits are payable to the spouse until he or she is deceased or remarried and to the children until they reach the age of 18. Other states limit the period for which death benefits are payable to 400 or 500 weeks.

In most states, there is coverage for occupational disease**,** which is usually defined as a disease peculiar to the occupation, not a disease to which the general public is exposed. Most states have a list of the particular diseases that are covered, whereas other states cover any and all occupational diseases. In states where the particular occupational disease is not covered by statute, the employee retains common law rights and may exercise them by bringing a tort action against the employer.

Generally speaking, the employer has no direct responsibility for rehabilitation costs. However, it is often in the economic interest of the employer to rehabilitate the injured worker rather than to be indefinitely obligated for compensation benefits. Some states have maintained rehabilitation programs, and employers indirectly bear the costs in various ways. In some states, there is a tax on awards paid to rehabilitation programs.

In some states, either the employer or the employee has an opportunity to reject the act prior to an accident with consequent forfeiting of statutory rights. Under "compulsory" laws, unless the type of employment is specifically excluded, statutory compensation is mandatory with neither the employer nor the employee having the right to reject the act. Compulsory laws also specify that all employers subject to the act must carry compensation insurance (or a formal self-insurance program, where permitted). Failure to do so subjects the employer to penalties provided in the statute and will restore the employee's common law rights, if the employee chooses to assert them while denying the employer common law defenses. Alternatively, in some states, the employee may claim the statutory compensation benefits, when then will be assessed against the employer. Under almost all compensation statutes, domestic servants and farm laborers are excluded from the benefits of the law.
Some laws further define domestic and farm workers to include "babysitters, cleaning persons, harvest workers, and similar part- time or transient help." Other employees excluded are casual employees not employed in the usual course of the employer's business as well as employees of charities.
In many states, the employer may voluntarily provide compensation benefits for employees who do not come within the scope of the compensation law coverage. These might include not only domestic servants and farm laborers but also those employed exclusively in a foreign country or those employed in an area of federal jurisdiction (such as in connection with interstate railroads or vessels). Depending on the state, the employer may or may not be able to make compensation the sole remedy for employees who have been voluntarily afforded compensation benefits. In the majority of states, the compensation statute creates a quasi-judicial body, variously called the Industrial Accident Commission or the Workers Compensation Board, whose duty it is to administer the law and, more importantly, to hear and determine claims and disputes. Appeals may be taken to the courts from any decision of such a body. In a few states, claims are heard and determined by the courts like any other type of lawsuit.

Methods of securing the payment of compensation benefits differ depending on the type of law in force in a particular state, but they may be described under the headings of (1) monopolistic state funds; (2) competitive state funds and private insurance; (3) private insurance only; and (4) self-insurance or retention. In any event the employer must comply with the applicable state law and generally must purchase workers' compensation insurance or qualify as a "self-insurer" with the state. Under most compensation laws, either by statutory provision or by judicial interpretation, where the contract of hire is made within the state and the employee does some work in the state, the compensation law of the state of hire can be applied to an accident the employee may have in another state, in a foreign country, or on the high seas.

Where the contract of hire is made in one state for work to be performed exclusively outside that state, the location of the place of the contract will not subject either party to the jurisdiction of that state compensation act. In such a case, the parties intended by implication that the state where the work is done would have jurisdiction. In the case of work to be performed in a foreign country, the law of that country will prevail unless the parties have agreed to other terms in the contract of employment.

Some states limit the extraterritorial effect of their compensation laws by applying the law only to accidents that occur within a certain time after the employee leaves the state. Such time periods may be as little as 90 days or as much as one year. Where the employee is injured by the negligence of a third party, the employee has a choice of remedies. The employee may (1) sue the third party and reject the compensation remedy; (2) accept compensation and forgo any remedy against the third party; or (3) accept compensation and also sue the third party. If the third alternative is selected, the laws generally provide that the suit must be brought within a certain period of time (to protect the employer's subrogation rights), and the employer or the employer's insurer has a lien on the proceeds of the employee's recovery to the extent of the compensation and medical payments made.

Inconsistency in Law- Where an employee is hired in one state, works only in that state, is not engaged in an occupation that would bring the employee under any of the federal statutes, and is injured in that state, there are no jurisdictional questions involved; the employee only has a claim under that state's workers' compensation act. Where the employee is hired in one state, does some work in that state, and then is injured in another state, the general rule is that the employee has a choice of jurisdictions and may make a claim in either state. Where the contract of employment is made in one state for work performed exclusively outside of that state, the workers' compensation law of the state of hire has no application. Where the employee is hired in one state and does work within the area of federal jurisdiction, the employer may have a liability under either the state or the federal jurisdiction.

Under any of these various circumstances where there is a question of which benefits can be claimed, it is to the advantage of the injured worker to make claim in the jurisdiction that provides for the highest benefits. Under certain circumstances, it is possible to make claims under laws of more than one jurisdiction, but it is generally not possible to "collect twice because benefits payable under one law are generally deductible from those of another." How a particular conflict in jurisdictions is settled depends on the specific facts of each case and the provisions of the laws involved.

Occupational Safety and Workers Compensation. Of relevance to state workers' compensation laws and federal statutes on employee injury is the Occupational Safety and Health Act of 1970 (OSHA), which authorizes the Secretary of Labor to promulgate and establish federal standards that promote occupational safety and health. It provides for inspections and citations for the violation of the regulations created by the Secretary of Labor. The Occupational Safety and Health Administration is thus authorized to regulate safety in the workplace. Employers have three responsibilities under the act: (1) to provide a safe place to work; (2) to comply with OSHA standards; and (3) to keep records. OSHA standards are enforced either by the federal or the state governments, and variances can be obtained when compliance with a standard is not possible or when the employer can evidence that a particular method of operation is at least as safe as what would be required by compliance with an OSHA standard. OSHA further provides for penalties for the violation of regulations in the form of fines.

This explanation of statutory law and liability, although brief, will serve as an introduction to liability, responsibility and codification of conduct deemed acceptable by society. The next chapter will look at the concept of liability and the common law. At times the concept may seem a bit more nebulous, but the idea of liability, both common law and statutory, are important ones to grasp.

Chapter 3: Civil Law Fundamentals- Liability, Tort, and Contracts

Civil law affecting commercial transactions comes under two major headings. The first heading is tort. These are cases that seek compensation for loss resulting from the conduct of others that is socially unreasonable. The second heading involves equity cases, the enforcement of agreements such as contracts, trusts, mortgages, mechanics liens, agency, license, and bailment.

Each person has certain legal rights. A legal wrong is a violation of a person's legal rights, or a failure to perform a legal duty owed to a certain person or to society as a whole. There are three broad classes of legal wrongs;

A <u>crime</u> is a legal wrong against society that is punishable by fines, imprisonment, or death.

A <u>breach of contract</u> is another class of legal wrongs.

Finally, a <u>tort</u> is a legal wrong for which the law allows a remedy in the form of money damages.

The person who is injured or harmed (called the plaintiff or claimant) by the actions of another person (called the defendant or tortfeasor) can sue for damages. The word "tort" is derived from the Latin "tortus" meaning twisted or crooked and from the French word for injury or wrong. At the time the common law was developing, "tort" was in common English usage as a synonym for a wrong. In legal usage, a tort is a wrong consisting of the violation of a right not created by contract for which the courts will provide a remedy. It is the infringement by one person of an inherent right that another person enjoys as against the entire world. A tort is committed when (1) a duty owed by one person to respect the correlative right of another, (2) is breached or violated and *(3)* results in injury or damage to the owner of the right.

The breach of duty is;

1) The harming or injuring of a person by killing him (wrongful death), by beating him (battery), by threatening to beat him (assault), by restricting his freedom of movement (false imprisonment), by defaming him orally (slander) or in writing (libel)

2) the harming of property by stealing or withholding it (conversion) or by damaging it (trespass to land or chattels)

3) the harming or injuring of a legally-protected relation (a) between husband and wife or parent and child (abduction, seduction, alienation of affections, criminal conversation); or (b) between employer and employee (interference with contractual relations); or (c) between businessman and customer (injurious falsehood, unfair competition)

Basis of Legal Liability

Harms or injuries may be inflicted intentionally, negligently, or by the improper use of one's own property (nuisance). In the early period of the common law, intentional harms were predominant; now the great majority of litigated torts are in the field of negligence (automobile collisions, injuries to pedestrians, malpractice by doctors, lawyers and others). A growing field of torts has resulted from injuries caused by foods, drugs and other products (product liability). Another expanding area is the invasion by the use of electronic devices of the right of privacy and the remedies needed to halt the invasion.

A rapidly changing aspect of tort law is the disappearance of common-law immunities:

- Governmental immunities, based upon the concept that the king could do no wrong and hence the sovereign power could not be sued, are becoming less and less available as a defense against suits brought against governmental agencies
- Charitable immunities as in the case of hospitals and other institutions
- Intra-family immunities, which prevent husbands and wives, or parents and children, from suing one another.

All of these developments reinforce the concept that there shall be a remedy for every wrong. In a tort action the injured party sues to recover compensation for damage he has suffered. The purpose of tort law is to compensate the aggrieved party, not to punish the wrongdoer, as is the case with criminal law. Of course, the same conduct may, and often does, constitute both a crime and a tort. Something may be criminal without being tortuous, and by the same token, an act may amount to a tort and not be a crime. The closest that tort law comes to an implementation of objectives of the criminal law is in certain cases where courts may award what are called "punitive" or "exemplary" damages. Where the defendant's tortuous conduct has been intentional and deliberate, exhibiting "malice" or a fraudulent or evil motive, most courts will permit a jury to award damages over and above the amount necessary to compensate the plaintiff. The allowance of punitive damages is designed to punish and make an example of the defendant and thus deter others from similar conduct.

The law of torts is an active and changing area of the law. A large part of all civil litigation is devoted to the trial of negligence actions.

Torts generally can be classified in the following three categories:
❶Intentional Torts- Legal liability can arise from an intentional act or omission that results in harm or injury to another person or damage to the person's property. Examples of intentional torts include assault, battery, trespass, false imprisonment, fraud, libel, slander, and patent or copyright infringement.
❷Absolute Liability- Because the potential harm to an individual or society is so great, some persons may be held liable for the harm or injury done to others even though negligence cannot be proven. Absolute liability means that persons are liable for damages even though fault or negligence cannot be proven. Some common situations of absolute liability include the following:
 Occupational injury and disease of employees under a workers' compensation law
 Blasting operations that injure another person
 Manufacturing of explosives, medicines, and food products
 Owning wild or dangerous animals
 Crop spraying by airplanes
❸Negligence- This is another type of tort that can result in substantial liability. Since negligence is so important in liability insurance, it merits special attention.
Negligence is defined as the failure to exercise the standard of care required by law to protect others from harm. There are four elements of a negligent act:

Existence of a legal duty
Failure to perform that duty
Damages or injury to the claimant
Proximate cause relationship

Under a <u>contributory negligence</u> law, if the injured person contributed in any way to the accident, he or she cannot collect damages. Under a <u>comparative negligence</u> law, the injured person could collect, but the damage award would be reduced. Under the *last clear chance rule,* the plaintiff who is endangered by his or her own negligence can still recover damages from the defendant if the defendant has a last clear chance to avoid the accident but fails to do so. Under the *assumption of risk* doctrine, a person who understands and recognizes the danger inherent in a particular activity cannot recover damages in the event of injury.

Under certain conditions, the negligence of one person can be imputed to another. Imputed negligence may arise from an employer-employee relationship, vicarious liability law, family-purpose doctrine, joint business venture, or a dramshop law.

Under the doctrine of *res ipsa loquitur* (the thing speaks for itself), the very fact that the event occurs establishes a presumption of negligence on behalf of the defendant. The term refers to a rule of evidence whereby negligence of the alleged wrongdoer may be inferred from the mere fact that the accident happened. That is, provided a.) that in the absence of negligence the accident would not have occurred and b.) the thing that caused the injury is shown to have been under the exclusive control of the alleged wrongdoer. The procedural effect of successful invocation of the doctrine is to shift the burden of going forward with the evidence, normally borne by the plaintiff, to the defendant, who is thereby charged with introducing evidence to refute the presumption of negligence that has been created.

In all, there are six modifications to the charge of negligence under civil tort law. The six modifications are:
1. avoidable consequence
2. last clear chance
3. comparative negligence
4. contributory negligence
5. gross negligence
6. assumption of risk

Inconsistency of Legal Procedure- Many times the law of several different states or jurisdictions will apply in a particular situation. This is common with insurance contracts. They frequently involve parties residing, doing business, or passing through different states. A person living in Texas might obtain insurance with a company in New York to cover property located in New Mexico. Automobile insurance is especially prone to such conflicts. Say a driver from a state with comparative negligence laws has a collision in a state with a no-fault law. Whose law will apply?

There is an inconsistency of legal rule and outcome from state to state. For example, with insurance cases involving motor vehicles, both parties- residents of one state- have an accident in a different state. The tort law of the state where the injury occurred will generally be applied, even if the suit is filed in the state where both parties reside. Thus there is a <u>situs</u> state, where the accident occurred, and a <u>forum</u> state, where the facts will be tried. The state with the “most significant contacts” to the tortuous act has its law applied. Such a rule may also be used in cases involving breach of contract. To confound matters even more, the procedural law of the residence state, where the suit was filed, would be applied. <u>Procedural</u> law involves the mechanics of the legal process. That is, the body of rules and practice by which justice is delivered by the legal system as opposed to the substance and content of the law itself.

Negligence and the Courts Two parties are involved in a negligence suit. The <u>plaintiff</u> is the party claiming injury and the <u>defendant</u> is the party responding to the complaint, the one who is sued and called upon to make satisfaction for a wrong complained of by another.

The purpose of the court is to determine what the facts are in a given case. Both sides present their view of the circumstances at issue. A judge or jury then determines the facts. After the facts are determined, the judge applies the appropriate legal remedy. Contrary conclusions may be reached by two different juries with regard to the same group of facts. A court in Oregon will view a person’s actions differently than a jury in the Midwest than a jury in Texas than a jury in Maine, and so on. What is deemed reasonable one place may be viewed as outrageous conduct in another locale. Until a judge or jury confirms the questions of fact, the outcome of a legal dispute cannot be determined.

Negligence and Liability- It was stated above that there are other types of liability besides that incurred because of negligence. There is a relationship between the two concepts. The relationship varies depending on the facts involved in a particular circumstance. The relationship depends on the facts and the facts in any case are decided by a judge or jury. Until the facts of a case are determined questions based on circumstances cannot be resolved. “The failure to exercise a degree of care that a person of ordinary prudence (i.e. reasonable man) would exercise under the same circumstances” is a short definition of negligence. Liability is an obligation to do or refrain from doing something or a duty that must ultimately be performed. Thus it is that tort liability results from some form or degree of negligence.

Liability Insurance and the Law

Third-party liability insurance is ubiquitous in today’s tort-conscious world. Life or property insurance protects the interests of the named insured. An insured uses third-party liability insurance to protect against potential tort liability. Loss to the insured’s property does not trigger coverage. It is initiated by the liability of the insured for damage to another person or property. Coverage is also contingent upon whether the insured’s liability to a third party arose out of an “occurrence” or and “accident” covered by the policy.

Everyone can understand the concept of insuring against the perils of a house fire or an auto crash. We see sensational accidents documented daily in the news media. Less coverage is afforded to the liability side of accidents. Few of us have direct experience with being sued. There is a general rule of law that states an individual is responsible for any loss they may cause others to suffer. Out of this concept we get the peril of legal liability. Liability insurance originated solely as a form of protection for the interests of the insured. The first policies were for employers’ insurance against loss through liability to employees for work related injuries. Subsequent legislation has worked to make an injured third-party with a cause of action against the insured an apparent third-party beneficiary of the liability policy.

There are two major distinctions among the types of policies that protect an insured from loss due to their causing harm to a third person or their property. One type policy provides that the insurer does not become involved until the insured has actually suffered an economic loss in the form of payment to the third party. This policy would be considered a pure indemnity policy. It would generally give rise to no cause of action by the third-party directly against the insurer. The other type of policy provides that the insurer becomes answerable once the amount of the insured’s obligation to pay has been finally determined by judgment against the insured or by written agreement of the insured, the claimant and the insurer. This style of clause makes the policy one of liability insurance. The insured has a cause of action on the policy when the liability to the third party is fixed as to amount.

Liability Special Conditions

An individual who commits certain acts will be liable for ensuing injury to another regardless of willful wrongdoing or negligence. This is the net effect of the doctrine of absolute liability or liability for acts done at one’s own peril. In recent years, certain tort liability problems have emerged that have caused serious problems for risk managers, business firms, physicians and other professionals, government officials, liability insurers, and taxpayers. These problems center on the increased number of liability lawsuits in certain areas and the cost and availability of liability insurance.

Government- Governments cannot be sued unless they agree to it according to common law tradition. Sovereign immunity is the basis of this doctrine. *Rex non potest peccare*, the king can do no wrong. We live in a republic and this doctrine has been modified over time by statute and court decisions. Generally, a governmental body can be held liable if it is negligent in the performance of a proprietary function. That is, activities that could be provided by the private sector. This includes utilities, auditoriums, stadiums and other money making endeavors. If a fire breaks out under the stands at a football stadium owned and operated by a governmental body, injured spectators could sue for negligence. Purely governmental functions such as traffic control, the police power and tax collection are generally immune from liability lawsuits. Yet abuse or negligence relating to these powers can result in damage awards.

Charitable Institutions- Immunity previously held by these institutions has been gradually eliminated by court decisions. Charity hospitals, for example, can be sued for medical malpractice. Church or lodge groups holding social gatherings can be sued for negligence for patron injury.

Employer and Employee Relationships- The negligent actions of an employee are the responsibility of the employer if the employee is acting on the employer's behalf. The doctrine of *respondeat superior*, let the master answer, is invoked. The premise is that when an employer is acting through the facility of an employee and tort liability is incurred, the employer or master must accept responsibility. Implicit is the common law notion that everyone must conduct their affairs without injuring another, whether or not the master employs agents or servants. Two tests must be met;
① The employee must be acting within the scope of employment. This means the employee must be doing the kind of work that they were employed to perform. Numerous factors come into play here, including whether the act is authorized by the employer, commonly performed by the employee, is criminal in nature, etc.
② The person's status must legally be that of an employee. An employee is someone given detailed and ongoing instructions on how to do a job, furnished tools or supplies by the employer, and paid wages or salary on a regular schedule.

Child-Parent relationships- Parents are normally not responsible for their children's torts. Children who reach the age of reason, normally around the age of seven, are responsible for their own wrongful acts. Conversely stated, persons old enough to have *mens rea* (a guilty state of mind) must be responsible for it. Exceptions to this general principle are as follows;
> Parents can be held liable if a child uses a dangerous weapon. If a child has access to a gun or knife and hurts someone else, the parents can be held liable. Examples of such tragedies are recounted frequently in the media.
> When a child acts as an agent for the parent, the parent incurs legal liability. When a child works in the family business or on the farm, the parents can be held liable for any injury to others caused by the child's actions.
>Parents can be held liable under the family purpose doctrine. When a family owned automobile is operated by a minor child, the parents are responsible.

Animals The owners of wild animals are held absolutely liable for the injuries of others even if the animals are considered domesticated. "Wild" animals are those which by local custom are not devoted to the use of man. They need not be ferocious, monkeys and elephants have been held to be wild animals. If a pet such as a big cat or a snake escapes and injures someone the owner is absolutely liable even if due care was used in keeping the pet restrained.

Damages caused by the trespass of any domestic animal are the responsibility of the owner. So if a horse or cow broke out of a fenced pasture and caused damage, there was absolute liability and proof of negligence was not needed. Dogs and cats are included as domestic animals, but since they seldom cause any property damage, even when trespassing, the rule of absolute liability was not applicable to them. The courts adopted a “one free bite” rule under which the owner would be held to have knowledge of the vicious nature of an animal only after it had previously bitten someone. As society has become more urban, the majority of states have passed laws holding the owner liable for injury to others even if the pet did not previously have a cranky nature.

Products liability refers to the legal liability of manufacturers, wholesalers, or retailers of products to persons who incur bodily injuries or property damage from a defective product. The number of products liability lawsuits has increased over time. Between 1974 and 1990, product liability lawsuits in the United States increased more than 1000 percent. Several reasons account for the substantial increase in products liability lawsuits. First, the courts have gradually rejected the older privity of contract doctrine. Under this doctrine, the original seller of the goods was not liable to anyone for a defective product except the immediate buyer or one in privity with him. This meant that only the person who was a party to the contract could bring action against the manufacturer of a defective product.

The courts and legislation have changed the concept. Today, a manufacturer or seller of a product can be held liable as a result of improper product design, improper assembly of the product, failure to test and inspect the product, failure to warn of inherently dangerous characteristics, deceptive advertising, and failure to foresee possible abuse or misuse of the product. Injured persons in most states can now directly sue the manufacturer of a defective product. An emphasis on consumerism, rightly or wrongly, has encouraged individuals to sue because of injuries from defective products. In particular, the Consumer Product and Safety Act has been credited with stimulating an increase in products liability lawsuits. Finally, the substantial number of new products has resulted in an increase in lawsuits from defective products that cause injury.

Products liability insurance covers injuries caused by consumer products that are defectively manufactured, defectively designed, or defectively marketed (with inadequate warnings or instructions for use). A situation that frequently arises is that a product-related injury or disease does not manifest itself until some years later, when a different insurance company is providing coverage to the manufacturer. At times the manufacturer has changed names or products altogether. In determining the insurer’s liability for latent product caused injuries three distinct legal theories have evolved, the exposure theory, the manifestation theory and the injury-in-fact theory. It is beyond the scope of this book to delve into those theories. Suffice it to say that reams of paper have been used to justify these legal theories and that much again to prove a different one on appeal.

Situations that come to mind include the mass litigation concerning the manufacture of asbestos. Another involves Diethylstilbestrol (DES), a synthetic drug that was taken on prescription by millions of pregnant women to avoid spontaneous abortion and other disorders stemming from low levels of the estrogen hormone. In 1971 a link was discovered between DES and a number of ailments, including cancer. The Dalkon Shield contraceptive device and Agent Orange were product liability mass litigation events. Everything from asbestos and annuities to ice cream and prescription drugs has the potential of another litigation bonanza.

Professional Liability

Some types of professional liability insurance and newer comprehensive general liability insurance policies provide coverage for claims that are made during the coverage period, rather than for occurrences during the coverage period.

Occurrence policies provide coverage if the insured event giving rise to liability occurred during the policy period, regardless of when the act or neglect was discovered or when the claim was filed with the insurer.
Claims made policies provide coverage if the act or neglect is discovered and brought to the insurer's attention during the policy's term, regardless of when the act occurred.

Medical malpractice- This is defined as negligence in doing some act that a reasonable physician would not have done under the same circumstances, or as a failure to do something that a physician would have done. Stated simply, malpractice is improper or negligent medical treatment in the eyes of the law. For example, a surgeon who performs a surgical procedure incorrectly can be held legally liable if the patient is paralyzed after the operation. Because of the fear of a malpractice suit, physicians are practicing defensive medicine that results in unnecessary diagnostic tests or longer-than-necessary hospital stays. Because of defensive medicine, health care costs in the United States are increased by billions of dollars annually.

Because of high premiums, some physicians have dropped their medical malpractice insurance and are practicing medicine with no coverage. Still others are using legal techniques to shield their financial assets from litigious patients, such as transferring assets to family members or moving assets into areas exempted from collection by creditors.

In addition, patients are more willing to sue their physicians than in the past. This is true for several reasons;

- According to experts who have studied the problem, there is a disturbing level of improper or negligent care provided by some physicians. All physicians do not offer high-quality medical care. In many cases, physicians attempt some medical procedure beyond their normal skills or make errors in judgment. As a result, the patient is harmed, and the physician is sued.

- Many patients sue their physicians because of unrealistic expectations. Advances in medical science and medical technology often result in high medical expectations. When patient expectations are high, failure to fulfill them often leads to a lawsuit.

- Some patients sue their physicians because of the philosophy of entitlement. This means that some Americans believe that somebody owes them something when things are not quite right. Jurors occasionally leave the impression that the key question is not whether negligence is present, but who is better able to bear the burden of loss. The real attitude is "someone is injured, and therefore someone should collect."

Legal Malpractice Lawsuits against attorneys for legal malpractice have also increased for several reasons;

- The standards for judging legal negligence have been broadened. Earlier, only a blatant legal error or omission could produce a malpractice suit. Today, because of adverse court decisions, attorneys are held to a higher standard of care than in the past.
- The old rule of privity, which made an attorney responsible only to his or her clients, has lost its former force. An attorney today may be held liable by a party who may benefit from the attorney's performance but is not a client.
- An increased willingness on the part of attorneys to testify against each other and even sue each other has recently been manifested. Testimony by one attorney against another was uncommon until recently.
- An increase in the scope of government has resulted in more complex laws, rules, and regulations. New laws with respect to pollution, ecology, consumerism, and privacy have produced an entirely new bundle of individual rights. Thus, the margin for legal errors or omissions continually decreases, resulting in additional lawsuits for legal malpractice.

Professional Liability in Other Fields- Other professional groups are experiencing similar liability problems. The number of malpractice lawsuits against architects and engineers has also increased in recent years. The increased number of lawsuits in this professional area can be explained by several factors. First, the increase in malpractice suits against architects is partly due to a broader interpretation of liability by the courts. Architects and engineers are now held legally liable for injuries to the general public as well as to the building owners, and to workers injured by a hazardous condition on the construction site. Public accounting firms have experienced a substantial increase in both the number and size of claims. Pharmacists are also being sued in large numbers. Insurance agents have experienced a substantial increase in lawsuits because of errors and omissions. Even education has come under the malpractice attack. Colleges have experienced an increase in personal injury suits by students who claim that the schools should have protected them from their injuries. In several instances, parents have sued their school district because their children can barely read, even though they have received diplomas.

Directors and Officers-Directors and officers of corporations also have experienced an increase in liability lawsuits. As a result, many corporations have found it difficult to get outside members to serve on the board of directors. Since average claim settlements are high, corporations have experienced a substantial increase in liability insurance for directors and officers, higher deductibles, and reductions in the amount of available insurance. Stockholders have filed the majority of suits against directors and officers because of financial losses.

Municipalities not Excluded- Cities are sued because someone is injured in a public park or playground; police officers are sued because of brutality, false arrest, wrongful death, or violation of civil rights. The state department of roads is sued because a motorist is seriously injured because of a road defect with inadequate warning. Liability even affects child care. Many day-care centers have experienced a substantial increase in liability premiums and difficulty in getting the desired amount of coverage. Also, reported cases of child abuse have increased substantially

No-Fault

There are flaws seen by many in the existing method of handling tort claims. No place is this more evident than in the auto liability system. Problems include the following:

- Over-compensation of minor injuries- Courts award unrealistic sums and insurers pay inflated claims to avoid the economic cost of litigation. This puts upward pressure on the price of automobile insurance. It is expressed in the form of higher premiums for all.

- Under payment of legitimate claims- Recovery is impossible from an uninsured motorist. Even if recovery is possible, attorney fees and other court costs can dramatically reduce the amount received by an accident victim. This would be compounded by a court finding of some form of contributory/comparative negligence

- Recovery process delayed- The wheels of justice turn slowly but the bills come every month. If a negligence case goes to trial it can be years before payment for damages is realized. This stall tactic plays well into the hands of the defendant’s counsel. Pressure to settle for less than perceived full recovery is strong. Cash strapped plaintiffs are often forced to settle early.

No-fault Alternative- No-fault insurance is an alternative to the traditional negligence-legal liability insurance system. Legal liability insurance protects the insured by agreeing to pay third parties who are injured by the negligence of the insured. This is a basic difference between the two systems. With no-fault insurance, the insured is safeguarded if injured by the negligence of a third party. An important part of this system is a fundamental change in the fundamental principle of compensation for injury. The simplest form of no-fault insurance would key recovery for the expenses of an auto accident on first-party insurance required to be carried by every driver in a particular state.

A conventional or “third-party insurance” system has proceeds payable to the injured third party. Since compensation will be made to the insured, no-fault insurance is known as “first-party” insurance. Another difference from the traditional legal liability system is the need to place blame for the accident or show responsibility for damages. The question of culpability is not raised. The injured party seeks compensation from their own insurer.

The objective of the no-fault insurance system is twofold. First, it provides expeditious payment for damages incurred. Second, no-fault insurance gets rid of the costs of litigation to recover damages. Both of these goals, if attainable under no-fault insurance, would reduce the cost of automobile insurance premiums to everyone.

There are two or three types of no-fault insurance systems in effect today, depending upon the legal scholar and how detailed an answer one wants. About half the states have some form of no-fault automobile insurance. One type is labeled “modified” or “true no-fault” insurance. It makes a fundamental change in the existing recovery system by restricting the ability of the insured to bring a tort action. Again, the goals of the system are to provide timely and complete compensation to automobile accident victims while reducing or controlling automobile insurance premiums. The other type of no-fault auto insurance system is seen by many as just window-dressing. It is referred to as “add-on” no-fault insurance. The no-fault insurance may be optional or it may be mandatory. It is an additional policy feature beyond normal liability insurance. The commonality is that the purchasers do not forego their right to bring suit to recover damages. Thus, lawsuits continue to flourish. There is no reduction in the cost of litigation or insurance premiums.

Viewpoint on No-Fault

Presented here are two viewpoints on the no-fault insurance system. In March of 1996, California voters defeated Proposition 200, an attempt to institute a no-fault system of insurance in that state. The debate over this ballot initiative seemed to pit well-heeled trial lawyers against consumer advocates in favor of the proposal. As is the usual case with such a contentious issue, the insurance industry was caught in the middle. The entire text of the proposed law was available at the time of this writing on the Internet by *searching* NO FAULT INSURANCE or PROPOSITION 200

Here is Why the No-fault Insurance Plan is No Cure-all

The San Diego Union-Tribune
Opinion
By INA DE LONG

A war is being fought over the airwaves over Proposition 200, the no-fault auto-insurance initiative on the March 26 ballot.
I am deeply concerned that this campaign is being turned into a battle between big-business interests and trial attorneys. Consumers need to look beyond the 30-second clips and focus on the facts.
Here are some of the most important ones:
- You won't find after carefully reading the initiative a single word about a drop in insurance rates. There is not one word that guarantees rates will not go up, or even stay the same.

If the Alliance to Revitalize California is so sure insurance will be more affordable under no-fault, why didn't they put it in writing?

- Every other state that has no-fault auto insurance has seen rates go up an average of 40 percent. In Hawaii, rates skyrocketed more than 50 percent after a no-fault law took effect. These statistics are based on recent data provided by the National Association of Insurance Commissioners.
- Connecticut, Georgia, Nevada and the District of Columbia have all repealed no-fault systems because they were too costly and unwieldy for consumers.
- Proposition 200 covers no car repairs. It is not “pure no-fault” as proponents would have you believe. Fender-bender repairs, the most common type of accident, are not covered by this initiative. In fact, there is not one word in the initiative that it will fix your car if it is damaged in an accident, if you are injured or not.
- Proposition 200 would eliminate our right to seek redress through the courts when insurance companies do not fairly compensate us for our injuries or for the death of a loved one, when someone else is responsible.

- **No right to sue**
- Every other no-fault plan, recognizing that some injuries are serious and permanent, allows you to sue the reckless driver. Not this initiative. In place of the right to recover your losses from the responsible person, this initiative offers an insurance policy that would provide a maximum of $50,000 for all medical care, rehabilitation, lost wages and death benefits.
- This small amount would be used up in just a matter of days in the event of an accident causing serious injuries. These injured people are going to become wards of the state. I don't want to let guilty people off the hook and increase my taxes. Do you?
- Bad drivers will not be held responsible for anything. Under Proposition 200, no matter how seriously people are injured, good drivers and their passengers can file a suit only against their own insurance company for their injuries.

Filing a claim against your own insurance company doesn't mean it will be problem-free.
I was employed by a major insurance company for more than 22 years and quit in protest to the way it treated its own policyholders by denying payment of legitimate claims.
The medical portion of your automobile policy is in theory “no-fault” now, and that is where most disputes arise.
- Proposition 200 is only good for the chosen few. Unless you own an insurance company, or are a millionaire, you aren't among them.

You need to read the initiative. Get the facts. Examine all the fine print; look at what isn't there.
DE LONG is co-founder and executive director of United Policyholders, a nonprofit organization specializing in insurance-consumer education.

Another View
The following is a *Research Brief* from the Institute for Civil Justice, an organization who describes their mission as to "…help make the civil justice system more efficient and more equitable by supplying policymakers and the public with the results of objective, empirically based, analytic research." Information concerning this organization is easily found on the Internet.

Choosing an Alternative to Tort
Escalating auto insurance premiums have been a major public policy issue at the state level for the last three decades. No-fault auto insurance, spawned in the 1970s, was one response, offering cost savings to motorists and speedier compensation to auto accident victims. But because it required claimants to give up rights to seek compensation through the courts unless their losses exceeded a specified threshold, many states found it an unappealing alternative.
Choice- auto insurance was proposed to address this concern. Under a choice auto insurance system, drivers may choose either a traditional auto insurance plan (tort) or a no-fault plan. Those who choose tort retain traditional tort rights and liabilities. Those who choose no-fault neither recover, nor are liable to others for, noneconomic losses (typically, pain and suffering) for less-serious injuries incurred in auto accidents.

Giving motorists a choice of coverage has strong appeal. But how does the choice alternative affect the premiums motorists pay? In a series of analyses, Stephen Carroll and Allan Abrahamse estimated how a choice auto insurance plan would affect insurance premiums in each state. Their basic finding: Overall, choice auto insurance could reduce the price tag for auto insurance by about 30 percent.

Approach
To understand the cost effects of choice auto insurance, the researchers estimated how a plan that offers a choice between tort and no-fault would affect the costs of auto insurance in each state that now relies on the traditional tort system. The plan they analyzed is *absolute no-fault*, the most extreme version of choice: Motorists may never sue, or be sued, for noneconomic loss. Thus, these estimates suggest the upper bound on the savings that can be accomplished in each tort state via the choice approach. The researchers also estimated the cost effects of a choice plan in each state that already has some form of no-fault auto insurance. These estimates suggest the upper bound on the savings that can be accomplished in current no-fault states by extending the no-fault concept to its limit.

Results for Each State
In the tort states- the costs of compensating accident victims on behalf of drivers who elect no-fault would be at least 60 percent less than they would have been if those drivers had been insured under the traditional tort system. These savings include both the compensation paid to accident victims and the transactions costs incurred in providing that compensation.

If these savings are passed on to consumers, drivers in tort states who select choice could buy personal injury coverages for about 60 percent less than they pay for those coverages under the tort system. Because coverages for personal injury and property damage each account for roughly half of total auto insurance compensation costs, this 60 percent reduction translates roughly into a 30 percent reduction in a driver's total auto insurance premium. Premiums are unchanged for motorists who choose to remain in the traditional tort system.

In most no-fault states- a choice plan would have a similar effect on the costs of compensating accident victims and, again assuming that insurer savings are passed on to consumers, would result in similarly lower insurance premiums. And in most no-fault states, drivers who preferred to retain their current no-fault plan would pay no more for personal injury coverage than under the current system.

The savings an individual driver will realize from a choice system do not depend on the proportion of uninsured drivers in a state's current system, the proportion of previously insured who switch to absolute no-fault, or the proportion of the previously uninsured who switch to absolute no-fault. The effects of the plan on the total costs of auto insurance do depend on how many drivers choose to switch to the absolute no-fault option.

Nationwide, the reductions in personal injury premiums resulting from choice could be enormous. For example, if every currently insured driver in the country were to choose absolute no-fault, total auto insurance premiums in 1993--the last year for which data are available--would have been $26 billion lower. In addition to the savings in premiums, choice has another important cost effect. Because the no-fault premium is much lower than the premium for mandatory coverage under a tort system, some motorists who chose to drive without insurance under tort will choose no-fault. These uninsured drivers who switch to no-fault could contribute $1 billion to $4 billion to the compensation system nationwide.

Negligence-Four Important Concepts

When considering negligence and torts, four doctrines are important to remember. They are *respondeat superior,* imputed liability, the ownership statute and the family purpose doctrine.

Negligence and Employment The doctrine of *respondeat superior*- This Latin term means let the master answer. It means that a master is liable in certain cases for the wrongful acts of his servant, and the principal for those of his agent.

An employee may be liable for a tort committed by his employee. If the tort was committed during the time of employment, whether unauthorized, or in flagrant disobedience of the principal's instructions to the agent, the principal could be found liable for the action.

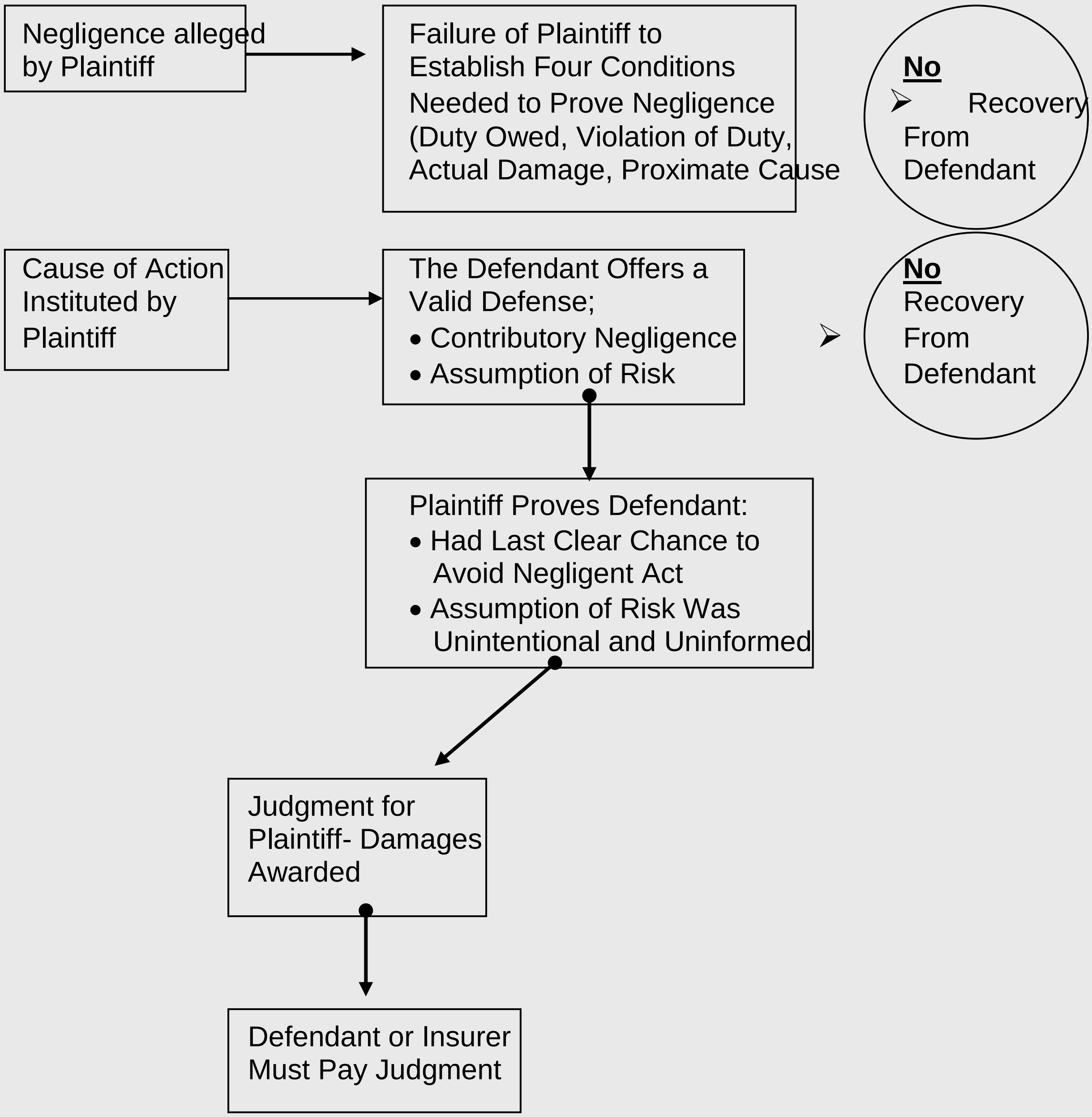
A person who multiplies his business activities through the use of agents and employees is liable for those persons' negligence occurring during the time they are carrying out their duties. The wrongful act must be connected with the employment and within the scope f the employment in order for the principal to be held liable for injuries or damage to third persons.

Jones employs Smith to deliver merchandise to another city. While driving the delivery truck Smith hits and injures someone. Jones is liable. If Smith is driving to another city to visit a friend and has an accident, Jones is not liable to the party injured. In either case, Smith is personally liable to Jones if driving the delivery truck.

If an agent commits a criminal act, the principal is not ordinarily liable. Guilt of a crime requires a guilty mind, and this condition would not apply to the principal when the agent commits the crime. If an agent commits a tort and a criminal offense, and it is connected to and occurs during the agent's employment, the principal can be liable for civil damages, but not for the crime. There are some cases, however, in which a principal may be involved criminally, such as in the publication of a criminal libel in a newspaper, or in the case of a statutory crime such as selling liquor to minors or to intoxicated persons, in which a person is compelled at his peril to see that the law is not disobeyed.

Non-Delegable Duty- The doctrine of respondeat superior does not apply to torts committed by an independent contractor. His client is not a principal and therefore not in a liable position as such if the contractor commits a tort.

Illustration 3-1
Potential Outcomes for a Negligence Suit



Certain duties imposed by law, however, are held to be non-delegable and the consequences of their non-performance are not delegated to the contractor by contract. A client who permits his contractor to maintain a dangerous condition on the client's premises, such as an excavation without a guard rail or night lighting, can be held liable to a member of the public who falls into the excavation.

If the tort committed by the employee is purely negligent, and neither intentional nor a crime, the employer's responsibility depends on whether the act was within the scope of employment. As mentioned earlier, the first requirement is that the employee be acting in this capacity when the specific act in question occurs. Going to or coming from work generally is not considered an act of employment. Conversely, when an employee is out driving most of the time, if the employee goes from the house directly to the place of business of a customer, the interpretation may be different.

Another requirement for employer responsibility is that the employee be performing some act he or she was hired to do. The concept of scope of employment with regard to negligence cases has grown with the litigious nature of our society. Some experts believe this is because insurance coverage has been provided by employers to cover accidents that occur on the job. This includes accidents involving employees outside the scope of workman’s compensation as well as those involving workers and third parties.

Imputed Liability-- Sometimes a situation arises in which one individual becomes responsible for the actions of another. Negligence in such a case may be shifted from one person to another who was not directly negligent. This situation is known as vicarious liability, or imputed liability. Again, if one individual is responsible for the actions of another, the liability may be termed vicarious liability or imputed liability. The Latin phrase for this situation is "respondeat superior," or "let the master answer." Respondeat superior signifies that one person is responsible for the actions of another because one person has a certain control over the other person.

In this example, is the company responsible for John's actions?
Ammonia Co. employs John to drive a load of anhydrous ammonia to a chemical distributor. John falls asleep on the way and the truck overturns. Private property is damaged by the escaping chemical. Liability for the negligence of an employee is imputed to the employer while the worker is engaged in activities for the benefit of the employer. The "doctrine of respondeat superior" imputes the liability to the employer.

The ownership statute: The ownership statute provides that the owner of a vehicle is liable for the negligence of other operators of the car if the owner gives them permission for its use. This means that the owner has liability for the negligence of an individual. This is not an example of a bailment relationship although one has legal possession of another's property. There is no contract between the person driving and the person owning the car. A bailment relationship is one of contract.

Remember that guest in a vehicle cannot charge that the driver has liability for the passenger unless the driver is guilty of gross negligence. The ownership statute provides that the owner of a vehicle is liable for damages resulting from operation of the vehicle by another driver if the owner has given permission for its use. The vehicle owner can be charged with gross negligence. This is an extension of the respondeat superior concept.

Family purpose doctrine- This is another extension of the idea of respondeat superior. The owner of a vehicle is held liable for damages resulting from the negligent operation of the vehicle by his immediate family. The family purpose doctrine applies when the vehicle owner has given permission to a family member to drive the vehicle.

Bob is sixteen years old. He needs to buy airplane glue from the local hobby shop. Against his parents' orders he takes the family car and speeds to the mall. He hit the back of another car. The driver sues Bob's parents for damages. Since Bob's parents did not give him permission to drive the car, the driver cannot use the family purpose doctrine as a charge against the parents. Mack lets his sister borrow his camper truck for a family weekend outing. She causes an accident in which passengers in another car are injured. The family purpose doctrine can be applied and Mack can be found negligent.

Marvin decides to play a practical joke and takes his friend Andy's car without the owner's permission. Before he can return, he has a wreck with a truck. The ownership statute does not apply and Andy probably cannot be charged with negligence.

Liability and the Facts Here is a case that illustrates the concepts of liability, interpretation of facts, and the way the law is ultimately applied by the courts. It is important to also think of this case and how it ties in with the concept of <u>contract</u> in the section that follows.

Collins V. Farmers Insurance Co. of Oregon

Supreme Court of Oregon
312 Or. 337, 822 P.2d 1146 (1991)
PETERSON, JUSTICE.
This declaratory judgment proceeding concerns the amount of liability insurance available under the defendant's motor vehicle liability insurance policy. The plaintiff asserts that because an exclusion in the defendant's policy is "illegal," the exclusion must be disregarded, as a result of which $100,000 of insurance coverage is avail-able. The defendant asserts that the exclusion is unenforceable only to the extent of the $ 25,000 mandated by the Financial Responsibility Law....

Ernest and Irene Gali had a motor vehicle liability policy with the defendant, with liability limits of $100,000 per person and $300,000 per occurrence. Their nephew, the plaintiff, lived with them.
The defendant's policy contained these provisions, among others:
Throughout this policy, "you" and "your" mean the "named insured" shown in the Declarations and spouse if a resident of the same household. "We," "us" and "our" mean the Company named in the Declarations which provides this insurance.
"Family member" means a person related to you by blood, marriage or adoption who is a resident of your household.
"Insured person means". . . you or any **family member.**
We will pay damages for which any insured person is legally liable because of bodily injury to any person and property **damage** arising out of the ownership, maintenance or use of a **private passenger** car, a **utility** car, or a utility **trailer.** (Bold in original.)

The policy also contained exclusion ll(a):
This coverage does not apply to. . . liability for bodily injury to an insured person.
The plaintiff agrees that he was a "family member" who therefore comes within the definition of "insured person."
The policy also contained this sentence:
Policy terms which conflict with laws of Oregon are hereby amended to conform to such laws.
In 1987, the plaintiff was injured while riding as a passenger in the Galis' car. At the time of the accident, the car was being operated by the plaintiff's cousin, Stacey Gali, the daughter of Ernest and Irene Gali. The plaintiff made a claim for damages for bodily injuries. The defendant responded with this offer:
This letter is to communicate our offer of settlement of $ 25,000.00.
Our insured's policy limits are $ 100,000.00, but that limit does not apply because of exclusion #11 (a) of the policy, which reads "This coverage does not apply to Liability for bodily injury to an insured person."
The policy defines "Insured Person" as "you or any family member." "Family Member" is defined as "a person related to you by blood, marriage or adoption who is a resident of your household."

We understand that this exclusion does not apply to the 25/50 limits required by the financial responsibility statutes, and that is what our offer is based upon.

The plaintiff disagreed with the defendant that only $ 25,000 of coverage was available and filed a complaint for declaratory judgment, asserting that the exclusion quoted above is unenforceable and that, therefore, the full liability limit ($100,000) was available.

Both sides moved for summary judgment. The trial court granted the plaintiff's motion, denied the defendant's, and entered a judgment declaring that the insurance policy provides $100,000 liability coverage on the plaintiff's bodily injury claims. The Court of Appeals affirmed. *Collins v. Farmers Ins. Co.,* 101 Or. App. 463,791 P.2d 498 (1990).

Under Oregon law, every motor vehicle liability insurance policy issued for delivery in Oregon must, at the least, provide coverage in the amounts required by statute. ORS 742.450....

The only question before us concerns the effect of exclusion 11(a). Is the exclusion to be disregarded only as to the amount of the minimum liability coverage required by ORS 742.450? Or is the exclusion to be disregarded totally? ORS 742.464 answers the question. It contains two sentences and three clauses:

Any policy which grants the coverage required for a motor vehicle liability insurance policy under ORS 742.450 . . . may also grant any lawful coverage in excess of or in addition to the required coverage, and such excess or additional coverage shall not be subject to the provisions of ORS 742.031. .

Each sentence and clause of ORS 742.464 has an unambiguous meaning. The first clause-"Any policy which grants the coverage required for a motor vehicle liability insurance policy under ORS 742.450 . . . may also grant any lawful coverage in excess of or in addition to the required coverage"-means that liability insurers can write motor vehicle liability insurance policies with higher limits and coverage than that required by ORS 742.450....

The manifest purpose of ORS 742.464 is to permit an insurer to write any other lawful coverage that the insurer wishes to write, in addition to the required coverage. Such coverage may include higher limits than those required by ORS 742.450. But as to such higher limits, the mandatory requirements of ORS 742.450 . . . do not apply. The insurer may limit such additional coverage by any exclusion not otherwise prohibited by law . . .

The Financial Responsibility Law requires specified coverage. As to amounts and other coverage apart form that minimum, it is lawful to restrict that additional coverage by an exclusion.

The decision of the Court of Appeals is reversed. The judgment of the circuit court is reversed, and the case is remanded to the circuit court with instructions to grant the defendant's motion for summary judgment.

UNIS, JUSTICE, dissenting.

The majority opinion, unfortunately, provides a disincentive to insurance companies to issue insurance policies that affirmatively, candidly, and truthfully-and with clarity and certainty-reveal the extent of their and the insureds' reciprocal rights and obligations. The majority's holding offends the public policy of promoting fair and equitable business practices that underlies state regulation of the insurance industry.

The majority argues: The insured's policy provides liability coverage of $100,000 per person; FRL requires minimum liability coverage of $25,000 per person for family members; the policy "grants excess or additional coverage," *i.e.,* $75,000 in liability coverage in excess of the $25,000 minimum; the family-household exclusion is legal and enforceable when applied to this excess coverage; the liability coverage for family members is, therefore the minimum liability coverage required by FRL, *i.e.,* $25,000 per person.

The majority's argument is flawed. Farmers' policy does not grant the required coverage. It cannot, therefore, limit the excess coverage. The only way the family-household exclusion can apply to limit the excess coverage provided by the policy is if the policy grants the statutorily-required minimum. The first sentence of ORS 742.464 begins, "Any policy which *grants* [required] coverage ...." (Emphasis added.) The first sentence of ORS 742.464 concludes that "such excess or additional coverage *[i.e.,* where the required minimum has first been granted] shall not be subject to the provisions of ORS 742.031, 742.400 and 742.450 to 742.464." That is, if the policy first grants the required minimum $25,000 coverage for family members, it may exclude them from excess coverage without being bound by ORS 742.454 as to the excess coverage.

In other words, the policy is forced by operation of law to provide, but does not grant, liability coverage to the insured for claims made against the insured by family members. .
Even assuming, arguendo, that the majority's interpretation that . . . excess coverage could be limited, the majority, by enforcing that interpretation against the insured, seems to suggest without deciding that the insured has the duty to read and understand not only clear insurance terms and policies, but also complex terms and their relationship to each other, to the statutory requirements, and to case law. If that is the majority's position, it is inappropriate for the majority to suggest without deciding that this duty exists and to base its decision on this unsupported duty. It is important to analyze why imposing this duty to read and understand the policy is neither clearly required nor clearly rejected by past decisions of this court.

Two competing decisional approaches to interpreting insurance contracts have evolved: (1) the "traditional" or "formalist" approach; and (2) the "functional" or "reasonable expectation" approach.
Under the "traditional" or "formalist" approach, the court looks to the "four corners" of the insurance policy and interprets it by applying rules applicable to all contracts in general. *Id.* The insured is held to have read and to have understood the clear language of the policy. Extrinsic evidence relating to the insurance contract may be examined for the purpose of determining the parties' intention to an objective analysis of the "four corners" of the contract.

Language supporting the "traditional" or "formalist" approach can be found in several decisions of this court. The following excerpts are illustrative:

. . . "Contracts of insurance must have effect like all other written contracts.
The intention of the parties must govern and control, and when the language is plain and unambiguous, such intention must be gathered from such language. In such case the court simply ascertains the language the parties themselves have agreed to and written down in their contract and enforces it according to its legal effect." *Weidert v. State Ins. Co., 19* Or. 261, 269-7O, 24 P. 242 (1890). "An insurance company is entitled to have its contract enforced as it is written." *Ausman v. Eagle Fire Ins.,* 250 Or. 523, 529-3O, 444 P.2d 18 (1968). "The obligation of [an insurer under an automobile liability policy] is measured by the policy alone." *Roemhild v. Home Ins. Co.,* 130 Or. SO, 57, 278 P.2d 87 (1929).
The rationale behind the "formalist" approach is that contracts of insurance rest upon and are controlled by the same principles of law that apply to other contracts, and the 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. *Clark Motor Co. v. United Pac. Ins. Co.,* 172 Or. 145, 149, 139 P.2d 570 (1943). *See also Brown v. Equitable Life Ins. Co.,* 60 Wis. 2d 62O, 211 N.W.2d 431, 435 (1973).

The competing approach to insurance contract interpretation-the "functional' or "reasonable expectation" approach-is that the policyholder's reasonable expectations to coverage under the insurance policy should be honored even though those expectations vary from the policy provisions. *See generally* Keeton & Widiss, *Insurance Law, A Guide to Fundamental Principles, Legal Doctrines, and Commercial Practices, §* 6.3 (Practitioner's ed. 1988); Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part One,* 83 Harv. L. Rev. 961 (1970); Keeton, *Insurance Law Rights at Variance with Policy Provisions: Part Two,* 83 Harv. L. Rev. 1281 (1970); Jerry, *Understanding Insurance Law 99* (1987).

The "functional" or "reasonable expectation" approach is supported by the notion that insurance contracts are not ordinary contracts negotiated by parties with roughly equal bargaining strength. Rather, they are largely contracts of adhesion, where the insurance company, in preparing a standardized printed form, has the superior bar-gaining position, and the insured has to accept such a policy on a "take-it-or-leave-it" basis if the insured wants any form of insurance protection. *See Standard Oil Company of California v. Perkins,* 347 F.2d 379, 383 (9th Cir. 1965) (" 'Adhesion contract' is a handy shorthand descriptive of standard form printed contracts prepared by one party submitted to the other on a 'take it or leave it' basis. The law has recognized there is often no true equality of bargaining power in such contracts and has accommodated that reality in construing them."); *Reeves v. The Chem Industrial Co.,* 262 Or. 95, 101, 495 P.2d 729 (1972) (defining an adhesion contract as a "take-it-or-leave-it" contract that is the product of unequal bargaining power between the parties); *Knappenberger v. Cascade Ins. Co.,* 259 Or. 392, 398, 487 P.2d 80 (1971) (insurance contract is ordinarily viewed as an adhesion contract, as the insured rarely has any control over the "bargain"). *See also* Rakoff, *Contracts of Adhesion: An Essay in Reconstruction,* 96 Harv. L. Rev. 1174 (1983); Kessler, *Contracts of Adhesion: Some Thoughts About Freedom of Contract,* 43 Column. L. Rev. 629 (1943)....

This court has not explicitly adopted the doctrine of "reasonable expectation," at least by name, in any of its forms. Neither has this court explicitly rejected it.

Language in at least two of our recent opinions, however, suggests support for the doctrine. In *Totten v. New York Life Ins. Co.,* 298 Or. 765, 771, 696 P.2d 1082 (1985), this court said: "We interpret the terms of an insurance policy according to what we perceive to be the understanding ending of the ordinary purchaser of insurance." That principle is also stated in *Botts v. Hartford Acc. & Indem. Co.,* 284 Or. 95, 100, 585 P.2d 657 (1978). Moreover, various past members of this court have expressed their preference for the "reasonable expectation" approach, *see, e.g., Lewis v. Aetna Insurance Co.,* 264 Or. 314, 323-24, 505 P.2d 914 (1973) (Bryson, J., specially concurring, joined by McAllister, J.).

At some point, this court will have to address this series of conflicting precedents in our cases which today's majority opinion simply ignores.
For the foregoing reasons, I would hold that the full amount of liability coverage provided in Farmers' policy ($100,000 per person and $300,000 per occurrence) applies to plaintiff's injuries, and not the minimum amount of liability coverage ($25,O00) required by FRL. I would, therefore, affirm the decision of the Court of Appeals, but for different reasons. I would affirm the judgment of the circuit court.
VAN HOOMISSEN and FADELEY. JJ, join in this dissenting opinion.

Ω

Contracts

Contract law deals with promises. A simple definition of a contract is "a promise enforceable by law." A broad definition of a contract is as follows. A promise or promises for which the law gives a remedy, or the performance of which the law recognizes as a duty in cases of breach or nonperformance.

What promises ought the courts to enforce? This is the basic inquiry of contract law. For every issue regarding the legal enforcement of a promise is properly a contract's issue. The law of contracts relates to a promise or "undertaking, however expressed, either that something shall happen, or that something shall not happen, in the future."

Meaning and Development of Contract- Many definitions of contract have been advanced over the years. Blackstone, the great English jurist, defined a contract as "an agreement, upon sufficient consideration, to do or not to do a particular thing." Since a contract may come into being without "agreement" in the sense of an actual subjective assent of two parties, it is deemed better to define contract in the terms of that element that is common to all contracts, the promise. Hence, a brief but acceptable definition is "a promise enforceable by law." Legally, a promise is an undertaking, however expressed, either that something shall happen or that something shall not happen, in the future. A contract is thought of as a legal document containing the promises made by the contracting parties, but a contract may be oral or written.

What precisely is *the* contract? In common speech the document or writing containing the parties' promises is spoken of as the contract. This is obviously inadequate, since contracts may be oral as well as written. Again, the contract might be regarded as those events leading up to the formation of the contract, such as the offer and the acceptance. Yet while these are requisites for the formation of the ordinary contract and are evidence of the contract, they can hardly be said to be the contract itself. Rather, the contract is the *legal relationship,* in terms of the rights and duties of the contracting parties. Thus, in the insurance contract the insurer has a duty to provide coverage and a right to receive the money, while the purchaser has a duty to pay the premiums and a right to receive coverage for a particular risk. These are correlative rights and duties, and the relationship establishing them is, strictly speaking, the contract.

Classification of Contracts- Contracts have been classified from various standpoints, as for example, their method of formation, their content, and their legal effect. There are several standard classifications:

(1) Formal and Informal Contracts
(2) Express and Implied Contracts
(3) Unilateral and Bilateral Contracts
(4) Void, Voidable and Unenforceable Contracts
(5) Executed and Executory Contracts.

① Formal and Informal Contracts. A formal contract depends upon a particular form, or mode of expression, for its legal efficacy. For example, at common law a promise under seal was enforceable without anything more. Another formal contract is the negotiable instrument, where the note or other instrument has certain legal attributes because of the special form in which it is cast. Recognizances, formal acknowledgments of indebtedness made in court, are other examples of formal contracts. All other contracts are called informal contracts, since as we shall see they do not depend upon mere formality for their legal existence. Our study is confined to informal contracts.

②Express and Implied Contracts- Contracting parties may sometimes manifest their willingness to enter a bargain by express language. Other times this is not the case. For example, a man might pick up an item at the auto parts supply house, simply show it to the clerk and walk out. The clerk knows from the customer’s actions and previous experience that the item is being purchased at the listed price. The customer wants the item charged to his account. This can be considered a valid contract. In this particular instance, actions speak as effectively as words.

If the manifestation of assent is verbal, the contract is known as an express contract. The other type, not using words to show assent, is called an implied-in-fact contract. Both types are actual contracts. The manner of assent is different in each one.

③ **Unilateral and Bilateral Contracts-** In the typical contractual transaction, each party makes at least one promise. The vendor promises to convey title, and the purchaser promises to pay the price. These are mutual promises, both parties undertaking to do something. When the contract comes into existence, at the time of the exchange of promises, each is under a duty to the other. This kind of contract is called bilateral (or two-sided). Each party is both a promisor and a promisee, and is under a duty to render a performance, and enjoys the right to receive a performance.

Suppose that at the time the contract comes into existence, there is only one promise outstanding. Suppose A says to B "If you will mow my lawn, I will give you five dollars." A contract will be formed when B mows the lawn. At that point there is an enforceable promise, the promise of A to pay the five dollars. There are no mutual promises.

Assuming that A requested the act of mowing the lawn as the acceptance of his offer, no contract would arise by B merely promising to mow it. Rather, A wanted the act and was not bound on his promise until the act was performed. Similarly, B was under no duty to mow the lawn. This is a unilateral (one-sided) contract. In a unilateral contract only one of the parties makes a promise, a promise that is exchanged for a performance by the other. There is no contract at all until the requested performance is rendered. A bilateral contract results from the exchange of a promise for a promise. A unilateral contract results from the exchange of a promise for an act or a forbearance to act.

④**Void, Voidable and Unenforceable Contracts-** A "void contract" is no contract. By definition a contract is enforceable. If we say there is no legal effect whatever, there can be no contract. This is a common classification, supported by wide usage, to denominate those transactions in which abortive efforts are made to contract, but for some reason no legal effects are produced.

A voidable contract, on the other hand, is not wholly lacking in legal effect. It is a contract but because of the manner or method in which it was brought about, one of the parties is permitted to avoid his duties thereunder. For instance, A through fraud induces B to enter into a certain contract. In such case B may, upon discovery of the fraud, avoid any liability under the contract. A contract induced by fraud is not void, but is voidable at the election of the defrauded party. A minor's contracts are also voidable, since the minor may at his option disaffirm them.

A contract may be neither void nor voidable in the usual sense and still be unenforceable. For example, a contract may be unenforceable because of a failure to satisfy the requirements of the Statute of Frauds which requires certain kinds of contracts to be in writing in order to be enforceable. A later writing, signed by the party to be charged, would make the contract enforceable against him. A necessary prerequisite of enforceability would then have occurred. Contracts upon which a right of action has been lost, as by the running of the Statute of Limitations which requires actions to be brought within prescribed time limits, are also commonly referred to as unenforceable, rather than void or voidable.

⑤ **Executed and Executory Contracts-** Once the terms of a contract have been fully performed on both sides it is referred to as an “executed contract”. The executed contract is one that exists in the past tense only. All duties under it have been discharged. The appellation “executed contract” serves as a handy term of reference for the completed or fully performed contract.

There are situations when there can be found one or more unperformed promises on one side or the other. One party to a contract has completed all their duties under the contract while the other party is sitting on undelivered promises to perform. This is known as an “executory contract”. Duties or promises are unperformed or executory (perhaps on both sides) in whole or in part.

Importance of Contracts

Events leading up to a contract, such as the offer and the acceptance, might be thought of as the contract. They are actually requisites for formation of a contract and evidence of the contract, rather than the contract itself. <u>The contract in essence is the legal relationship in terms of the rights and duties of the contracting parties.</u>

Nearly every business transaction is based on contract or on promises with contractual implications. Jones decides to sell a piece of property to Smith. Jones promises to convey title to the property. Smith promises to pay the purchase price. There may be other promises included in the contract with Mr. Jones such as payment of taxes or assumption of a mortgage. There could be a fire insurance policy. It is a contract itself involving the promise by an insurance company to pay up to a certain amount in the event of loss by fire. Also, Mr. Jones may accept a promissory note given for part of the purchase price. The note is a type of contract containing the purchaser's written promise.

Mr. Jones and the buyer will contract a lawyer to represent them in the transaction. When Mr. Jones deposits the proceeds of the sale into a bank, he has a contractual relationship with the bank. If the buyer decides to lease the property he has bought, he enters into a contract with the tenant.

<u>Invitations Seeking Offers</u>. A business owner desirous of selling merchandise is interested in informing potential customers about the goods, the terms of sale, and price. If the merchant makes widespread offers to sell to each person on their mailing list, it is conceivable that the number of acceptances and resulting contracts might exceed the ability to perform as seller. Consequently, the business person refrains from making offers by merely announcing that there are goods for sale, describing the goods, and quoting prices. The merchant thereby invites his customers, and in the case of published advertisements, the public, to become interested by making offers to him to buy the goods.

Responses to advertisements, circulars, quotation sheets, and display of merchandise, are not acceptances because no promise or offer to sell has been made. A quotation of prices is not an offer because (1) it does not contain a promise, and (2) it leaves unexpressed many terms that would be necessary to the making of a contract. It is important to distinguish language which constitutes an offer from that which merely solicits or invites offers.

Proposals in Jest. Occasionally, a person exercises his sense of humor by speaking or writing words which taken literally and without regard to context or surrounding circumstances could be construed as an offer. However, the promise is intended as a joke, and the promisee as a reasonable person understands it to be such. Therefore it is not an offer. It does not create a sense of reasonable expectancy in the mind of the person to whom it is made because of his realization that it is not being made in earnest. There is no contractual intent on the part of the promisor, and the promisee is or reasonably ought to be aware of that fact. However, the success of a joke or prank is measured by the extent to which it deceives the one upon whom it is practiced. The words in jest must be spoken with a straight face or appearance of seriousness, else they are fatuous. If the intended jest is so successful that the promisee as a reasonable man under all the circumstances reasonably believes that it has been made as an offer, and so believing accepts, the objective standard applies and the parties have entered into a contract.

Likewise, a promise made under circumstances of excitement or unusual strain is not an offer. For example, A, whose wife is trapped in his burning house, cries out that he will give a million dollars to anyone who will save her. B, a bystander, hears A, and at the risk of his life, rescues A's wife. Even if A could pay a million dollars, B could not recover that amount. Under the circumstances, A's statement was not an offer.

Auction Sales. The auctioneer at an auction sale does not make offers to sell the property that is being auctioned, but invites offers to buy. The classic statement by the auctioneer is "How much am I offered?" The persons attending the auction may make progressively higher bids for the property, and each bid or statement of a price or a figure is an offer to buy at that figure. If the bid is accepted, which is customarily by the fall of the hammer in the hands of the auctioneer, a contract results. A bidder is free to withdraw his bid at any time prior to its acceptance. The auctioneer is likewise free to withdraw the goods from sale unless the sale is advertised or announced to be without reserve.

Contract Essentials

A valid contract has four essential elements:
❶ Mutual assent
❷ Consideration
❸ Legality of object
❹ Capacity of the parties

Each requirement is essential for a valid contract, but the first and basic one is the manifestation of mutual assent. A contract frequently is referred to as the agreement between the parties. It is the agreement which is enforced when the contract is enforced. This agreement must be objectively manifested by the parties to one another, either by spoken or written words or by conduct.

Certain contracts are required by law to be in writing if they are to be enforced by the courts. The requirements vary from state to state. For instance a contract may need to be in writing if it sets terms for performance of more than one year, if it provides for the lease of real property for more than three years, or if it covers the sale of goods worth more than $500. Such a contract would not in itself be illegal if it was not in writing, but it would not be enforceable in the courts.

Contract Essential Mutual Assent or Agreement

OFFER AND ACCEPTANCE- Manifestation of mutual assent in forming a contract usually is by means of offer and acceptance. To be valid, an offer must be a definite proposal made by one person to another. By its terms the offer is conditional on an act, forbearance of an act, or a return promise given in exchange. The person making the proposal is the offeror, and the person to whom it is made is the offeree.

An offer is always a promise. When communicated to the offeree it creates a sense of expectancy on his part that by giving the promise or performance requested in exchange he will obtain whatever has been promised him by the offeror. When the offeree expresses his willingness to give such a promise he accepts the offer. For a contract to be formed the expression of acceptance must be unequivocal and must include all terms and conditions contained in the offer.

It is important in business to distinguish between an offer and a solicitation or invitation for an offer. When a seller advertises merchandise at a certain price, he is merely announcing that he has such goods for sale. A quotation of prices is not an offer because it does not contain a promise or express other terms necessary for the making of a contract.

A statement that may indicate a willingness to offer is not itself an offer. A promise which might be made as a joke would not constitute a contract if the offeree as a reasonable man should be aware that it was a joke. Offers made under unusual strain, under duress, or in great excitement cannot be held valid.

Under the Uniform Commercial Code an offer must define or describe its subject matter and set out terms of quantity, price, or refer to some standard by which these terms may be made certain. Any such specification is required by the code to be made in good faith and within limits set by commercial reasonableness.

COMMUNICATION OF AN OFFER- In order to have mutual assent, an offer must be communicated. The offeree must have knowledge of the offer, and the offer must have been communicated by the offeror. An offeree obviously cannot agree to something of which he has no knowledge. Jones tells Smith he is going to offer White $2,000 for his car. Smith tells White about the offer. There is no contract between Jones and White because no valid offer has been made by Jones to White.

The offeror may specify terms and conditions of the offer, including the time within which it is to be accepted. If no time is stated, the acceptance must be within a reasonable time. Until an offer is accepted, the offeror can cancel or revoke the offer at any time except in the case of a merchant who has made a written offer to buy or sell goods. The Uniform Commercial Code holds merchants to a stricter standard than non-merchants in such cases. An offer in writing signed by the merchant offeror may not be withdrawn for lack of consideration during the time stated within it for acceptance, or if no time is stated, for a reasonable time. Such a period of irrevocability is not to exceed three months.

OPTIONS AS CONTRACTS- An irrevocable offer is made in the case of an option or binding promise not to revoke within a specified time. An option to buy a piece of property at a stated price within thirty days is a unilateral contract on the part of the offeror to keep the offer open for that period. An ordinary offer is terminated by the death or insanity of either the offeror or the offeree, but this is not the case with an option. The contract contained in the option is a promise to keep the offer open for a stated period. This type of contractual obligation is not discharged by death. Jones gives Smith a 60-day option to buy a piece of property for $100,000. Jones dies before the 60-day period expires. Smith can exercise the option by giving written notice of his acceptance to the personal representative of the deceased Jones. If Smith should die without exercising the option, the executor of his will or administrator of his estate could validly exercise it within the remaining time.

REJECTION AND COUNTER-OFFER- Rejection of an offer by the offeree terminates the offer when communicated to the offeror. A counter-offer from the offeree to the offeror indicates a willingness to contract but on different terms from those in the original offer. It is not an acceptance. Since it implies an unwillingness to agree to the terms of the original offer it operates as a rejection of that offer.

Smith writes a letter offering to sell Jones a hunting dog for $500 and states that the offer is open for two weeks. Jones writes back that he will pay $300 for the dog. This is a rejection of the first offer. Jones may no longer accept the $500 price. Or, Jones writes that he wants to consider the $500 offer for two weeks but is willing to pay $300 for the dog at once. He has made a counter-offer that is not a rejection and has left the door open for accepting the original offer.

ACCEPTANCE- Acceptance of an offer is a necessary element for a valid contract. The offeree must have knowledge of the offer before acceptance can take place. The acceptance must be positive and unequivocal and may not change any of the terms of the offer. Any communication that attempts to do so is not an acceptance.

Acknowledgment of receipt of an offer does not form an acceptance. Some definite act by the offeree manifesting his agreement to the terms of the offer is necessary to give his acceptance validity. This may be done by spoken communication, or by written communication. Acceptance to a unilateral contract can be demonstrated, by performing the requested act.

Contract Essential: Consideration

One of the requirements of a valid contract is a legally sufficient consideration. Basically, consideration is whatever is given in exchange for something else. The consideration must meet the test of legal sufficiency. That means the consideration must be either a legal detriment to the promisee or a legal benefit to the promisor. In most cases there will be both, but either one is sufficient.

Legal detriment means the doing of something which the promisee was under no prior legal obligation to do. Legal detriment also means the refraining from doing that which he was previously under no obligation to refrain from doing. Legal benefit means the obtaining by the promisor of that which he had no prior legal right to obtain.

Legal sufficiency has nothing to do with whether the consideration is adequate. The law is not concerned with whether the bargain was good or bad, or whether one party received disproportionately more or less than what he gave or exchanged. The requirement is simply that the parties have agreed to an exchange. The subject matter exchanged for, or promised in exchange for, either imposed a legal detriment upon the promisee or conferred a legal benefit upon the promisor.

Where a promise is given for a past transaction, the element of exchange is absent. Past consideration is no consideration. A promise made as a result of something which the promisee has already done is not enforceable.

Contract Essential: Legality

A contract must be for legal purposes to be enforceable. In fact the terms illegal bargain or illegal agreement would apply rather than illegal contract. By definition a contract implies a legal and enforceable agreement. A contract based on an illegal agreement is unenforceable since the contract is void.

Illegal agreements are considered situations in which laws would be violated, situations that would be contrary to public policy, situations with a tendency to be injurious to the public or the public good.
Examples of illegal agreements include any agreement meant to restrain trade, obstruct the administration of justice, or corrupt public officials. Gambling contracts and usurious loan contracts are generally unenforceable due to their illegal nature.

<u>ILLEGAL AGREEMENTS-</u> An agreement that is harmful to the administration of justice is illegal and any resulting contract is unenforceable because the contract is void.

If an employer promises not to press criminal charges against an embezzling employee provided the funds are returned, that promise as a contract is unenforceable. The carrying out of the promise would involve concealment of evidence or false testimony. Either is regarded as an obstruction to the administration of justice. Compounding a felony is illegal. If the employer was in agreement to stop a criminal prosecution the agreement would be contrary to public policy.

An agreement to affect public interest adversely through the corruption of public officials or impairment of the legislative process is illegal and therefore unenforceable. Such cases would include agreements to influence legislation or procure government contracts through improper political pressure. A bargain by a candidate to make a certain appointment if he is elected to office is illegal. It is an agreement to pay a public officer something extra for performing his official duty.

An agreement by which a citizen promises to perform or refrain from performing a duty imposed on him by citizenship is illegal. An example, it is illegal for a potential voter to be promised money to register and vote.

If an agreement is illegal, neither party can sue the other for neither breach of contract nor recover for any performance rendered. If the parties are found *in pari delicto* (equal fault), the court will leave them where it found them, providing a remedy to neither. As Lord Mansfield wrote in a 1775 decision, "No Court will lend its aid to a man who founds his cause of action upon an immoral or an illegal act."

<u>EXCEPTIONS-</u> There are some exceptions to the rule. If one party to an illegal agreement changes his mind before the action has been carried out, he can withdraw from the agreement. He can recover what he has contributed unless the bargain is held to involve serious moral turpitude on his part. Some agreements are illegal because of statute, such as the statute which prohibits the sale of unregistered securities. The statute is primarily for the protection of purchasers. In such cases the statute may give the purchaser a right to recover the payments.

A person who is induced to enter an illegal agreement through fraud, duress, or undue influence, may not be guilty of moral turpitude (serious wrong) and may be allowed to repudiate the bargain. Jones fears a settlement judgment against him. He is induced by Smith, his lawyer, to protect his property by making a fraudulent transfer of the property to Smith. Smith agrees to transfer the property back to Jones when Jones is out of financial trouble. Smith then refuses to transfer the property back to Jones. Jones may be allowed to recover the property due to the inducement. In most cases however a debtor who makes a fraudulent transfer subject to an agreement to retransfer cannot recover.

If one of the parties to an illegal agreement is ignorant of the facts making the agreement illegal, and the agreement appears to be an ordinary agreement, the courts may permit the ignorant party to sue the other for damages. In a Massachusetts case, an employee successfully sued to recover for services he rendered in a business for which the employer had failed to procure a license. The plaintiff was held justifiably ignorant of that fact. If the employee had continued work after becoming aware of the illegality his action would have been lost and no recovery would have been allowed.

Illegality of any part of an agreement is ordinarily held to make the entire agreement void and unenforceable. However, it may be possible through terms severing the legal and illegal portions to secure partial recovery. If a contract provided for delivery of legal and illegal goods, and they were priced separately, the seller may be able to collect for the legal goods. The court may view the situation as if there were two contracts. The illegal contract would be void but the legal contract would not be void.

<u>STATUTE OF FRAUDS-</u> The term "Statute of Frauds" in contract law does not deal directly with frauds as in criminal matters but simply specifies what formal requirements are necessary to make certain contracts enforceable. For example, wills, agreements with an agent to sell real estate, agreements to pay commissions to a broker, or an obligatory agreement with a duration over one year must be in writing to be enforced. The promise to answer for the debt of another is enforceable only if written. Contracts for the sale of securities must be written.

Under the Uniform Commercial Code, a contract governed by the Statute of Frauds is said to be "within the Statute," and others are "without." A contract held to be within the Statute and does not comply with its regulations is not enforceable.
Actual fraud in the making of a contract through known or reckless misrepresentation on the part of one party makes a contract voidable.

If someone does not know what he is signing, for example if he thinks he is giving an autograph and actually is signing a contract, which constitutes "fraud in the execution." If the person knows he is signing a contract but has been induced to sign by fraud or deceit, it is known as "fraud in the inducement."

Force or threat of force used in causing a person to enter into a contract constitutes duress. The threat of criminal prosecution is held to be duress.

Contract Essential: Contractual Capacity

For an individual to enter into a valid contract he or she must have legal capacity. Minors' contracts are generally voidable, even in the case of an "emancipated" minor who because of marriage or other circumstances is no longer subject to strict parental control.

If a minor enters a contract to purchase a motorcycle, he need not go through with the deal, but the adult with whom he contracted is legally bound by it if the minor wishes to go ahead with the sale. Businessmen deal with minors at their peril.

If a minor is paying for necessities such as food or clothing, he is liable not for the agreed price but only for the reasonable value of the items, even if that is less than the selling price. Luxury items do not qualify. Courts have held that an automobile or farm tools might be necessary for a minor's livelihood and therefore a necessity. Life insurance has traditionally not been viewed as necessary.

A person lacking sufficient mental capacity to enter into a contract is not held competent even if he has not been judged insane by a court. He is one who is unable to understand the effect and nature of his act in making the agreement. An insane person's voidable contract can be ratified or disaffirmed by him when sane, or by his guardian during insanity or his representative after his death.

A person intoxicated and unable to comprehend the nature and effect of the transaction is not competent to contract. The agreement is voidable at his option. Even if the intoxication was due to his own voluntary conduct he may avoid liability.

The person intoxicated while contracting may ratify or disaffirm the agreement at his option. If the person disaffirms the contract the courts generally require him to make restitution to the other party. Restitution may not be required if the person dealing with the intoxicated party fraudulently took advantage.

Aliens, convicts, and married women were at one time held to be impaired contractually. Statutes have removed most of these disabilities except in the case of illegal or enemy aliens.
Corporations are limited in their contractual powers by the state laws under which they operate.

Other Contractual Conditions

AMBIGUITY- When terms and agreements in a contract are not made perfectly clear, the problem is called ambiguity. The originator of the contract has the responsibility for avoiding ambiguity. The importance of avoiding ambiguity in a contract is emphasized by the parol evidence rule. This rule disallows testimony that would modify the terms of a written contract if that contract clearly reflects the intent of the parties to it. Evidence or claims attempting to modify a valid contract are not accepted in court under the parol evidence rule.

QUASI-CONTRACTS- In addition to implied-in-fact contracts, there are implied-in-law contracts or quasi contracts which were not mentioned in the foregoing classification of contracts for the reason that a quasi (meaning "as if") contract is not a contract at all. It is not a contract because it is not based either upon an express promise or a promise implied-in-fact. Suppose, for example, that A by mistake delivers to B a plain unaddressed envelope containing $100 intended for C. B is under no contractual obligation to return it. However, historically, A was permitted to recover the $100 from B through the use of a legal remedy, an action of assumpsit, which was used for the enforcement of contracts. The law imposes an obligation upon B in order to prevent his unjust enrichment at the expense of A. This is the reason for liability in quasi contract.

DESTRUCTION OF SUBJECT MATTER- Mutual mistake of the parties as to the existence of the subject matter, or destruction of the subject matter, terminates an offer with respect thereto. Such destruction, as well as the death of a specified person whose continued existence was essential to the performance of a contract, would operate as an excuse for non-performance and be effective as a discharge of contractual duty if it occurred subsequent to the formation of the contract. For the same reason, based upon prospective impossibility of performance, an offer to buy, sell, lease, pledge, or mortgage is terminated upon the destruction of the subject matter of such offer; and, likewise, an offer with respect to personal services which contemplates the continued existence of a specific person is terminated upon the death of such person.

Insurance Contracts

Basic contract law applies to the special form of agreement known as an insurance contract. They differ from other types of contracts. Most contracts involve an even exchange between the contracting parties, but an insurer's promise to pay involves a much larger sum than the premiums being received. The insurance contract is enforceable only under certain conditions that probably will not occur, or else the policy would not be written. A contract, such as the insurance contract, in which losses and advantages to the parties depend on uncertain events is called an aleatory contract.

Insurance companies offer standardized policies to make possible the spreading of risks over a large volume of business. The prospective insurance buyer is in a position of accepting a given policy or doing without insurance. An insurance contract is thus sometimes said to be a contract of adhesion. An adhesion contract provides for one party to determine the provisions of the contract. The other party has little opportunity for bargaining.

Generally, the person to be insured is regarded as the offeror in an insurance contract. The contract is created when that offer is accepted by the insurance company. If the policy differs from that presented to the prospect, the insurance company is making a counter-offer which the applicant may or may not accept. An insurance contract is a unilateral contract in the sense that it involves a promise for an act. The act is the payment of premiums by the policy holder. The promise is that of the insurer to pay for specified losses.

Chapter 4: Components of Civil Law- Concepts and Insurance Relationships

This chapter continues with a discussion of the components of civil law. We now turn to the concepts, relationships, legal theories and rules that make up our legal system. With an understanding of these basic building blocks of civil law, the reader will be able to better understand concepts as they apply to insurance.

Agency

A relationship between two persons by which one of them is authorized to act on behalf of the other is called an agency. The person authorized to act is the agent. The person for whom he acts is the principal. Authorized acts of the agent bind the principal and create legal rights and duties for him with respect to third persons. In the legal sense the term "agency" applies to contractual or commercial dealings between two parties through the medium of another.

Changes in the legal position of the principal which may be produced by acts of an agent include the creation of contract rights and obligations, the existence of tort duties, and the transfer of title to property.

Without agency a business person could make transactions only by directly and personally participating in them or by closing contracts himself. Through the use of agents, he can enter into thousands of transactions in the time it would take him to make one in person. A corporation, which is a legal entity, could not do business at all without acting through its agents, officers, and employees. The agency concept is a necessity for modern business.

The basic principle of the law of agency is that the authorized act of the agent is the act of the principal. This is expressed in the Latin maxim "Qui facit per alium, facit per se," literally meaning that he who acts through another acts himself.

The most common method of creating an agency relationship is by contract or agreement, requiring a manifestation of consent by both the principal and the agent. Agency, however, may result from an order given by one person to another to act on his behalf with or without a promise of consideration. The element of consideration is not essential in the relationship of principal and agent. A statute may create an agency known as agency by operation of law. The non-resident motorist statute is such an agency. In most states the secretary of state is appointed as the agent of a non-resident motorist while on the highways of that state for service in case of an action arising out of that operation.

Agency by estoppel exists when a person, who by his conduct gives another person apparent authority to act on his behalf, and reasonably induces a third person to rely on dealing with that person as an agent.

Ratification can affirm the act of a purported agent or the unauthorized act of an agent, giving the commission of the act the same effect as if it were originally authorized.

Legality of Agency- In most cases whatever an individual may do personally he may do through an agent. There is an exception for acts so personal that their performance may not be delegated, such as personal services under contract.

Whatever a person may not legally do himself; he cannot legally authorize another to do for him. He cannot legally authorize another person to commit an illegal act or crime on his behalf. Any such agreement would be void. All parties planning or participating in the commission of a crime or unlawful act are held to be principals. Legally, war terminates commerce and trade between the belligerents. A citizen of a warring country cannot appoint or act through an agent in an enemy country.

Capacity- The capacity of an individual to act through an agent depends on the capacity of the principal to do the act himself. As contracts entered into by infants or insane persons are voidable, so appointments of agents by infants or insane persons are voidable. The incapacity of an agent to bind himself by contract as an agent, does not disqualify him from making a contract that is binding on his principal. An infant or insane person as an agent may make a contract with a third party who is valid between that party and the principal, even though the contract between the principal and agent may be voidable or void.

A person who has an interest adverse to that of the principal may not act as his agent. The Statute of Frauds prohibits a party to a contract from executing a note or memorandum as agent for the other party.

The relationship between master and servant is not one of agency. The servant does not have the right to enter contracts on behalf of the master unless there is a separate agency relationship. An independent contractor may or may not be an agent. The relationship depends on the nature of the work performed or services rendered and the extent of the control exercised over the contractor.

Kinds of Agents- An agent is one who has been given express or implied authority to act on behalf of the principal. An ostensible agent is one to whom the principal has given no authority but by conduct has induced others to reasonably believe that he has the authority for acting.

Another classification of agents is as general or special. A general agent is employed to transact all business of his principal or all business of a particular kind. A special agent is employed to act for his principal only in a specific transaction or for a particular purpose. A special agent does not have entire control over a particular business but only the authority to perform certain acts.

A subagent can be employed by an agent with the knowledge and consent of the principal. The subagent can assist the agent in transacting the affairs of the principal, not as a mere servant of the agent but with authority to bind the principal. He has a fiduciary relationship with the principal as does the agent.

Fiduciary Duties- A duty arising out of a position of trust and confidence is called a fiduciary duty. An agent has fiduciary obligations to his principal. Other examples of fiduciary obligations include the duty owed by a trustee to the beneficiary of the trust, by an officer or director of a corporation to that corporation and its shareholders, or by a lawyer to his client. A fiduciary duty exists in every relationship where one person is induced to put his trust and confidence in another. The fiduciary duty is one of good faith and utmost loyalty.

In the fiduciary relationship the agent must act solely in the interest of his principal. He must not act in his own interest or in the interest of a third party. He may not take a position in conflict with his principal's interest. He may not enter into any transaction in which he has a personal interest unless the principal consents and has full knowledge of all the facts. Full disclosure is required by the agent to his principal at all times. He cannot compete with his principal or act on behalf of a competitor. He cannot act for persons whose interest's conflict with those of the principal. He may not buy from himself. An agent employed to sell may not become the purchaser nor act as agent for the purchaser. His loyalty must be undivided.

An agent cannot use information obtained during the agency for his own benefit and contrary to the interest of his principal. If before the expiration of his employer's lease on a property he secretly obtains a lease for his own benefit, he may be forced to transfer it to his principal.

The agent is entitled to receive the agreed salary or commission, or if the amount was not fixed by agreement, a reasonable compensation. He is not allowed to make a secret profit out of the matter involved in the agency.

If a broker knows his principal will accept $75,000 for a piece of property with an asking price of $80,000, and the broker tells a prospective buyer he will try to get the seller to take $75,000 on condition the buyer pays the broker a secret $2,500, the fiduciary duty has been violated. The broker can be required to pay the secret $2,500 to the seller and also forfeit his right to a legal commission.

Other Duties of Agent- An agent owes his principal other duties in addition to his fiduciary obligations. He is expected to act with reasonable care and skill in the performance of his work. He is to conduct himself with propriety in order not to bring disrepute on the principal or his business. He is to avoid conduct which would make friendly association with the principal impossible. He is to use reasonable efforts to give the principal information on the affairs entrusted to the agent that is relevant and which he knows the principal would wish to have. He must maintain and provide to the principal a true account of money or other items the agent has received or paid out on behalf of the principal.

There are times when the agent cannot communicate with the principal. Also, the principal has given no specific instructions. The agent must refrain from binding actions which are expensive, speculative in nature and uncertain in attaining the principal's objectives. All reasonable instructions and directions of the principal must be obeyed by the agent. He must follow the directions of the principal even though the terms of employment do not prescribe such directions. The agent does not have to follow directions that violate a privilege of the agent to protect his own or another's interest. The agent must refrain from acting as agent after termination of his authority.

Principal’s Duties to Agent- In addition to whatever specific duties may be set out in a contract arrangement between principal and agent, the principal is under contractual duty to refrain from unreasonably interference of the agent's work. Simply by contracting to employ an agent, a principal does not promise to provide him with an opportunity to work, but such a promise may be implied by the nature of the employment or by the circumstances under which the agreement was made.

A principal who has reasonable knowledge of possible physical harm or monetary loss in the performance of the agent's duties is duty bound to inform the agent of such risks.

It is the principal's duty to maintain and render to the agent a true account of money or other things due the agent. He also has a duty to conduct himself in such a way as not to harm the reputation of the agent.

Reimbursement- Authorized payments made by the agent on behalf of the principal, and expenses incurred by or resulting from authorized acts of the agent, are to be reimbursed by the principal. The principal is under a duty to pay the fair value for the agent's services rendered if the agency agreement does not specify a definite amount or rate of compensation.

Commission Advances- Courts have held that unless there is an express or implied agreement otherwise, a salesperson is not required to pay back any excess of advances over commissions. One decision called an arrangement with a salesperson "a joint enterprise in which the employee furnished his time and ability and the employer furnished the money necessary to enable the employee to devote himself thereto. Both expected the adventure to produce a fund (the earned commissions) from which each would be fully compensated.

The agent expects compensation for his time and labor, and the principal expects a return on his money. The advances are therefore not regarded as loans to the employee but as speculations in a common enterprise. Without a promise to repay contained in the agreement under which the advances were made, a promise to advance money for a particular purpose in the furtherance of the principal’s business does not import an expectation of its return personally by the person to whom the money was advanced.

Liability to Third Persons- An agent can cause his principal to become bound to third persons. Since the principal can manifest his will through an agent, the acts or omissions of the agent impose liability on the principal. The agent has the power to subject his principal to either contract or tort liability. Power is defined as the ability of a person to produce a change in legal relations. Whether power is used rightly or wrongly it results in the creation of new rights and new duties. A principal is liable to third persons on contracts made by his agent when the agent is acting within the scope of his actual or apparent authority. The principal is not liable in contract for the unauthorized acts of an agent. To be binding on the principal, the actions of the agent must be strictly within the limits of the authority given to him by the principal.

Express and Implied Authority- Express authority is granted the agent in spoken or written words of the principal directing the agent to do something specific. Implied authority is based on the consent of the principal manifested to the agent. Implied authority is not given through expression or explicit words but is inferred from the principal's conduct and consent.

Implied authority includes authority to use all reasonable means to accomplish a particular task assigned to the agent. The agent employed to manage an apartment building for a commission has the implied authority to pay utilities, hire a porter, and pay for repairs. These acts may be reasonably inferred as necessary to proper management of the building.

An agent has apparent authority through manifestation by the principal to the third person with whom the agent is dealing. Smith writes Jones a letter authorizing Jones to sell Smith's car. Smith sends a copy of the letter to White, a prospective purchaser. Smith then writes a second letter to Jones revoking the agency agreement but does not send a copy of the second letter to White. Jones at this point has no actual authority to sell the car but as far as White is concerned, Jones continues to have apparent authority, since White has not been informed of the revocation of the agency.

Authority of Subagents- An agent may be authorized to appoint or select subagents to assist in the performance of his duties. Subagent appointments may be ratified by the principal. In cases where an agent is authorized to employ a subagent on the principal's behalf, the acts of the subagent are as binding on the principal as if the agent had performed them. A privity of contract is said to have been created between the principal and the subagent. If the agent employs a subagent that is working on the agent's behalf, there is no privity of contract between the principal and the subagent. As far as the rights of third parties are concerned, it makes no difference whether there is privity of contract between the principal and the subagent or not. Privity of contract affects only the rights and duties as between the principal, the agent, and the subagent. If there is privity of contract, the agent discharges his duty to the principal by the exercise of reasonable care in the selection of the subagent. The agent is not liable for acts or defaults of the subagent. If there is no privity of contract between the principal and subagent, but only between the agent and subagent, the agent is responsible to the principal for the subagent's acts and defaults.

In some situations it may be clear that the principal intended to permit the agent to delegate authority. The deciding factors may be the character of the business or the usages of trade, or prior conduct of the parties involved. Established rules have developed for particular types of agencies in the modern business environment. A check may be deposited in a bank for collection at an out of state bank. Authority is implied to the bank to employ another bank for collection at that location.

Limits to Authority- Ordinarily the authority to sell land includes only authority to obtain a prospective buyer, not the power to bind the principal by a contract to sell. An agent expressly authorized in writing to convey title to property is by that means authorized to receive whatever part of the purchase price is payable at the closing. The agent is not authorized however to receive deferred payments.

Authority to sell personal property confers implied authority to sell for cash and not for credit unless expressly stated. Authority to sell the property confers implied authority to enter into a private sale agreement and not an auction agreement. However, authority to buy includes implied authority of the agent to buy at an auction sale as well as a private sale.

Authority to buy or sell property for the principal includes authority to agree on the terms, to demand or make usual representations or warranties, to receive or execute the required instruments, to pay or receive as much of the purchase price as is to be paid at the time of the transfer, to receive possession of the goods if a buying agent or surrender possession of them if a selling agent, unless terms are otherwise specified. Authorization to buy or sell does not give an agent implied authority to rescind or modify the terms of the sale after completion except to correct for fraud or obvious mistake.

The mere authority to purchase goods does not give an agent authority to pay for them unless he receives possession of the goods or receives title to the goods. An agent does not have the implied authority to borrow money on behalf of his principal unless it is incidental to his authorized duties. An agent has implied authority to make usual and customary warranties on the goods he is authorized to sell. He has no implied authority to further warrant the goods.

General authority to conduct business transactions for the principal implies authority to buy and sell property to the extent that such transactions are usual, customary or reasonably necessary. The authority is to buy or sell at the market price if any, or otherwise at a reasonable price.

Liability of Principal- If a principal authorizes his agent to commit a tort against the person or property of a third person, the principal is liable. Smith authorizes Jones as his agent to make certain representations about Smith's property that Jones is trying to sell. Smith knows the representations are false but Jones does not. Jones sells the property to White using the misrepresentations. Smith is liable to White for damages.

A principal may be liable for a tort committed by his agent. If the tort was committed during the agent's employment, whether unauthorized, or in flagrant disobedience of the principal's instructions to the agent, the principal could be found liable for the action.

This form of liability without fault is based on the doctrine of respondeat superior, "let the superior respond." A person who multiplies his business activities through the use of agents and employees is liable for those persons' negligence occurring during the time they are carrying out their duties. The wrongful act must be connected with the employment and within the scope of the employment in order for the principal to be held liable for injuries or damage to third persons.

Jones employs Smith to deliver merchandise to another city. While driving the delivery truck Smith hits and injures someone. Jones is liable. If Smith is driving to another city to visit a friend and has an accident, Jones is not liable to the party injured. In either case, Smith is personally liable to Jones if driving the delivery truck.

If an agent commits a criminal act, the principal is not ordinarily liable. Guilt of a crime requires a guilty mind, and this condition would not apply to the principal when the agent commits the crime. If an agent commits a tort and a criminal offense, and it is connected to and occurs during the agent's employment, the principal can be liable for civil damages, but not for the crime.

There are some cases, however, in which a principal may be involved criminally, such as in the publication of a criminal libel in a newspaper, or in the case of a statutory crime such as selling liquor to minors or to intoxicated persons, in which a person is compelled at his peril to see that the law is not disobeyed.

Non-Delegable Duty- The doctrine of respondeat superior does not apply to torts committed by an independent contractor. His client is not a principal and therefore not in a liable position as such if the contractor commits a tort. Certain duties imposed by law, however, are held to be non-delegable and the consequences of their non-performance are not delegated to the contractor by contract. A client who permits his contractor to maintain a dangerous condition on the client's premises, such as an excavation without a guard rail or night lighting, can be held liable to a member of the public who falls into the excavation.

Liability of Agent- An agent is not a party to the contract he makes with a third person on behalf of a disclosed principal. The third person knows that he is dealing with an agent and that the authority of the agent is limited to that conferred on him by the principal. The resulting contract is between the third person and the principal. The agent is not liable for the nonperformance of the contract by either party.

Under certain other circumstances, an agent may acquire rights against a third person. There are other cases, however, in which an agent may be liable to a third party. These include acting on behalf of an undisclosed or partially disclosed principal, acting without authority or exceeding the authority granted, entering into the contract himself, guaranteeing a principal's performance, or committing a wrongful act.

Undisclosed Principal- When an agent appears to be acting in his own behalf and the third person with whom he is dealing does not know that he is acting as an agent, he is acting for an undisclosed principal. The agent's instructions are not only to conceal the identity of the principal but also not to disclose the agency relationship. The third person is dealing with the agent as though he were a principal. In the case of a partially disclosed principal, the existence of the principal is known but his identity is unknown.

The agent is personally liable when he enters into a contract with a third person on behalf of an undisclosed or partially disclosed principal, unless after the discovery of the existence and identity of the principal the third person elects to hold the principal to the contract. The third person has relied on the agent individually and has accepted his personal undertaking to perform the contract. After the discovery of the undisclosed principal's identity, the third person may hold either the principal or the agent to the performance of the contract, but not both.

If a person warrants that he is authorized to make a contract on behalf of the party he purports to represent, and does not have that authority, the agent is bound by the contract unless the principal ratifies it. In a case of false representation by the agent to a third party that he has authority to make a contract on behalf of a principal the agent is liable to a tort action of deceit.

An agent who may be representing a partially incompetent principal is not impliedly warranting the capacity of his principal to contract. The third person is assumed to have some knowledge of the principal if he is willing to make the contract with him. In such a case the agent is not liable for nonperformance by the principal. He may become liable if he expressly warrants the legal capacity of his principal.

Non-Existent Principal- In the case of a person professing to act as agent for a non-existent principal, that person is liable on a contract entered into with a third person on behalf of such a principal. A promoter of a corporation still to be organized who enters into contracts with third persons is personally liable on such contracts. The corporation can ratify such pre-incorporation contracts after coming into existence and then the corporation becomes bound and the liability of the promoter is terminated.

If an agent enters into a contract with a third person on behalf of a person who has died, the agent is personally liable on such a contract unless the third person knows of the principal's death at the time of the making of the contract. If the agent does not know of the principal's death at the time of the contract, the courts consider circumstances that would indicate an intention of the parties not to hold the agent to the contract if the principal were dead. If both the agent and the third person knew that the principal was in a war zone, the courts probably would hold that the existence of the principal was an implied condition to the contract.

If an agent who receives payment from a third person fails to remit to the principal, the third person has discharged his debt to the principal by payment to the agent and has no right of action against the agent. If the third person has paid the agent more than the amount due or made a payment by mistake, the agent is under obligation to return the excess to the third person if the demand for it is made before the agent has settled accounts with the principal or made remittance to him.

A building owned by Jones burns and his agent Smith collects from the White Insurance Company the amount of loss resulting from the fire. Before remitting that amount Smith discovers that the fire was deliberately set by Jones to collect the insurance. Smith is under duty to return the amount to the White Insurance Company. If Smith gives the money to Jones before discovering the arson facts, however, Smith is not liable.

Rights of Agent- If an agent makes a contract with a third person on behalf of a disclosed principal, he has no right of action against the third person for breach of the contract. The agent is not a party to the contract or a promisee of the third person. An agent for an undisclosed or partially disclosed principal, however, may bring an action in his own name against the third person for breach of contract. Suit by the agent is permitted on the grounds that he sues and recovers as trustee for his principal.

An agent who has made advances on goods on behalf of the principal has a lien on the goods and may assert it against the rights of a third person to the goods.

If an agent has paid money to a third person under a mistake of fact, or paid money or delivered goods to a third person on a fraudulent inducement, the agent may rescind the voidable contract and recover in his own name the consideration he has paid. An agent in possession of his principal's goods may maintain in his own name a tort action against a third person who has converted the goods.

The agent can bring a tort action in his own name against a third person who assaults him while he is protecting his principal's goods, who defames him because of his relationship with the principal, or who maliciously and without justifiable cause induces the agent's employer to discharge him.

Agency Termination- In the termination of an agency relationship, the authority of the agent may be revoked by notice from the principal. The power of the agent to bind the principal by contract to third persons, however, will continue until the third persons have knowledge of the termination.

With the termination of authority, the agent is no longer entitled to compensation for services and his fiduciary duties are ended. He is free to deal with the matters covered by his former agency for his own individual profit. When the power of the agent is terminated, it is no longer possible for third persons to obtain rights against the principal by dealing with the agent.

The agent's authority may be terminated by
* mutual agreement of the parties
* fulfillment of the purpose of the agency
* revocation by the principal
* renunciation by the agent
* bankruptcy of the principal or the agent
* death or insanity of the principal or agent
* change in business conditions
* loss or destruction of the subject matter
* loss of qualification of principal or agent
* disloyalty of the agent
*change of law making the exercise of the authority illegal
*outbreak of war when principal and agent are citizens of warring countries.

If the agency is coupled with an interest of the agent in the subject matter, the authority of the agent is irrevocable by the principal even in case of his death, insanity, or bankruptcy.

Here is a case that shows how the actions of an agent affects the insurance contract;

Weaver v. Metropolitan Life Insurance Co.

United States District Court, Eastern District of Missouri
545 F. Supp. 74 (1982)

[Plaintiff, George Weaver, was a World War II veteran rated ninety per cent disabled by the Veterans Administration. On July 9, 1974, plaintiff applied for a life insurance policy with a waiver of premium upon total disability clause. Plaintiff supplied all the medical information required for such a clause. On September 20, 1974, Maddox, the Metropolitan agent who sold the policy to Weaver, delivered the policy to his residence. The policy did not contain the waiver clause and, in Weaver's absence, his wife signed for the policy. Maddox did not inform Mrs. Weaver of the absence of the provision; however, she knew it was missing and the premium did not include a charge for it. Subsequently plaintiff returned the policy requesting a new one with a waiver of premium clause. Clayton, another agent of defendant, wrote the new application, promising to have the clause requested. In fact it was not. Clayton repeatedly assured plaintiff Weaver that the premium included the charge for the waiver.]

WANGELIN, CHIEF JUDGE.

. . . Clayton used "sales aids" provided by defendant which indicated that for that particular premium price he would receive the waiver of premium in the event of disability benefit. Although the policy did not contain the waiver provision, Weaver never received a refund. Contrary to the representations of Clayton, the factors used by Metropolitan in deciding whether to extend the waiver of premium benefit-age relative to retirement and work history-would have precluded Weaver from receiving the benefit.

On October 1, 1975, Weaver became disabled within the meaning of the insurance contract, and contacted Clayton to process a claim for the waiver of his premiums. Clayton perfidiously stated that Weaver was required to wait two years before making such a claim. Twenty-seven months later, and after having continued to pay full premiums for this period, Weaver again contacted Clayton about filing a claim. On May 8, 1978, Clayton finally processed the proper claim forms. On June 2, 1978, Weaver was notified that his claim was rejected since the waiver of premium benefit was not contained in his policy. Although there existed considerable uncertainty over the amount of Weaver's monthly premium (Weaver was supposed to receive a discount of some amount for the preauthorization of the premium payment), and also if the premium he paid corresponded to the proper payment for waiver of disability protection, this Court finds that the evidence of full payment for such protection more persuasive. Throughout these events and even after the denial of the benefit by defendant, Clayton continued to assure Weaver that the policy did contain this benefit, and that he would rightly receive it....

Conclusions of Law

Mr. George Weaver, plaintiff herein, seeks recovery against Metropolitan for acts largely done by Metropolitan's agent, Donald Clayton. Mr. Clayton is not a party to this action, and it is apparent from the facts herein that plaintiff may have foregone a viable cause of action against Clayton for his false representations to the effect that Weaver was indeed covered by the waiver of premium benefit....

The question remains as to whether the potential wrongs by Weaver may properly be imputed to Metropolitan by means of the law of agency.

It is normally held that a principal is responsible for acts of agents if the agent is acting within the scope of authority, even though the agent acts with fraudulent intent.. . .

In the absence of fraud on the part of the insured and agent, an insurance company is bound by all acts, contracts, or representations of its agent, whether general or special, which are within the scope of his real or apparent authority, notwithstanding they are in violation of private instructions or limitations on his authority, of which the person dealing with him, acting in good faith, has neither actual nor constructive knowledge." *Baker v. St. Paul Marine Ins. Co.,* 427 S.W.2d 281 at 285, 286 (Mo. Ct. App. 1968), quoting 44 C.J.S. Ins. § 149, pps. 817 to 818. Limitations upon the authority of the agent are not binding upon the insured unless the limitations are known or brought to the notice of the insured.... No such notice was brought to the attention of Mr. Weaver, nor was Mr. Weaver aware of any such limitations.

Mr. Weaver would appear to be precluded from recovery in contract, since in the absence of proven authority, an agent cannot change written terms of a policy by oral contract.... The contracts for insurance herein do not contain the waiver of premiums in the event of disability benefit even though Metropolitan's agent continually asserted that it did. And although it is normally the law that an agent cannot bind the insurer with his unauthorized representations to the insured, an insurer is bound by the agent's acts which are within its apparent authority, though not actually granted, when the insurer knowingly permits the agent to exercise such authority.... Certainly Weaver had a right to assume in these circumstances that Metropolitan had conferred upon Clayton the authority to relate the company's position as to his policy....

By means of its acceptance of plaintiff's premiums in the amount corresponding to a proper payment for the waiver of premium benefit, and the use of the ambiguous "sales aids" herein to demonstrate (obfuscate) their policy's features to plaintiff, Metropolitan ratified representations and practices of agent Clayton which plaintiff relied on in purchasing and paying for the policy of insurance herein. The authority of Clayton to act on Metropolitan's behalf was manifested by these acts.... The retention of the premiums by Metropolitan with knowledge of facts *(i.e.,* Weaver's disability) which render the policy void, waives the right to enforce the forfeiture provision.... This rule certainly applies to a feature (waiver of premiums in the event of disability) of a policy, as well as the efficacy of an entire policy.

Metropolitan is also imputed with the tort liability for acts of Mr. Clayton in accordance with the law of *respondeat superior.* Metropolitan is responsible for the injury to plaintiff by any negligence or misconduct of which the servant is guilty while acting within the scope of employment.... Metropolitan is therefore responsible for damages suffered by Weaver precipitated by the misrepresentations of Mr. Clayton....

License

When an individual is granted a right to do something by someone in authority, the individual is said to have permission or license. Permission to enter the property of another for a specific purpose constitutes a license. A person who enters the property of another without constraint, but for the sole benefit of the visitor, is known as a licensee. Such permission to make use of property creates no interest in the property. Usually the license is exercised only at the will of the owner and is subject to revocation at any time.

A typical license is illustrated by a theater ticket or the use of a hotel room, in which there is no interest acquired in the premises but simply a right of use for a given length of time. Such a license requires no formality. A shopkeeper by being open for business licenses members of the public to enter his establishment.

In another sense of license, every legal jurisdiction has statutes requiring licenses for individuals who are engaged in certain businesses, trades, or professions. Licensing commonly is required for doctors, lawyers, teachers, accountants, brokers, contractors, plumbers and insurance agents.

A distinction is made between licensing statutes that are regulatory, designed to protect the public against unqualified persons, and statutes which are enacted merely to raise revenue and which do not establish standards of competence. The revenue raising statute is considered a taxing measure and does not preclude an unlicensed practitioner from enforcing a business contract.

For a professional or other person needing a regulating license establishing competence, the lack of such a license may be expressly stated in the statute as cause for making all bargains on that person's part with regard to his work unenforceable. Thus an unlicensed lawyer, doctor, or broker could not recover for professional services rendered.

In the case of a broker who was licensed in one state but executed a contract in another where he was not licensed, the Supreme Court of the first state denied a recovery of the promised fee. When there has been no statute precluding an unlicensed person from enforcement of his brokerage contract and no such prohibition could reasonably be implied, brokers have been able to collect. The courts held that the statutes were revenue measures only.

Licensing and Insurance- Statutes that require licensing are the primary form of state control of the insurance industry. It is mandatory that every insurer, local or out-of-state, that intends to write insurance in the state, as well as every agent and broker who will take part in the sale or servicing of policies within the state, shall be licensed by the various departments of insurance. Licensing allows the insurance department, acting in its regulatory authority, to evaluate the economic stability and methods of operation of each insurance company. The regulator can also judge the level of competence and ethics of every agent and broker licensee in the state. States are also allowed under their licensing power to statutorily regulate the types of investments that insurers can make. This warrants conservative handling of the funds that ultimately guarantee the policies of the insureds.

On occasion a consumer or business may require insurance of a type, or in an amount, not available from insurers doing business in that state. When insurance is unavailable it may be placed with a nonadmitted insurer. The states control such business by requiring domestic agents to secure a surplus-lines license. Brokers or agents who offer surplus-lines generally may not place business with a nonadmitted insurer unless they can establish that domestic insurance is unavailable. The surplus lines practice has led to questions concerning foreign (sister state) insurance companies. Can insurers move out of state if they fail to meet some requirement of the domestic (in-state) insurers? What do such requirements imply for the status of foreign and alien reinsurers? Such questions are beyond the limits of this text. It does show that the more information one has on the subject of insurance and the law, the more questions arise.

The state insurance department can also refuse the application for renewal of an insurer's license if the insurance commissioner no longer considers the company to be safe, reliable, or entitled to public confidence. State legislatures have the power to license insurance agents and brokers. The main object of such statutes is to justify the revocation or suspension of an insurance agent's license in order to protect the public, not to punish licensees or applicants. The general label of "untrustworthiness" has been used to deny license. In Florida, an insurance agent's license was revoked after he pled guilty to conspiracy to distribute marijuana. This was the basis for a finding of fitness to engage in the business of insurance. *Natelson v. Department of Ins.,* 454 So. 2d 31 (Fla. App. 1984). Agents or applicants who practiced or aided in the practice of fraud, forgery, deception, collusion or conspiracy in connection with any insurance transaction may be denied a license, or have his license suspended or revoked. It has been held previously that the taped conversations between an applicant and undercover police officers, criminal records or felony convictions can be taken into account when deciding whether to grant, revoke, or suspend a license.

Status of Finders- The question of whether a finder in business ventures comes under brokerage licensing requirements has arisen more frequently than before in the recent climate of corporate acquisitions and mergers, capital procurement, and similar arrangements. Since statutes require licenses for brokers who negotiate transactions for their client, it has been held that a finder who takes no part in negotiating the transaction need not be licensed.

A finder, usually though not always a broker, may seek to acquaint one company with an opportunity to purchase or merge with another company. If successful, he expects a commission from one or both parties. An Illinois court held, in deciding that a broker's license was not necessary for collection of a finder's fee, "One who merely procures, does not act as an agent in the consummation of the sale. . . . The principals negotiate the terms between themselves. All the finder is required to do is bring the seller to the attention of the purchaser."

Concept of Property

Personal Property

Personal property in this sense is different from the personal effects of an individual. Everyone has letters from a loved one, trinkets, or other mementos that have been saved for sentimental reasons. Although priceless to the person who keeps them, they are often of little market value. Insurance is an economic tool. It is not and cannot be efficiently used to insure against the loss of such items. Personal property refers to things movable, as opposed to real property or things attached to real property (appurtenances and improvements). Included in this category would be commercial and homeowner's belongings as well as the inventory of a business.

Property involves ownership, the exclusive right to use something. The right is protected by law and must be respected by the members of a society. The laws of real and personal property are different in several ways. The way title is passed and the mechanics of inheritance are two areas where the rules differ.

An important idea is the difference between ownership and possession of property;

Ownership is defined as the exclusive right of possessing, enjoying, and disposing of a thing. It includes the concept of possession and that of title and it is broader than either of these. To own something creates a relationship between the owner and the rest of society that includes the right to exclude all others from the property. There are also obligations of ownership, including the duty to pay taxes due on property and to use it in a way that does not clash with the rights of others.
Possession- This is the having, holding or detention of property in one's control. This is distinguished from mere custody (bailment). Possession involves custody plus the assertion of a right to exercise dominion.

Actual Possession is the immediate and direct physical control over property.

Constructive Possession is the condition of having the conscious power and intention to exercise control over the property, but without direct control or actual presence upon it. A person can be in possession of property without obtaining ownership. Someone may possess property as a bailee, finder, or as a thief. When a person is in possession of property, the law generally protects that possession against everyone except the true owner. If possession is granted by the true owner, as in renting or leasing, the possessor's rights to custody and control may be above those of the owner during the period of lease agreement.

The ownership of property in the United States occupies a unique status because of the protection expressly granted it by the Federal constitution as well as by most State constitutions. The Fifth Amendment to the Federal constitution provides, in part, that, "No person shall be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation." A similar injunction is incorporated into the fourteenth amendment: "No State shall deprive any person of life, liberty, or property, without due process of law." This protection afforded to property owners is subject, however, to regulation by public authority for the public good.

In spite of these protections, uncertainties arise because the term "property" is not easily defined. This should not be surprising because the term "property" includes almost every *right,* exclusive of personal liberty, that the law will protect. Land is valuable only because our law provides that certain consequences follow from the ownership of it. The right to use the land, to sell it, and to say to whom it shall pass on death, are all included within the term "property." In this sense, property is not so much a thing capable of being reduced to physical possession as it is an interest, or group of interests, that will, at any given time, be honored by society.

When someone speaks of "owning property" they may have two separate ideas in mind. It may be a reference to the *thing* itself, as when a home owner says, "I just bought a place in Pittsburgh," or when a corporation president reports to the board of directors that the company "has acquired a site in Santa Fe" In each of these cases, outright and complete ownership of a physically identifiable object usually is implied.

Any one physical object, however, is really made up of a bundle of rights or interests that may belong to one person or to a number of persons, each of which may be less than full ownership, and none of which may be capable of reduction to *physical* possession. The term "property" also refers to any one of these interests in the physical object. Thus, for example, with respect to land, a tenant under a lease for years owns a property interest in the land leased; the holder of a mortgage on the land has a property interest in the mortgaged premises although the legal ownership is in the person who secured a debt by mortgaging the property; and a person who has a right-of-way over the land of another has a property interest in the land even though he does not own the land.

Property includes many things or ideas in addition to land and the rights incident thereto and many attempts have been made to effect a logical catalog of types of property. It should be apparent from the wide scope of the term that any formal classification is difficult and certainly of little practical advantage. For a limited explanation, property will be considered from the standpoint of its classification as tangible or intangible Property, and real or personal Property.

1. Tangible and Intangible Property- A 40-acre farm, a chair, and a household pet are *tangible* property. The group of rights or interests referred to as "title" or "ownership" is embodied in each of these physical objects. On the other hand, a stock certificate, a promissory note, and a deed granting X a right-of-way over the land of Y are in*tangible* property. Each is nothing but a piece of paper with little value except as it represents and stands for certain rights that are not capable of reduction to physical possession, but that has a *legal* reality in the sense that they will be protected. The same item may be the object of both tangible and intangible property rights.

This distinction between "tangible" and "intangible" property can have significant consequences. The courts have frequently been called upon to decide the classification of things for the purpose of retail sales tax laws levying taxes upon "tangible personal property." Several States have exempted the sale of gas and electrical energy from these laws because they are not "tangible" personal property. Other States have included both these sources of power within the definition of taxable property.

2. Real and Personal Property-. The most significant practical distinction between types of property is the classification into things real and things personal. A simple definition would be to say that land and all interests therein are real property and every other thing or interest identified as property is personal. For most purposes this easy description is adequate although certain physical objects that are personal property under most circumstances may, because of their attachment to land or their use in connection with land, become real property. Although this volatile characteristic may be important in certain relations such as that existing between landlord and tenant, most property always remains either real or personal. The importance of the distinction between real and personal property stems primarily from very practical legal consequences that follow from the distinction. Some of these consequences are:

✧Transfer of property during life- As will be explained hereafter, the transfer of real property during life can only be accomplished by certain formalities, including the execution and delivery of a written instrument known as a deed. Personal property, on the other hand, may be transferred with relative simplicity and informality.

✧Devolution of title on death-. One basic doctrine of property that still has considerable vitality today is the rule that if a person dies without directing by will how title to property shall pass, title to his real property passes directly to whomever the law declares to be his heirs while title to his personal property passes to the decedent's personal representative who, in turn, must distribute it as the law directs. A widow's right to dower in her deceased husband's property was, by the common law, limited to a specified interest in his *real* property and even where the old right of dower has been abolished or modified, the widow will generally be allowed a different percentage of the real property than of the personal property of her deceased husband.

✧Taxation- Most States levy a tax on the ownership of both real property and personal property. However, the applicable tax rate will be dependent on whether the property is classified as real property or personal property.

✧The Applicable Law- Although all laws in the fifty States are subject to the provisions of the Federal constitution; there is ample room for variation among the States as to the rules governing rights in property within the constitutional limits. There are, in spite of a growing tendency toward uniformity, many rules that vary from State to State. It is for this reason that the following rule has considerable practical consequence: The governing law with respect to real property is the law of its location or *situs* whereas the governing law with respect to personal property is frequently the domicile of the owner, regardless of where the personal property is located. Thus, suppose a resident of Delaware dies without a will, having real estate in Maryland and stocks and bonds in Virginia. Each State has its own laws prescribing who shall receive what interest in the estate of a person who dies without a will. The Indiana real estate will be distributed in accordance with the laws of Maryland, not of Delaware. The stocks and bonds, however, will be distributed according to Delaware law, not the law of Virginia.

Title Acquisition To Property

Title to personal property is acquired and transferred with relative ease and with a minimum of formality. The facility with which personal property may be acquired and transferred is due also to the demands of a society based upon commercial necessities. Trade and industry concern themselves with personal property. If the sale of a share of stock or a suit of clothes required the formalities accompanying a sale of land, the present extent of our daily transactions in commerce would be impossible.

Much of the law of personal property has been standardized to meet the particular needs of the various phases of commerce. The Uniform Commercial Code includes the law of sales of goods, the law governing the acquisition and transfer of title to commercial paper, such as promissory notes, and the rules governing the purchase and sale of certificates of stock. These subjects constitute branches of the general field of the law of personal property.

Title by Gift. A gift is a transfer of property from one person to another without consideration. The lack of any consideration is the basic distinction between a gift and a contract. Because, by definition, there is no compensation or consideration, a gift to be effective must be completed by delivery. A gratuitous promise to make a gift in the future is not binding. A will be bound if he delivers a painting to B intending to make a gift of it. A will not be bound if he tells B that he intends to make B a gift of the painting "next month." Delivery is absolutely necessary to a valid gift. The term "delivery" has a very special meaning including of course, but not limited to, manual transfer of the item to the recipient.

Real Property

Rights of ownership in real estate are called estates and are classified to indicate the quantity, nature, and extent of the rights held in such real estate. The two major categories are freehold estates (those existing for an indefinite time) and estates less than freehold (those which exist for a predetermined time).

There are two kinds of Freehold estates;
1.) Fee estates (estates of inheritance)- A fee estate is one giving the owner rights throughout his lifetime, which estate or rights will be distributed to his heirs and assigns at his death.
2.) Life estates- These exist only as long as the person lives whose life measures the duration of the estate. Estates less than freehold, or leasehold estates, are included in this category

Fee Simple Estate The absolute rights of alienability and of transmitting by inheritance are basic characteristics of a fee simple estate. The estate signifies full dominion over the property. That is, the property is owned absolutely (possibly subject to a mortgage) and it can be sold or disposed of by will. If estates are measured by the quantity of the rights possessed in the property the fee simple signifies the greatest quantity of possible rights. When a person says that he has "bought" a house, the property is generally held in fee simple.

A fee simple is created by any words that indicate an intent to convey absolute ownership. "To B in fee simple" will accomplish just that. "To B forever," means legally just what the grantor said. The general presumption is that a conveyance is intended to convey full and absolute title in the absence of a clear intent to the contrary.

A practical consequence of a fee simple title is that it may not only be voluntarily alienated but it also may be levied upon and sold at the instance of judgment creditors. A fee simple estate is subject to the dower/curtesy rights of a spouse.

Life Estates By tradition, life estates are generally divided into two major classes;
1.) Conventional Life Estates- The grant or a devise "to A for Life" creates in A an estate which terminates on his death. Such a provision may stand alone in which case the property will revert to the grantor and his heirs or, as is more likely, it will be followed by a subsequent grant to another party such as "to A for life and then to B and his heirs." A is the life tenant and B is generally described as the "remainderman." A's life may not be the measure of his life estate, as where an estate is granted "to A for the life of B." Upon B's death, A's interest terminates and, if A dies before B, A's interest passes to his heirs or as he directs in his will for the remainder of B's life.

No particular words are necessary to create a life estate. It is always a matter of determining the intent of the grantor. Life estates arise most frequently in connection with the creation of trusts, a subject important to those interested in estate planning. A man may leave his property upon death to trustees who are instructed to pay the income from the property to the widow during her life, and, upon her death, to distribute the property itself to the children. The widow has what is known as an equitable life estate. Or, a man may convey property to trustees who are instructed to pay the income therefrom to him during his life and, upon his death, to distribute it in a particular manner. The grantor has thereby reserved a life estate in the property to himself. Occasionally, life estates are created with the power given to the life tenant to dispose of the proceeds as he may direct in his will. Thus, A may leave his property to trustees "to pay the net income to my wife during her life and to distribute the principal as she may direct in her will."

There are particular rights and duties of the life tenant as opposed to someone who is entitled to the property at the end of the life estate (the remainderman). If a ranch is left "to A for life and on his death to B," A cannot sell the ranch to the detriment of B, but what limits are there upon A's use of it? Generally, A may make such reasonable use of the property as long as he does not commit "waste." Any act or omission that does permanent injury to the realty or unreasonably changes its characteristics or value will constitute waste. For example, the failure to make repairs on a building, the unreasonable cutting of timber or the neglect of an adequate conservation policy may subject the life tenant to an action by the remainderman to recover damages for waste. Where land is involved, a life tenant can generally use the property to the extent it was being used by the former owner and such actions do not constitute waste. Similar problems arise where the property consists of investments in securities. If A, the life tenant, has a right to the income during their life and B is to receive the securities outright upon A's death, there is a probability of a conflict of interests. A will want the capital invested in securities which realize a high return. B, on the other hand, is obviously concerned only that the capital be unimpaired when title passes. Since these two conditions are not usually found in the same investment, the opportunity for dispute is apparent. Where the property is under the direction of a trustee the attempt to maintain a reasonable balance between these two extremes is a difficult task.

The life tenant is obligated to pay the general taxes on the property but he may demand contribution from the remainderman to pay any special assessment or tax that results in a permanent improvement. A conveyance by the life tenant passes only that interest. The life tenant and the remainderman may, however, join in a conveyance to pass the entire fee to the property, or the life tenant may terminate interest by conveying it to the remainderman.

Landlord and Tenant A lease is both a contract and a grant of an estate in land. It is a contract by which the owner of the fee or of a lesser estate in land, the landlord, grants to another, the tenant, an exclusive right to use and possession of the land for a definite or ascertainable period of time or term. The possessory term thus granted is an estate in land. The principal characteristics of this estate are that it continues for a definite or ascertainable term and that it carries with it the obligation upon the part of the tenant to pay rent to the landlord.
<u>Creation of the Leasehold Estate-</u>. By statute, in most jurisdictions, leases for a term longer than a specified period of time must be in writing. The period is fixed at one year in some jurisdictions; in others it is three years.
<u>Tenant's Obligation to Pay Rent-</u> While the leasehold estate carries with it an implied obligation upon the part of the tenant to pay reasonable rent, the contract of lease almost always contains an express promise, known as a covenant, by the tenant to pay rent in specified amounts at specified times. The reason for this is that, in the absence of such express covenant providing the amount of rental and the times for payment, the rent is a reasonable amount and is payable only at the end of the term.

Apart from the economic advantage of setting the amount of the rent without recourse to the courts and of obtaining its payment in stated installments, the tenant's express covenant to pay rent serves other useful functions. Most leases contain a provision to the effect that breach by the tenant of any of his covenants in the lease will entitle the landlord to declare the lease at an end, and will give him the right to regain possession of the premises. The tenant's express undertaking to pay rent thus becomes one of the covenants upon which this provision can operate. At common law, where there is no such provision in the lease, the tenant's failure to pay rent when due gives the landlord only the right to recover a judgment for the amount of such rent; it gives him no right to oust the tenant from the premises. This is a direct result of the common law doctrine that the mutual covenants in a lease are independent of one another, unless the lease contains an express provision to the contrary. If the tenant breaches his covenant to pay rent, or fails to perform any of the other covenants in the lease, the landlord is not thereby relieved of his covenant to provide the tenant with quiet enjoyment of the premises.

In many jurisdictions today the conditions affecting rent payment has been changed by statute, to the extent that the landlord is given a right to dispossess the tenant for nonpayment of rent although there is no provision for this in the lease. However, such statutes give the landlord a meaningful remedy only where the lease contains an express covenant to pay rent in stated installments or in advance.

Property Owner's Responsibility

The property owner has a responsibility to others on the property. In asking whether John, who suffers loss while on the property of Mary, can hold her responsible for the loss, we find that the answer depends on why John was on Mary's property. John's status can be viewed in one of three ways.

1. Invitee- Mary is most likely to be held liable for injury to John if John is an invitee. This is a person invited onto the premises for some purpose, whether expressed or implied, involving potential benefit to the owner of the property. An invitee, using reasonable care to protect his own safety, has the right to expect that the property owner will take reasonable care to prevent injury from any danger that the owner knows of or should know exists. The property owner has the responsibility for being sure that the premises are reasonably safe for the invitee.

2. Licensee- A visitor who is on the property of another without constraint, but for the sole benefit of the visitor, is a licensee. The duty owed by a property owner to a licensee is less than that owed to an invitee. The property owner is expected to use ordinary care in maintaining the property, but the licensee must take the property as it is.

Judy is standing outside a department store waiting for a bus when a rain shower starts. She steps inside the entrance of the store to wait. When she sees the bus coming, she rushes through the doors, drops a package and trips over it, and is injured. She is a licensee of the store.

A pedestrian taking a short cut through a parking lot accidentally runs into the side of a delivery truck while looking in another direction. He is a licensee.

Martha has an important letter to mail and wants it to go off as soon as possible. She goes into a nearby apartment building to use their outgoing mailbox. She falls through a loose plate glass door panel and cuts her arm. She is a licensee.

3. Trespasser- A third type of visitor is one who is on the property of another without expressed or implied permission from the owner. This person is a trespasser. The property owner may not deliberately attempt to harm the person, but the trespasser must take the property as it is. Mike, getting ready for a Halloween party, goes one evening to a nearby corn field to get some dried cornstalks and pumpkins, ignoring posted warnings. Carrying the cornstalks and pumpkins back to his truck he falls and breaks a leg. Mike is a trespasser.

Alf rides his horse every morning through a pasture owned by George. In spite of complaints from George that this action disturbs his cattle, Alf continues. George rigs a thin wire across the83path Alf takes. The horse trips and throws Alf. Alf sues George for his injuries. Alf is a trespasser, but George cannot cause intentional harm to him. Alf possibly can collect for his injuries from George.

Property and Insurance

Many things can happen to personal or real property, some of them bad. When we get a new car from the dealership, as soon as it is driven off the lot the value declines. The wear and tear of assets is counterbalanced by a plan of maintenance. Theft, fire, flood, loss, or storm damage to assets is covered by insurance. Coverage for personal property began with the earliest form of insurance, underwriting vessels at sea and their cargo. From there the industry branched out into fire and theft insurance. Property that is permanently situated at a fixed location is covered by fire or casualty insurance.

Inland marine insurance covers goods in transit. The name comes from the fact that rivers, lakes and canals used to be the primary arteries for bringing goods to market. It now applies to all types of transportation insurance. This includes bailees' customer policies and personal and commercial property floaters. In general property floater policies provide all-risk insurance on personal property that is subject to being moved to a different location at any time. The policy covers the property both while at a fixed location and during transit. Personal property floaters can cover either specific items for stated amounts or all non-business personal property without scheduling each item separately. This type coverage usually extends to property belonging to or borrowed or leased by the insured, members of the insured's household, or visitors.

Business floater policies cover the stock in trade or equipment of a business firm, regardless of where the property is located. Standard policies exist for specific types of businesses. A policy for a jewelry store normally covers all jewels, precious metals, watches and the like belonging to the jeweler, bailed to the proprietor by a customer, or consigned regardless of where the property is located. The same sort of policy is available to retail or wholesale merchants in other types of business.

The original Statute of Frauds in England had a provision requiring written evidence for the contract for the sale of goods. Today in the United States a contract for the sale of goods valued over $500 is not enforceable unless it is in writing. Property and its sale are covered by contract and by insurance to protect the individual merchant as well as the integrity of the economic system.

Bailment

Origins of the law of bailment lie further back in time than do those of the law of contracts. Bailment remains a separate area from contract law primarily because to require a contract for simple everyday business transaction would be impractical. A person who takes clothes to be cleaned or leaves his car in a parking lot does not want to have to sign a contract to be sure his property is safe.

Bailment deals with delivery of possession of personal property without transfer of title. The owner or rightful possessor, known as the bailor, delivers possession of the property to a person known as the bailee for the accomplishment of some particular purpose. After that purpose is accomplished the property is to be returned to the bailor or to a person designated by him. Goods delivered to a repair person or a pawnbroker come under the law of bailment, as do the contents of a safe deposit box at a bank.

For bailment to be effective there must be lawful possession by the bailee, without title, for a determinable time, of personal property which the bailee must restore when his lawful possession comes to an end, to the bailor who is either the owner or a person who has the superior right of possession.

The bailor need not have actual ownership nor make actual delivery of the property to the bailee. Jones has possession of personal property owned by Smith and delivers it to White. Jones retains the right to have the property returned to him or to a person he designates. It is also possible for Smith to intervene and assert a better right to possession than either Jones or White in this case.

Possession by a bailee involves power to control and either an intention to control or an awareness that the rightful possessor of the personal property has lost control of it.

If a customer entering a restaurant should hang his hat or coat on a hook inside the door, the property is in an area which is under the physical control of the restaurant owner but he is not the bailee unless he clearly indicates that he intends to exercise the power to control the property in question. This would occur if the customer checked the hat and coat, thus delivering them to the restaurant owner.

If the owner of a hat did not check it and forgot to take it with him when he left, and the restaurant owner then noticed it and realized it had been left behind by one of his customers, he would become a bailee of the hat. This occurs not because a delivery has taken place but because the restaurant owner, who has physical control of the area in which the hat was found, realizes that the rightful possessor has relinquished the power to control the hat. The restaurant owner now has both the power and intent to control and therefore has possession of the hat.

A similar situation existed in a famous case involving a pair of glasses left behind in a certain restaurant in Los Angeles. At one point, the family of waiter Ron Goldman, who attempted to return the glasses to the rightful owner, wanted to collect workman's compensation because his death was in the line of employment. The claim was denied. Goldman had not informed his employer about the forgotten glasses. No condition of bailment existed. He was returning the glasses on his own time and of his own accord.

A person who finds a billfold lying in the street does not become a bailee if he merely sees it lying there. He becomes a bailee when he picks it up, thereby evidencing an intent to assume control over the property. The finder in the street, unlike the restaurant owner, does not have physical control of the area in which the property is found, so he must assume physical control of the billfold before he becomes a bailee.

The measure of control over the property determines the condition of bailment. If in a parking lot an owner locks his car and takes the keys with him it is generally held to be a license situation. If the owner leaves his car with an attendant who assumes control and parks it, bailment is held to have occurred. The basic question is the amount of control the parking lot operator holds himself out to the public as exercising.

A bailee is not liable for the contents of a closed container unless he has express notice of what the contents are or ought as a reasonable man to have anticipated the presence of such contents. A parking lot owner is generally not held liable for items stolen from the trunk of a car unless he has or reasonably should have had notice of the contents of the trunk. A bank or safe deposit company, on the other hand, is liable for the contents of a safe deposit box regardless of value because it has a high degree of control in preventing unauthorized access and reasonably should anticipate that a safe deposit box would contain valuables.

Bailment can only exist with regard to personal property. Delivery of possession of real property is covered by real estate law.

A bailor ordinarily is not an insurer of the subject of the bailment. Negligence in the care of property is the basis of his liability. In the absence of negligence he is not liable when goods are lost, stolen, or destroyed. Certain bailees such as common carriers, public warehousemen, and innkeepers are not permitted to limit their liability except as provided by statute. Others may vary their duties and liabilities by contract with the bailor.

If liability is limited by contract, as in the case of professional bailees such as garage repair persons or others who deal with the public on a uniform rather than an individual basis, it is not ordinarily binding on the bailor for the bailee simply to post a notice on the walls of the place of business or put it on a claim check stub. The bailee must call the bailor's attention to the writing and inform him that it contains a limitation or variation of liability. He does not have to read or interpret the limitation or variation to the bailor.

Presumption of Negligence- In case of loss or damage to goods while in the possession of the bailee, it may be impossible for the bailor to gather enough information to show that the loss was due to the bailee's negligence. The law comes to the bailor's aid with the presumption that the bailee was negligent. The bailor need only show that certain goods were delivered to the bailee and that he has failed to return them or that they were returned in damaged condition. On proof of such facts, the burden rests with the bailee to prove that he exercised the degree of care required of him or that he has another adequate defense.

If the bailee has an obligation by custom or by express agreement with the bailor to insure the goods against certain risks he is liable for damage or non-delivery even though he has exercised due care.

Waiver and Estoppel

Estoppel is defined as a restraint or a bar. It arises where a person has done some act that the policy of the law will not permit him to deny, or where circumstances are such that the law will not permit a certain argument because it would lead to an unjust result. Estoppel does not require any actual surrender of a known right. Rather, it implies some misleading act, conduct, or inaction on the part of the insurer upon which the insured detrimentally relies. Estoppel is an equitable principle imposed as a rule of law.

What does that last sentence mean? This goes back to the principals of law in Chapters 1 & 2. An equitable principle refers to one that brings about justice or fairness. There can be no strategic maneuvering or wrangling in this situation. The insurer must come into the agreement with clean hands. In England the common law was unable to provide a remedy for every injury. So the crown established the court of chancery, to do justice between parties in cases where the common law would not give satisfactory redress. The idea is that equity will find a way to achieve a lawful result when legal procedure is inadequate. Rule of law means that this is a part of law that is applied by the courts. No statutory act by the legislature created estoppel. It is a concept that has developed over time as a part of our legal tradition.

Waiver is an intentional and voluntary surrender of some known right, which generally may either result from an express agreement or can be inferred from circumstances. It is the relinquishment of a known right which may result from either the affirmative acts of the insurer or its authorized agents, or from the insurer's nonaction, with knowledge of the applicable facts

These two terms are similar in nature and need to be considered jointly. A clear difference between the two legal theories is confused for the following reasons. Over the years the courts have put forth an effort to counter the unilateral nature of insurance contracts. Insurers control the drafting of the policy language. It can be complex language unfamiliar to the layman. The courts refuse to allow the insurance companies to reap an unfair advantage in litigation with policyholders.

Thus it was in earlier times that any unfair advantage perceived by the courts was branded as one or the other, if not both waiver and estoppel. No regard was given to the accurate usage of the terms. Insurance law litigation dealing with breach of warranty and misrepresentation issues has been called "the happy hunting ground for waiver and estoppel." As important as these concepts are, however, some courts define them inaccurately.

In *Globe Mut. Life Ins. Co. v. Wolff (S.Ct.1877)* Justice Field said, “The doctrine of waiver, as asserted against insurance companies to avoid the strict enforcement of conditions contained in their policies, is only another name for the doctrine of estoppel.” The terms have been frequently treated as synonyms. As pointed out earlier, there are actually differences between the two.

In considering waiver and estoppel, keep in mind that the insurance business is done almost exclusively through agents, and thus waiver and estoppel arguments applied against the insurer most often involve an act or omission by an agent or officer of the insurer who must necessarily be acting within the scope of their authority.

The legal doctrine of waiver applies to those circumstances where an insurer knows it has justifiable grounds for rescission of the policy or defense to any claim on the policy. In spite of this knowledge, the insurer conveys to the insured its voluntary surrender of such a right. This situation usually manifests itself in the form of the agent accepting a premium payment from the insured. This legal doctrine is applicable only in cases where the insurer has actual knowledge of the grounds for cancellation of the contract. A situation in which the insurer is aware of facts that would cause a reasonable person to inquire and discover the pertinent grounds for rescission or defense on the part of the insurer.

Assume that an agent fails to pass along information affecting the status of a policyholder to the insured. It is still generally held that the knowledge of the general agent of the insurer constitutes knowledge of the insurer. Similarly, an insurance broker is generally considered to be an agent of the insured. That person's knowledge is also attributed to the insurer. On the other hand, information or knowledge of someone acting in the capacity of soliciting agent is not treated in this manner. The knowledge of a person who only solicits and forwards applications does not constitute knowledge of the insurer.

Waiver of Rights

A waiver of rights to contract can come about in two ways:

Express Waiver- The agent conveys to the insured that a situation contrary to the terms of the policy will not be relied upon by the policy issuer as a means of avoidance of its obligations under the policy. An example of this would be leaving a property vacant for an extended time.

Express waiver can also apply to the rights of the insurer. An example would be misrepresentation of information in the application by the insured. The same would apply to a breach of condition precedent to formation of the contract, such as the requirement of payment of the first premium upon delivery of the policy. The same applies to the breach of a condition or warranty during the term of the policy, such as a functioning alarm system.

Implied Waiver-The voluntary surrender of a known right will at times be implied by the courts. Examples of these circumstances include;

- Acceptance of a premium for future coverage by the agent with knowledge of an existing breach of condition or warranty.
- Receipt and retention of proof of loss without objection.
- The exercise of a right under the policy, such as the demand for an appraiser or arbitrator.

The results of silence on the part of the insurer depend on the circumstances. If an insurer learns of grounds for rescission or defense prior to a loss under the policy, it is not sufficient to constitute a waiver unless previous business practices require the insurer to give some affirmative notice to the insured. This situation commonly arises when the insured fails to pay a premium and prior waivers of late premium payments lead the insured to expect that the policy would continue in effect absent any notice to the contrary from the insurer. Some states require the insurer to notify the insured if they are to rely on nonpayment of premiums as a reason for forfeiture.

Contract Rescission and Estoppel

Estoppel- This generally applies to an insurance contract when an insurer is or should be aware of its right to rescission on the basis of a misrepresentation by the insured. With this condition extant, the insurer expressly or impliedly represents to the insured that the policy is enforceable. The insured is thus unaware of the grounds for policy rescission and relies on the representation of the insurer to his or her detriment. Under the doctrine of equitable estoppel, A makes a representation to B. This person B, having a right to do so, relies on the representation to their detriment. A is now estopped from denying the truth of the representation, or from taking a position inconsistent with the representation.

To illustrate further, consider that it is a general rule that the doctrine of estoppel does not apply to government or its agencies. This applies not only to true government functions but also when the government is performing functions that have a private counterpart. A farmer applied to the Federal Crop Insurance Corporation for crop insurance on reseeded wheat. The farmer made full disclosure to the agency, paid the premium and the policy was issued. A loss ensued. Payment was denied however, because the FCIC had adopted a regulation against insuring reseeded wheat. This particular regulation had been published in the Federal Register, but the farmer had no knowledge of it. In the case *Federal Crop Insurance Corp. v. Merrill* (332 U.S. 380, 1947), the court acknowledged that a private insurer would be estopped from denying coverage under these circumstances. The principle does not extend to government agencies and coverage was denied.

How can the insured be unaware of the grounds for rescission? The terms and conditions are spelled out right there in the policy. The reality is that courts across the country are split as to whether or not an insured can claim an inculpable lack of knowledge of the grounds for rescission if it is a result of policyholder’s failure to read the policy. The insured is not inclined to read the fine print of policies and is often unable to read or comprehend abstruse contractual verbiage. As a result, the courts impose no obligation on the insured. Estoppel is used to counter the insurance company’s defense of misrepresentation or breach of condition by the insured. It cannot be used to extend coverage to losses not included or expressly excluded from coverage under the policy.

Promissory estoppel- A promise may be binding even though the promisor may have received nothing by way of an agreed upon exchange for it where made under circumstances which should lead the promisor reasonably to expect that the promisee will be induced thereby to take definite and substantial action in reliance thereon and the promisee does take such action. The basis of the promisor's liability is promissory estoppel, and consideration for the promise is not required. The promisor is estopped from pleading a lack of consideration for his promise where it has induced the promisee to make a substantial change of position in reliance thereon.

The rationale of promissory estoppel is similar to that underlying the principle of a true waiver. A person waives a condition upon which his liability depends when he tells a person who has the power and capacity to bring about the happening of the condition that it will be unnecessary to do so. A party waives the defense of the Statute of Limitations when he induces his creditor to forbear bringing an action by a promise of payment or a promise not to plead the statute as a defense. In these cases the condition or defense is waived because of the justifiable reliance upon the statement that induced a forbearance to act or a change of position.

Agency by Estoppel

At the beginning of this chapter the concept of agency was reviewed. In some instances the law imposes an agency relationship even when there is no actual consent between the principal and agent. When statements and/or conduct of the principal cause a third party to reasonably believe that an agency condition exists, and the third party relies on the representation when dealing with the purported agent, the principal will be estopped from denying the agency. There is no actual authorization of the agent, only an apparent agency. The result is the same as actual agency. The principal is bound by the acts of the agent and is estopped from denying the relationship. The appearances of agency must be created by the principal and not by the agent to create an agency by estoppel. Mr. Jones produces business cards showing he is a representative of Zeta Co., owned by Ms. Tran. So long as Ms. Tran has no knowledge of the falsehood, she may deny agency. Persons relying on the ruse created by Mr. Jones are relying on appearances created by Jones, not Ms. Tran.

Parol Evidence Rule

The parol evidence rule emphasizes the importance of avoiding ambiguity in a contract. The rule provides that evidence is not admissible in court to change or modify the terms of a written contract. The contract must clearly reflect the intent of the parties. If a contract is disputed once it's agreed on, usually evidence will not be accepted that will modify the meaning of the contract. The contract must be obvious in its intent.

An insurance agent writes a policy for a baking company. Before the policy is written he tells the baker that the policy does not include business interruption coverage. The baking company reviews the policy when the agent delivers it. The baker finds that the policy does include the business interruption coverage.

After an oven explodes at the bakery, the baker files a claim for property loss and business interruption. The insurer denied coverage. The insurer alleges a misunderstanding concerning the business interruption coverage. It appears that the bakery would prevail. The policy appears to have no contract ambiguity. The parole evidence rule prevents the insurer from denying coverage for the loss.

A contract reduced to writing and signed by the parties is frequently the culmination of numerous conversations, conferences, proposals, counter proposals, letters and memoranda, and sometimes the result of negotiations conducted, or partly conducted, by agents of the parties. At some stage in the negotiations tentative agreements may have been reached on a certain point or points which were superseded, or so regarded by one of the parties, by subsequent negotiations. Offers may have been made and withdrawn, either expressly or by implication, or lost sight of, in the give and take of negotiations that have continued for a period of time.

Ultimately a final written contract is prepared and signed by the parties. It may or may not include all of the points which have been discussed and agreed upon in the course of the negotiations. However, by signing the written agreement, the parties have solemnly declared it to be their contract, and the terms as contained therein represent the contract that they have made. As a rule of substantive law, neither party is permitted subsequently to show that the contract that they made is different from the terms and provisions as they appear in the written agreement.

The word "parol" means literally "speech," or "words." It is a term applied to contracts which are made either orally or in writing, not under seal, which are called parol contracts, in order to distinguish such contracts from those which are under seal and are known as deeds or specialties. The term "parol evidence" refers to any evidence, whether oral or in writing, which is extrinsic to the written contract.

The parties may differ as to the proper or intended meaning of language contained in the written agreement, where such language is ambiguous or susceptible to different interpretations. To ascertain the proper meaning requires a construction of the contract. “Construction” in this sense does not involve any change, alteration, modification, addition to, or elimination, of any of the words, figures, or punctuation, in the written agreement, but merely a construing of the language in order to ascertain its meaning. While the parol evidence rule precludes either party from introducing any evidence in any lawsuit involving the written agreement which would change, alter, or vary the language or provisions thereof, rules of interpretation or construction permit the introduction of evidence in order to resolve ambiguity and to show the meaning of the language employed and the sense in which both parties used it.

Reasoning Behind the Rule-The parol evidence rule applies only to an integrated agreement or contract, that is, one in which the parties have assented to a certain writing or writings as the statement of the agreement or contract between them. When there is such an integration of an agreement or contract, no parol evidence of any other agreement will be permitted to vary, change, alter, or modify any of the terms or provisions of the written agreement.

The rule is recognized for a valid reason. The parties, by reducing their agreement to writing, are regarded as having intended the writing that they signed to include the whole of their agreement. The terms and provisions contained in the writing are there because the parties intended them to be in their contract. Any provision not in the writing is regarded as having been omitted because the parties intended that it should not be a part of their contract. The rule excluding evidence which would tend to change, alter, vary, or modify the terms of the written agreement is therefore a rule that safeguards the contract as made by the parties.

Some Cases Where the Rule Does Not Apply- The parol evidence rule, in spite of its name, is not an exclusionary rule of evidence, nor is it a rule of construction or interpretation. <u>It is a rule of substantive law</u> which defines the limits of a contract. Bearing this in mind, as well as the reason underlying the rule, it will be readily understood that the rule does not apply to any of the following:

- A contract that is partly written and partly oral. Where a written offer is accepted orally, there is no integration of the contract in a writing.
- A receipt for goods or merchandise. This is not a contract.
- A gross clerical or typographical error that obviously does not represent the agreement of the parties. Where a written contract for the services of a skilled actuary provides that his rate of compensation is to be $1.50 per hour, a court of equity would permit reformation of the contract to correct the mistake upon a showing that both parties intended the rate to be $150 per hour.
- The lack of contractual capacity of one of the parties, by proof of minority or insanity.
- A defense of fraud, duress, undue influence, or illegality. Evidence establishing any of these defenses would not purport to vary, change, or alter any of the terms of the written agreement, but merely to show such agreement to be voidable or unenforceable.
- A condition agreed upon orally at the time of the execution of the written agreement and to which the entire agreement was made subject.
- A subsequent oral mutual rescission or agreed modification of the written contract. Parol evidence of a later agreement does not tend to show that the integrated writing did not represent the contract between the parties at the time it was made. If the contract is one which the Statute of Frauds requires to be in writing, a subsequent mutual rescission or modification must also be in writing.

- Usage and custom- Parol evidence of usage and custom which is not inconsistent with the terms of the written agreement is admissible to define the meaning of the language in the agreement, where both parties knew or should have known of the existence of the usage or custom in the particular trade or locality.

Statute of Frauds

This is a statutory requirement that certain kinds of contracts be in writing to be enforceable. Except as otherwise provided by statute, an oral contract, i.e., one made by word of mouth and not evidenced by any writing, is in every way as enforceable as a written contract. An oral agreement to pay $750,000 to a writer for a new movie script to be written by him, the employment by oral agreement of a public relations firm for an indefinite period at a monthly rate of $1,000, and an oral agreement to purchase a household appliance for $80, are common examples of some commercial contracts that are completely valid and enforceable notwithstanding that they are not evidenced by a writing.

The requirement that certain kinds of contracts must be in writing to be enforceable is traced back to 1677, when the English Parliament passed legislation requiring that certain classes of contracts be in writing, "signed by the party to be charged," before an action could be brought on them. This was part of a comprehensive statute, entitled "An Act for Prevention of Frauds and Perjuries," designed to prevent fraud and perjury in the proof of various kinds of legal transactions. Sections 4 and 17 of this "Statute of Frauds," as it came to be called, pertained to contracts, and these provisions have been substantially reenacted in almost every State in this country. Although the word "Frauds" is contained in the commonly accepted name of the Statute, it should be borne in mind that the Statute does not directly pertain to fraud, but only to formal requirements necessary to the enforceability of certain types of contracts.

Section 4 of the original Statute of Frauds provides as follows:
No action shall be brought
① whereby to charge any executor or administrator up on any special promise, to answer for damages out of his own estate;
② or whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriage of another person;
③ or to charge any person upon any agreement made upon consideration of marriage;
④ or upon any contract or sale of lands, tenements or hereditaments, or any interest in or concerning them;
⑤ or upon any agreement that is not to be performed within the space of one year from the making thereof unless the agreement upon which such action shall be brought, or some memorandum or note thereof, shall be in writing, and signed by the party to be charged therewith or some other person "hereunto by him lawfully authorized."

Section 17 of the original Statute reads as follows:
"No contract for the sale of any goods, wares and merchandizes, for the price of ten pounds sterling or upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain, or in part payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract, or their agents hereunto lawfully authorized."

In addition to those contracts specified in the original statute, some modern statutes require that others be written; for example, a contract to make a will, to authorize an agent to sell real estate, or to pay commission to a real estate broker. If there is no statute in the jurisdiction requiring a contract to be in writing, it remains true today that an oral contract will be enforced.

Contracts of a type or class governed by the Statute of Frauds are said to be "within" the Statute. Those contracts to which the provisions of the Statute do not apply: are "without" or "not within" the Statute of Frauds.

In Azevedo v. Minister, (1970)-Nev.-, 471 P.2d 661, the court said:

"The development of the action of *assumpsit* in the fourteenth century gave rise to the enforceability of the oral promise. Although parties to an action could not be witnesses, the alleged promise could be enforced on the strength of oral testimony of others not concerned with the litigation. Because of this practice, a party could readily suborn perjured testimony, resulting in marked injustice to innocent parties who were held legally obligated to promises they had never made.... The statute of frauds was enacted to preclude the practice.... The passage of the statute did not eliminate the problem, but rather, has precipitated a controversy as to the relative merits of the statute. Those favoring the statute of frauds insist that it prevents fraud by prohibiting the introduction of perjured testimony.... They also suggest that it deters hasty action, in that the formality of a writing will prevent a person from obligating himself without a full appreciation of the nature of his acts.... Moreover, it is said, since business customs almost entirely conform to the mandates of the statute, an abolition of the statute would seriously disrupt such affairs....

"On the other hand, in England the statute of frauds has been repealed. The English base their position upon the reasoning that the assertion of the technical defense of the statute aids a person in breaking a contract and effects immeasurable harm upon those who have meritorious claims.

"It is further maintained by the advocates of the English position that the rationale for the necessity of the statute has been vitiated because parties engaged in litigation today may testify as witnesses and readily defend against perjured testimony.

"The Uniform Commercial Code, however has attempted to strike a balance between the two positions by seeking to limit the defense of the statute to only those cases where there is a definite possibility of fraud."

The term assumpsit above in Latin means “he promised”, or “he undertook”. This means an express or implied promise or undertaking in contract law. It can be made either orally or in writing not under seal. In reference to one of the old forms of action in the common law, assumpsit was an action in equity. It was applicable to almost every case in which money had been received that in equity and good conscience should have been refunded.

Scope of the Statute of Frauds- Section 4(1) of the statute applies to promises of an executor of a decedent's will or the administrator of his estate if he dies without a will to pay debts of the estate he is administering out of his own funds. If an executor or administrator promises to pay, out of his own funds, a debt of the decedent, the promise is unenforceable unless in writing. The substance of this section is included within Section 4(2) relative to promises to answer for the debt of another. The "other" is the estate that the executor or administrator is administering.

Section 4(2) of the statute; Promise to Answer for the Debt of Another; This is often called the "Suretyship Section," this provision applies typically to contracts wherein a promise is made to a creditor to pay the debts or obligations of a third person, the debtor. Thus, if a father tells a merchant to extend credit to his son, and says "If he doesn't pay, I will," the promise must be in writing to be enforceable. The factual situation can be reduced to the simple "If X doesn't pay, I will." The promise is said to be "collateral," in that the promisor is not the one who is primarily liable. He does not promise to pay in any event; his promise is to pay only upon the default of the one primarily obligated.

It is sometimes difficult to ascertain whether a promise is "collateral" ("I'll pay if X doesn't"), or whether the promisor undertakes to become primarily liable, or, as the courts say, makes an "original" promise ("I'll pay"). For example, a father tells a merchant to deliver certain items to his son, and says "I will pay for them." The Statute of Frauds does not apply, and the promise may be oral. Here, the father is not promising to answer for the debt of another; he is making the debt his own. It is to the father, and to the father alone, that the merchant extends credit and looks for payment.

Statute of Frauds and Insurance Contracts- Most states require that contracts of life, accident, and health insurance are in writing. Yet, the general rule is that oral contracts of insurance are enforceable as long as they can be performed within one year. In order to provide immediate temporary insurance until a written binder can be issued, oral contracts are often used in cases of fire, casualty, and marine insurance. There is always a danger of fraud or collusion so the time period during which oral binders are in effect is kept to a minimum.

The parties only discuss the bare essentials of the insurance contract when an oral agreement is formed. Terms of the contract usually consist of evidence of an understanding that the standard form of policy was meant to fill in the missing terms. When the agent represents more than one insurer writing the particular type of coverage that the agent agreed to, there must be some objective evidence other than the unwritten decision of the agent as to which insurer the agent has selected to write the policy. The mention of the insurer to the insured or written field notes of the agent have been held as sufficient for this purpose.

Reinsurance- Under the usual contract of reinsurance, the obligation of the reinsurer is to indemnify the original insurer. No obligation is owed by the reinsurer directly to the original insured. As such, the reinsurer is not considered to be the guarantor of any debt of the insurer. The contract for reinsurance is not within the statute of frauds and need not be in writing to be enforceable.

Assignments of Policies- As a way to protect assignors and beneficiaries against the dangers of allowing contract assignment without full formalities the courts have strictly enforced the statute of frauds. It is required that any assignment of a life insurance policy be in writing. Exceptions to this rule are those of “part performance” in nature. This usually involves factual indications such as the take-over of premium payments by the assignee and delivery of the policy to the assignee.

Here is a case that actually involves “fraud” in the literal sense. It also involves the question of “If he doesn’t pay, I will” as discussed above.

Great American Indemnity Co v Berryessa.
(1952)122 Utah 243, 248 P.2d 367.

WADE, J. The Great American Indemnity Company, appellant herein, brought this suit against Frank Berryessa and W. S. Berryessa, the obligors on a joint promissory note. Frank Berryessa was not served with summons and did not participate in the trial. W. S. Berryessa pleaded as defenses-duress and lack of consideration and also counterclaimed for the return of $1,500 paid by him and the cancellation of a personal check given by him and not cashed at time of suit. This appeal is from a jury verdict and judgment thereon in favor of respondent W. S. Berryessa.

Viewing the evidence in the light most favorable to respondent, as we must, the jury having found in his favor, it discloses that Frank Berryessa, a son of W. S. Berryessa, misappropriated some funds of his employer the Eccles Hotel Company, which operates the Ben Lomond Hotel in Ogden, Utah. When the father first learned of this, it was thought that the sum involved was approximately $2,000 and he agreed to repay this amount if the bonding company would not be notified and no publicity given to the matter, and gave the hotel his promissory note for $2,186 to cover the shortage. Before this note became due, it was discovered that the shortage would probably be over $6,000 and therefore the manager of the hotel called W. S. Berryessa in for a conference. W. S. Berryessa knew he couldn't pay this larger sum and it was decided that the bonding company, the appellant herein, should be advised of the shortages. The hotel didn't try to collect the note for $2,186 after the bonding company was notified apparently expecting that company to reimburse the hotel for the entire shortage discovered.

After the bonding company was notified, its agent had several conferences with the Berryessas and the hotel management in which there was ascertained that the total shortage amounted to $6,865.28 and Frank Berryessa signed a statement that he had misappropriated that amount. Frank Berryessa had stated that he had given a brother-in-law some of the money he had embezzled and it was suggested that he sign a note along with the Berryessas. The brother-in-law did not sign the note and at a further meeting of the Berryessas with the agent W. S. Berryessa indicated that he did not think his son Frank would be able to make the payments of $250 quarterly suggested and that he was sure that he personally would not be able to do so and therefore did not want to sign the note. Mr. Berryessa then testified, although this was denied by the agent, that the agent thereupon swore, pounded his fists on his desk, and told him, "You can't come here and tell me what you will do." and then told them that if W. S. Berryessa would pay $2,000 in cash and sign a note with Frank Berryessa for $4,865.20, payable at the rate of $50 a month, that Frank would not be prosecuted but that if he did not sign Frank would have to be prosecuted. Thereupon, W. S. Berryessa agreed to do this and a couple of days later signed the note sued upon herein and about a month later, having secured a loan by mortgaging his home, gave the agent a cashier's check in the amount of $1,500 and a personal check in the amount of $500 as payment for the $2,000 cash agreed upon. Mr. Berryessa asked the agent not to cash the $500 check for about a month until he could get some more funds to pay it. This is the check which was never presented for payment by the appellant.

At the conclusion of the trial, appellant moved for a directed verdict in its favor and for a dismissal of the counterclaim because there was insufficient evidence of duress or lack of consideration. The court refused to grant its motion and this refusal is relied upon by appellant for reversal in this case.

It is appellant's contention that there was insufficient evidence of duress to present that question to the jury and that the court erred in giving its instructions numbered 1 and 6 because it gave the jury the idea that there were two separate and distinct defenses to the validity of the transaction. Respondent pleaded both duress and illegal consideration as defenses.

It will be noted that these instructions correctly placed the burden of proving their defenses of duress or illegal consideration upon the Berryessas.

It is well settled that a note given to suppress a criminal prosecution is against public policy and is not enforceable between the parties. See 10 C.J.S., Bills and Notes, § 154, pages 630-631 and Simon Newman Co. v. Woods, 85 Cal.App. 360, 259 P. 460, on pages 462, 463, wherein the court said:

"It is conceded that a note or mortgage given on promise to refrain from the prosecution of a person for a felony, or under threats of arrest or prosecution, would be void as against public policy;"

In this case respondent relied on two separate defenses, duress and illegal consideration, either one of which is sufficient to nullify this note. So if the jury found that the note was the result of duress or that respondent signed the note because appellant promised to refrain from criminal prosecution of his son, either one would be sufficient to invalidate the note and would constitute a defense thereto.

The uncashed check and the payment of $1,500 cash, present a different problem. Respondent had given the hotel a note for slightly over $2,000 to pay for the son's defalcations. At the time this note was given, there can be no question that no coercion was exercised against respondent and that his act was voluntary and at his own suggestion. There is nothing in the record to indicate that this note was given under duress or a promise to suppress prosecution. When appellant as surety paid the hotel the entire amount embezzled, it was entitled to be subrogated to the rights of the hotel and to an assignment of the note which respondent had given it. Respondent knew he had signed the note and was liable thereon. He, therefore, substituted for his promise to pay the hotel a promise to pay $2,000 to the Indemnity Company. In conformity to that promise, he paid $1,500 and gave his check for $500. This should be regarded as the extinguishment of a pre-existing, valid debt, which the appellant had a right to collect. Under such circumstances, the court erred in submitting the issue of duress and illegal consideration to the jury on respondent's counterclaim.

The judgment against appellant on its complaint is affirmed. The judgment in favor of the respondent on his counterclaim is reversed.

Suretyship

As the case above indicates, the concepts of contract, insurance and bonding do not exist in a vacuum. As with other facets of the field of insurance, they are often interrelated. Bonding is not insurance, but the two are closely related and in most states the same department regulates both industries statewide. A surety bond involves three separate parties. The surety bond (a contractual responsibility), obligates the surety to pay a second party, the obligee, if a third party, the principal, fails to fulfill an obligation to the obligee. Figure 4-1 shows how bonding works.

There are two important differences between surety and insurance;
1.) **Parties to the Agreement-** The surety bond contract involves three parties as mentioned above. That is, the principal, the surety, and the obligee. An insurance contract involves two parties, the insurer and the insured. When dealing with fraud or misrepresentation (the perils that suretyship safeguards), this matters. If the principal tires to defraud the obligee, the surety’s liability to the obligee remains. The reason the bond is required in the first place is to protect against fraud or dishonesty.

With an insurance contract, if the insured commits an illegal act as a means of collecting the insurance proceeds, the insurance contract generally becomes void and unenforceable. The only time fraud will void a surety arrangement is when a principal and obligee conspire to defraud the surety.

2.) **Relationship Between the Parties-** It is different between the surety and the principal. If an insured’s negligent act results in a claim, the insurer must pay the claim. A child can start a fire while left unattended by parents or the insured causes injury to another because of a negligent act. The insured’s act helps cause the loss yet the insurer must still pay the claim. The insurer has no recourse, nor can it make a claim for damages against the insured.

When a principal’s negligence or fraud causes a claim to be paid by the surety to the obligee, the surety will then look to the principal for whatever satisfaction it can obtain. The surety will take over the position of the obligee in the legal right to seek redress from the principal. This is a distinction between suretyship and insurance. The surety has the ability to seek reimbursement for losses from the principal; This is the party whose actions are warranted by the obligor, the surety.

Alamo Construction has contracted to build a new branch library for the Fort Bend County Library Board. Libraries are deemed vital to the operation and well-being of the county. They want it put up quickly and in a workmanlike manner. A surety bond is employed for the contract. The obligee is the Fort Bend Co. Library Board. The principal is Alamo Construction. If Alamo does not perform its obligation as spelled out in the construction contract, the surety bond requires the surety to pay the library board. There are two contracts involved in this sequence of events. A construction contract has the library board and Alamo as parties. A surety contract exists between the construction company, the board, and the bonding company.

For whatever reason, if Alamo Construction cannot complete the terms of the construction contract, the surety bond comes into play. When the breach of contract occurs, the library board looks to the surety for satisfaction of claims. The board does not have to engage in costly and time consuming litigation to solve its problem of getting a new library built. Money furnished by the surety allows a new contractor to be employed to finish the job. Certainty is substituted for uncertainty. This is the function of insurance. This allows the new branch library to be completed in a timely manner. The literary needs of the public are met. Help in construction of the library has been provided by the surety in the form of two essential services; It has furnished its financial strength and credit to that of the contractor's. The surety has also investigated the financial status and capability of the principal/contractor, Alamo Construction. Time and resources are saved for the library board, the obligee. They are in the business of lending literary tomes, not erecting edifices.

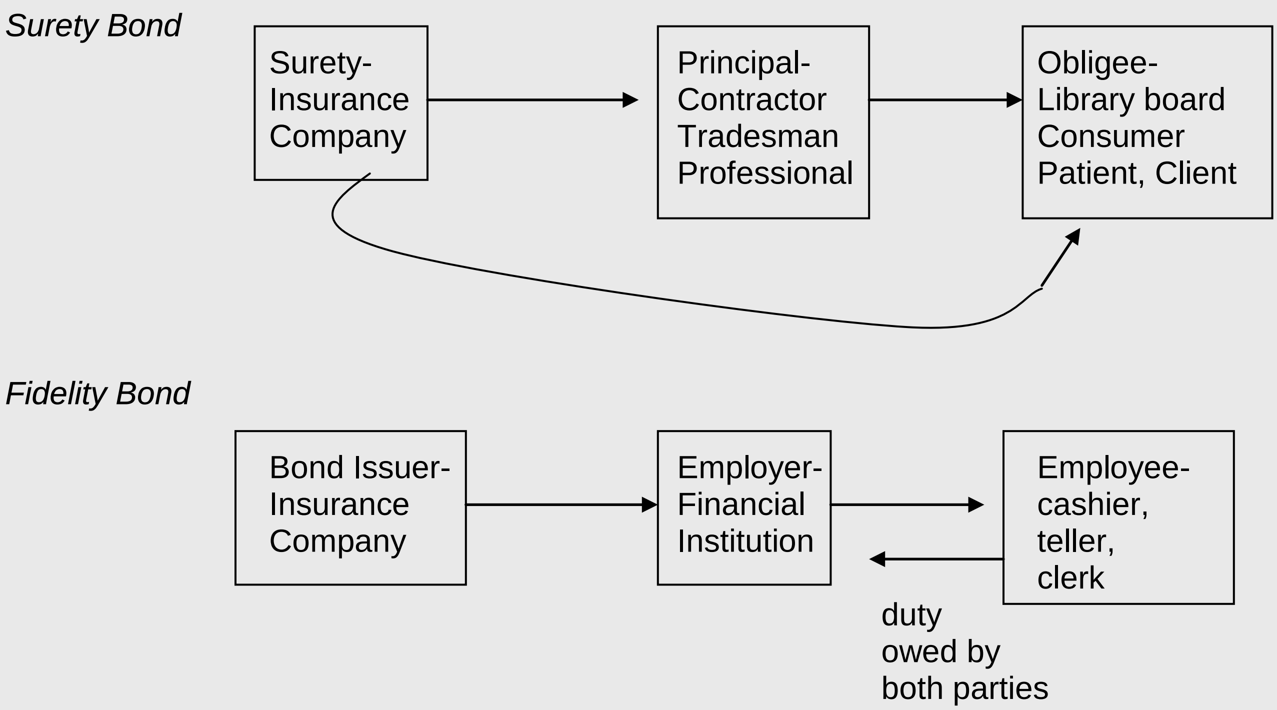
Bond Underwriting

Bond underwriters carefully select their exposure to loss. Three facets of the principal's overall business operation are examined;
▫ Financial situation of the principal- The financial statements are reviewed. For a corporation this would be the balance sheet and the income, cash flow, and owner's equity statements. Analysis of ratios and relationships expressed in the statements allow the surety to draw conclusions concerning the financial stability of the company.
▫ The past performance of the principal is examined. A track history of the company shows how previous contracts, manufacturing assignments or other projects were completed.
▫ Potential for moral hazard is examined. The reputation of the principal is examined. Payment practices, community or trade reputation, and employee integrity are among the important items to consider in underwriting a bond.

Bond Classifications Bonds of this type are put in two classes;
<u>Surety bond</u>- This type of bond guarantees the performance of the principal. This guarantee includes the principal's honesty.
-Contractor bonds are included here. They work as in the example above. Such bonds guarantee the performance of a construction contract.
-Judicial bonds are used by the courts to insure the performance of persons coming before the court. A probate court requires bonding of the executors of estates. Guardians of minors or mental incompetents must also be bonded.
-Court bonds are designed to protect one person (the obligee) against loss if the person bonded does not prove that they are legally entitled to the remedy sought against the obligee.
-A bail bond is used to insure appearance in court. The amount of the bond will be forfeited if the bonded person fails to appear in court at the appointed time.

Sheriffs, tax collectors, and other public officials who manage public funds are often required by law to post a bond. When a firm or individual must have a license to ply a trade or profession, a bond is required. Tradesmen, alcohol and tobacco manufactures and public warehouses are examples of the broad section of business requiring bonds to operate.

Figure 4-1
Bonding Flowchart



Fidelity bond- This type of bond protects businesses from the duplicity of employees. The employer in this case is the obligee. Performance refers to honesty, that which is expected from the employee. The employee is the principal. The surety bonds the principal's actions and agrees to indemnify the employer if dishonest acts of the employee result in a loss. Savings and loans, banks, and credit unions are businesses that must have bondable employees. The work force in these institutions handles cash and negotiable instruments on a daily basis. Theft, embezzlement, mis- and malappropriation of assets are a constant threat. The fidelity bond helps protect companies from the potential ruin that can be caused by these dishonest acts.

Chapter 5: Insurance Law Fundamentals

Characteristics peculiar to the insurance contract

Insurance contracts are unique. Of course, the contract has the same basic requirements as any other contract. There must be an offer, acceptance, consideration, legal capacity and legal purpose. Beyond these are features associated with the insurance contract that distinguish them from all other contracts. Courts across the United States have recognized the distinctive features of the insurance contract often enough that their understanding is necessary for an understanding of the agreement. Differences include the concepts of indemnity, subrogation, utmost good faith, and adhesion. Insurance contracts are aleatory in nature, but so is gambling. We will look at these ideas in this chapter. Other features associated with contract law sometimes take on a life of their own when applied to the insurance contract. Most property and casualty policies are contracts of indemnity. Insurance contracts are based on utmost good faith. Policyholders must maintain an insurable interest. The insurance contract is unique among contracts and the courts treat it differently from other contracts.

Normally, insurance contracts are ended by <u>performance</u>. Each party to the contract does what they said they would do. The insurer pays claims if a loss occurs while the insured remits premiums in a timely manner. For most insureds no catastrophic loss occurs but the insurer has done its job by standing ready to pay claims. This is a difference between insurance and everyday business transactions. Insurance is not an option, not a matter of choice. Coverage is frequently required by law, such as with auto insurance. In a market economy, with no government-provided social safety net, the dangers of loss that threaten most middle and working class people and property must be addressed by the individual. One is derelict, if not downright foolish, not to obtain insurance coverage.

As a result, society acknowledges that the insurance business is a business affected with the public interest, the recognition manifests itself in mandates from legislatures and courts. Insurance is a big factor in the economic planning of people and businesses. The insurance industry cannot market and maintain its product in the same manner as those industries in products far removed from the economic heartbeat of the microeconomic system. The insurance product is not like an automobile or a loaf of bread. The contract uses arcane language (even in the “plain English” versions) that render it difficult for the average consumer to understand precisely what they have bought. Because of this, the branches of government will invoke the “public interest” when assuring that the insured ends up with something close to what he or she intended to buy. The insurance contract is viewed as having sweeping scope and authority. The reliability of the insurance product is of vital importance to the public. Insurance involves an obligation that affects the public interest. As such, it is subject to certain restrictions. Sometimes this involves interpreting ambiguous policy language to the detriment of the insurer. This could even go to the extent of disregarding the written agreement entirely in order to satisfy the purported needs and expectations of the insured.

Although differing from other types of contracts, basic contract law applies to that special form of agreement known as the insurance policy. Most contracts involve an even exchange between the contracting parties, but an insurer's promise to pay involves a much larger sum than the premiums being received.
The insurance contract is enforceable only under certain conditions that probably will not occur, or else the policy would not be written. A contract, such as the insurance contract, in which losses and advantages to the parties depend on uncertain events, is called an aleatory contract.

Insurance companies offer standardized policies to make possible the spreading of risks over a large volume of business. The prospective insurance buyer is in a position of accepting a given policy or doing without insurance. An insurance contract is described as a contract of adhesion. An adhesion contract provides for one party to determine the provisions of the contract. The other party has little opportunity for bargaining.

Generally, the person to be insured is regarded as the offeror in an insurance contract. The contract is created when that offer is accepted by the insurance company. If the policy differs from that presented to the prospect, the insurance company is making a counter-offer which the applicant may or may not accept.

An insurance contract is a unilateral contract in the sense that it involves a promise for an act. The act is the payment of premiums by the policy holder. The promise is that of the insurer to pay for specified losses.

Characteristics of a Property Casualty Contract

As with all insurance contracts, the typical property/casualty contract is designed to create a binding agreement between two parties that will be clear and understandable. The purpose of the contract is to transfer the exposure to loss of one party, the insured, to a second party, the insurer. Such a simple concept, yet the agreement contains arcane language that at times can befuddle the most astute linguist. The insurance company is staffed with well-trained lawyers whose job it is to explain in precise language the purpose and intent of the insurance contract. This striving for exactitude at times sacrifices clarity.

The first time most people look closely at the language in their insurance policy is after a loss has been sustained. In this situation, the most important problem for the insured is trying to collect on the claim. To get an idea of whether a claim will be paid, the insured must think about the following questions;
Did the loss occur during a covered time period?
Is the loss caused by a covered peril?
Is the property covered?
Do any exclusions apply to the coverage?
Are there any policy clauses or conditions that limit the amount of coverage?
Is the person sustaining the loss covered?
Is the location of the loss covered?
Standard versions of the most widely used property and liability insurance contracts are prepared by insurance rating organizations. Most American insurers use forms prepared by the Insurance Services Office or the American Association of Insurance Services. These services also provide standard rates to be used with their policies. Standardized insurance policies provide all parties to the contract with advantages. They are more economical for the insurer to print and use. These savings should be reflected in lower insurance rates. It is more economical to calculate an insurance rate for standardized policies than for numerous different individual insurance policies, since there is a larger statistical base. That is, because numerous insurers use the same policy, their loss data and other statistics can be combined. Such would not be the case if each company covered different perils or had different conditions in their individual contracts. The meaning of standardized policies becomes widely known by those in the insurance business and by some consumers. This knowledge reduces litigation about the interpretation of these policies.

Components Of The Contract

Property/Casualty insurance contracts have several elements in common;
①Insuring Agreement- The insuring agreement gives force to the insurance policy. In broad terms, it describes the insurer's and the insured's rights and duties. Typically, the insurer indicates it will provide the insurance described in the policy, and the insured agrees to abide by the conditions of the policy. Here are some examples-

The Homeowners Insuring Agreement:
"We will provide the insurance described in this policy in return for the premium and compliance with all applicable provisions of this policy."

The Personal Auto Policy reads somewhat differently. A policy master agreement is set forth, followed by subagreements for any coverages the insured purchases. The master agreement reads:
"In return for payment of the premium and subject to all terms of this policy, we agree with you as follows:..."

②Definitions- What does a particular word mean in the context of a type of insurance policy? The definition of a unique term is given at times in a glossary included with the insurance policy. They may also be found in the body of the text, explained as the policy terms unfold. Definitions must be succinct and relevant to the contract at hand. In the insurance contract, the insurer agrees to assume a risk of loss in exchange for premium payments. The extent of this risk assumed by the insurer, the policy coverage, is defined and limited by the language in the insurance policy. A primary goal of insurance contract language is to avoid ambiguity. There is a good reason for this. The general rule covering contracts of adhesion (i.e., insurance contracts) is that any language a court decides is ambiguous or open to doubt will be construed against the drafter of the contract. If the contract does not adequately define a word, the courts will.

③Declarations- This is the part of an insurance policy containing information regarding the insurance risk for which the policy was issued. It is a statement relative to underwriting made by the prospective insured at the time of the application. The policy declarations identify the insured, the nature and amount of coverage, the basis by which the premiums are determined, and any supplemental information provided by the insured.

④Exclusions- The clauses related to exclusions would list any type of risk, hazard, specific property or condition in the contract that are not covered by the policy. Policies try to clearly identify losses not covered by the policy. Usually excluded are losses that could arise from a catastrophic event or losses associated with a moral hazard, such as a theft committed by the insured. The insured has no right to collect payment for the specified losses, if they occur. The relationship between exclusions and coverage issues will be examined in the next chapter.

⑤Conditions- Include prerequisites or requirements or possible future events that will trigger the duty to perform a legal obligation. In the insurance contract, they are the limiting and defining provisions that state the rights and duties of the insured or the insurer. A condition might state how the contract is terminated or define what would exclude coverage under the contract. A foundation is provided for the policy by the conditions listed. They enumerate the relationships, rights, and duties between the insurer and the insured.

New York insurance law has served as a model for much insurance regulation all over the country. Other states have laws with similar, if not identical, requirements. The illustration following has relevance in every state. The 1943 New York Standard Fire Insurance Policy (SPF) serves as an example of comprehensive conditions. It is shown separately as Unit 5-1. Follow the bold print down the page. Line 1 is "Concealment, fraud"; line 7, "Uninsurable and excepted property"; line 11, "Perils not included"; line 25 "Other Insurance"; and so on... These headings are the components of the insurance contract as mentioned above.

This policy served as the mainstay of all property insurance forms for three decades and has been tested and interpreted by the courts. It has been replaced today by updated forms written in "plain" English, but still serves as a good example of conditions associated with policies.

⑥Endorsements or Riders- These are written modifications of an insurance policy that changes the original, often standardized, contract if insurance. Endorsements may broaden or narrow the original policy language. Strictly speaking, a rider is documentation attached to an existing policy that augments or deletes from policy provisions. It is generally used to extend coverage for some specific reason. Endorsements are themselves often standardized. Basically, endorsements or riders are the documents used to shape the standardized policy to fit individual needs. At least one form must be added to the insuring agreement and the terms and conditions in order to structure a complete contract. One form that would complete the policy is the general property form. This is a form developed by the Insurance Services Office (ISO). It is intended to bring additional standardization to the fire policy. The form includes provisions for covering the building and permanently attached machinery of an insured as well as covering personal property for the insured. Another frequently utilized endorsement is the extended coverage endorsement. For an extra premium, the insured adds coverage for perils including explosion, riot, civil commotion, smoke, windstorm and hail...

⑦Deductibles- It is a common provision in property/casualty insurance policies for the insured to pay the first dollars of an insured loss. A deductible provision in an insurance policy causes this result. A straight deductible has the insurer pay only for the amount of loss in excess of the deductible amount. Thus, if there were a $5,000 loss and a $500 straight deductible, the insured would pay $200 and the insurer would pay the remaining $4,500.

Deductibles are found in the contract provisions for two reasons. They reduce the moral hazard as the insured must pay a small part of every loss. They eliminate the expenses that would be involved in settling small claims. The savings from reduced expenses and loss claims translates into lower insurance costs for the public. As the insured’s deductible becomes larger, the premium gets smaller. Many individuals and firms see the higher deductible-lower premium cost savings as a positive step towards self-insurance on low-frequency loss perils.

Unit 5-1; Standard Fire Insurance Policy

Concealment fraud This entire policy shall be void it, whether before or after a loss, the insured has wilfully concealed or misrepresented any material fact or circumstance concerning this insurance or the subject thereof, or the interest of the insured therein, or in case of any fraud or false swearing by the insured relating thereto.

Uninsurable and excepted property. This policy shall not cover accounts, bills currency, deeds, evidences of debt money or; securities; nor, unless specifically named hereon in writing, bullion or manuscripts.

Perils not included. This Company shall not be liable for loss by fire or other perils insured against in this policy caused, directly or indirectly, by (a) enemy attack by armed forces, including action taken by military, naval or air forces in resisting an actual or an immediately impending enemy attack, (b) invasion, (c) insurrection (d) rebellion; (e) revolution; (f) civil war; (g) usurped power; (h) order of any civil authority except acts of destruction at the time of and for the purpose of preventing the spread of fire, provided that such fire did not originate from any of the perils excluded by this policy; (i) neglect of the insured to use all reasonable means to save and preserve the property at and after a loss, or when the property is endangered by fire in neighboring premises, (j) nor shall this Company be liable for loss by theft.

Other Insurance Other insurance may be prohibited or the amount of insurance may be limited by endorsement attached hereto.

Conditions suspending or restricting insurance. Unless otherwise provided in writing added hereto this Company shall not be liable for loss occurring
(a) while the hazard is increased by any means within the control or knowledge of the insured; or
(b) while a described building, whether intended for occupancy by owner or tenant, is vacant or unoccupied beyond a period of sixty consecutive days; or
(c) as a result of explosion or riot, unless fire ensue, and in that event for loss by fire only.

Other perils or subjects Any other peril to be insured against or subject of insurance to be covered in this policy shall be by endorsement in writing hereon or added hereto.

Added provisions. The extent of the application of insurance under this policy and of the contribution to be made by this Company in case of loss, and any other provision or agreement not inconsistent with the provisions of this policy, may be provided for in writing added hereto, but no provision may be waived except such as by the terms of this policy is subject to change.

Waiver provisions No permission altering this insurance shall exist, or waiver of any provision be valid, unless granted herein or expressed in writing added hereto. No provision, stipulation or forfeiture shall be held to be waived by any requirement or proceeding on the part of this Company relating to appraisal or to any examination provided for herein.

Cancellation of policy This policy shall be cancelled at any time at the request of the insured, in which case this Company shall, upon demand and surrender of this policy, refund the excess of paid premium above the customary short rates for the expired time. This policy may be cancelled at any time by this Company by giving to the insured a five days' written notice of cancellation with or without tender of the excess of paid premium above the pro rata premium for the expired time, which excess, if not tendered, shall be refunded on demand. Notice of cancellation shall state that said excess premium (if not tendered) will be refunded on demand.

Mortgagee interests and obligations If loss hereunder is made payable, in whole or in part, to a designated mortgagee not named herein as the insured, such interest in this policy may be cancelled by giving to such mortgagee a ten days' written notice of cancellation.

If the insured fails to render proof of loss such mortgagee, upon notice, shall render proof of loss in the form herein specified within sixty (60) days thereafter and shall be subject to the provisions hereof relating to appraisal and time of payment and of bringing suit. If this Company shall claim that no liability existed as to the mortgagor or owner, it shall, to the extent of payment of loss to the mortgagee, be subrogated to all the mortgagee's rights of recovery, but without impairing mortgagee's right to sue; or it may pay off the mortgage debt and require an assignment thereof and of the mortgage. Other provisions relating to the interests and obligations of such mortgagee may be added hereto by agreement in writing.

Pro rata liability. This Company shall not be liable for a greater proportion of any loss than the amount hereby insured shall bear to the whole insurance covering the property against the peril involved, whether collectible or not.

Requirements in case loss occurs The insured shall give immediate written notice to this Company of any loss, protect the property from further damage, forthwith separate the damaged and undamaged personal property, put it in the best possible order, furnish a complete inventory of the destroyed, damaged and undamaged property, showing in detail quantities, costs, actual cash value and amount of loss claimed; **and within sixty days after the loss, unless such time is extended in writing by this Company, the insured shall render to this Company a proof of loss,** signed and sworn to by the insured, stating the knowledge and belief of the insured as to the following: the time and origin of the loss, the interest of the insured and of all others in the property, the actual cash value of each item thereof and the amount of loss thereto, all encumbrances thereon, all other contracts of insurance, whether valid or not, covering any of said property, any changes in the title, use, occupation, location, possession or exposures of said property since the issuing of this policy, by whom and for what purpose any building herein described and the several parts thereof were occupied at the time of loss and whether or not it then stood on leased ground, and shall furnish a copy of all the descriptions and schedules in all policies and, if required, verified plans and specifications of any building, fixtures or machinery destroyed or damaged The insured, as often as may be reasonably required, shall exhibit to any person designated by this Company all that remains of any property herein described, and submit to examinations under oath by any person named by this Company, and subscribe the same; and, as often as may be reasonably required, shall produce for examination all books of account, bills, invoices and other vouchers, or certified copies thereof if originals be lost, at such reasonable time and place as may be designated by this Company or its representative, and shall permit extracts and copies thereof to be made.

Appraisal In case the insured and this Company shall fail to agree as to the actual cash value or the amount of loss, then, on the written demand of either, each shall select a competent and disinterested appraiser and notify the other of the appraiser selected within twenty days of such demand The appraisers shall first select a competent and disinterested umpire; and failing for fifteen days to agree upon such umpire, then, on request of the insured or this Company, such umpire shall be selected by a judge of a court of record in the state in which the property covered is located. The appraisers shall then appraise the loss, stating separately actual cash value and loss to each item; and, failing to agree, shall submit their differences, only, to the umpire. An award in writing, so itemized, of any two when filed with this Company shall determine the amount of actual cash value and loss. Each appraiser shall be paid by the party selecting him and the expenses of appraisal and umpire shall be paid by the parties equally.

Company's options. It shall be optional with this Company to take all, or any part, of the property at the agreed or appraised value, and also to repair, rebuild or replace the property destroyed or damaged with other of like kind and quality within a reasonable time, on giving notice of its intention so to do within thirty days after the receipt of the proof of loss herein required.

Abandonment. there can be no abandonment to this Company of any property.

When loss payable The amount of loss for which this Company may be liable shall be payable sixty days after proof of loss, as herein provided, is received by this Company and ascertainment of the loss is made either by agreement between the insured and this Company expressed in writing or by the filing with this Company of an award as herein provided.

Suit. No suit or action on this policy for the recovery of any claim shall be sustainable in any court of law or equity unless all the requirements of this policy shall have been complied with, and unless commenced within twelve months next after inception of the loss.

Subrogation. This Company may require from the insured an assignment of all right of recovery against any party for loss to the extent that payment therefor is made by this Company

Characteristics Of Life Insurance Contracts

There is no standardized life insurance policy. That makes it more difficult to catalog than a homeowner's policy. The format or policy language may vary among insurers, but most life insurance companies sell policies that have comparable provisions. These basic provisions are required by state law.

➊ Incontestable clause- This part of the life insurance contract prevents the insurer from denying a claim for alleged fraud occurring at the policy's inception. The insurer has a limited period of time, usually one or two years, to discover any such fraud. After that, there can be no defense for nonpayment by the insurer. This means the insurer must pay even if fraud can be proved. Insurance contracts are contracts made in good faith. An applicant may not answer questions untruthfully or conceal information that an honest person would reveal. If the insured lies or conceals facts, the insurer may take steps to void the policy. After the statutory time period has transpired, the insurer may not contest the policy. The life insurer has a relatively short period of time to uncover any fraud. Indeed, the insurance industry itself initiated the incontestability item. This came about in the 19th century because some unscrupulous companies were voiding insurance contracts for the smallest inaccuracies.

➋ Suicide Clause A limit to the insurer's exposure in the event of suicide by the insured. If the insured commits suicide within a one or two year period after a policy's issue, payment is often limited to a return of premiums paid. The purpose of this clause is to control the moral hazard. After the restriction period is over, the insurer will pay for suicide deaths. A justification for this is that suicide, after an extended waiting period, is presumably caused by mental illness. The life insurance policy pays for death caused by any other illness. Death caused by mental illness must also be covered. Many times, a policy will contain a broad exception for "suicide, sane or insane." Courts have held that an act that would be considered suicide if committed by a sane insured will be so considered if committed by an insane insured.

An interesting counterpoint to the suicide clause is that any beneficiary who intentionally and unlawfully, as opposed to negligently or even recklessly, causes the death of the *cestui que vie* (Old Fr.: the one who lives)is held by the courts to be disqualified from receiving the proceeds. "Intentional" in this context is limited to the actual specific intent to bring about death. The *cestui que vie* is the person by whose life the duration of the insurance contract is measured. It is not coextensive with the more expansive tort or criminal definition of the word. An exception to this rule is that the beneficiary is not disqualified if he caused the death as an act of self-defense or while insane.

➌ Grace Period- This is a limited period of time, generally 30-31 days, in which an insured can pay a past-due life insurance premium without having to go through the formalities of reinstating the policy. If death occurs during this time, the premium is deducted from the proceeds payable. If payment is not made during the grace period the policy is said to have lapsed. With a lapsed policy the insured has given up the life insurance contract. Most of the expenses of acquiring the life insurance policy and putting it in force occur in the first years of the policy. Consequently, these costs must be recovered in the early years of the contract. A lapsed policy is expensive for the insurance company.

Grace periods generally provide that an insurer cannot forfeit coverage under the policy during a given grace period. Remittance of an insurance premium prior to the end of the grace period keeps the policy in force. The period was established in recognition of the fact that certain enumerated personal insurance policies are often long-term insurance contracts which require additional safeguards against policy forfeiture for nonpayment of premiums. As a result, grace periods in most states are now statutorily mandated under applicable state insurance law. One reason for this is that the rules for grace periods applicable to group insurance policies are far more complex than those for individual life policies.

❹ Reinstatement Provision- This is a provision that gives a life insurance policyholder the right to return a lapsed contract to its original terms. Reinstatement must occur within the specified time limits provided in the policy. Reinstatement requires evidence of insurability, as well as payment of all policy financial obligations such as outstanding loan balances and missed premium payments. In New York, for example, there is a limit of three years from the date of default within which time the policy may be reinstated. The right of reinstatement can be valuable to the insured if premium rates have risen or if settlement or annuity options in the old policy are more favorable than ones being currently offered. This does not preclude the insurer's conditioning of reinstatement on the acceptance by the insured of changes in the terms of the policy.

❺ Entire Contract Provision- Acknowledgment must be made that the written policy, including the application for insurance when attached to the policy, makes up the complete contract between the parties. This allows the insured time to review the responses recorded in the application. Applicants should review and record all responses in the insurance application for correctness. A statement made in connection with the application cannot be used by the insurer to deny a claim unless the statement is a material misrepresentation. This provision also keeps the insurer from including any unwanted restrictions as a part of the contract. In times past changes were accomplished without the knowledge of the insured by modifying the charter or bylaws of the insurance company. The beneficiary of the policy as well as the named insured are protected by this provision. Policyholders should double-check all documentation to avoid mistakes.

❻ Misstatement of Age Provision- The age of the applicant is a key factor in the underwriting process for life, health, and auto insurance. Be it unintentional or otherwise, a misstatement of age will cause rating errors. This misstatement does not allow the insurer to avoid a policy when the misstatement is discovered. It permits the insurer to adjust the face amount of insurance to reflect the insured's actual age. Assume that Mr. Smith, rated as a 45-year old, was paying $25 per $1,000 of insurance. It turns out Mr. Smith is actually 49 years old. The premium for someone that age is $28 per $1,000 of insurance. The face amount of coverage for Mr. Smith will be adjusted downwards by 25/28 (about 11%). If the misstatement of age was to be discovered after Mr. Smith's death, the death benefit of $100,000 would be reduced to $89,285 (25/28 x 100,000).

❼ Dividends and Surplus- Life insurance companies that offer participating policies must make an annual determination as to whether or not any dividends are payable to policyholders. The details of the arrangement must be described in the insurance contract. Participating life insurance is associated with mutual insurers, since almost all of their plans are sold on the participating basis. However, both stock and mutual insurers issue participating policies. The policyholder has a right to share in the divisible surplus of the insurer. This "dividend" is not income; it is a return of an overcharge of premium. Policy dividends originate in the following ways;
❅ difference between expected and actual mortality experience
❅ excess interest earnings on the legal reserve assets portfolio
❅ variance between expected and actual operating expenses

The dividends can be received by the insured in several ways;
▪ Cash- The policyowner receives a check from the insurer at some time stipulated in the contract.
▪ Reduction of Premiums- The next premium payment will be reduced.
▪ Accumulate- The insurer retains the dividend and interest is paid.
▪ Paid-up Additions- An additional amount of paid up insurance can be purchased.
▪ Term Insurance- One year or yearly renewable term insurance can be purchased with the dividend.

Policies that do not pay dividends are nonparticipating policies. The companies offering these policies calculate the operating results for the company on a narrower actuarial basis. They are more realistic concerning operating projections than the conservative projections of the mutual companies. What this means is the insurers are using smaller margins of error, there loss range (standard deviation) is allowed to be tighter. This should not be seen as a “good” or “bad” situation. Statistical modeling, that is, the forecasting of death rates, becomes more sophisticated every year. With the advent and availability of more powerful computing tools, mid-sized companies can easily use data available to them to economically predict loss ratios. Stock life insurance companies normally sell their policies on a nonparticipating basis. These types of policies are known in the vernacular as “par” and “nonpar” insurance policies.

❽ Other Restrictive Clauses- Other restrictive clauses will be found in the life insurance contract. Among them are aviation, scuba and skydiving restrictions, war restrictions, and hazardous occupation restrictions. The purpose of these restrictions is to reduce the risk exposures for the insurer. Riders covering these activities can be attached to an individual contract at an increased premium rate.

Insurance Contract Riders and Options

As with the property/casualty policy, options and riders are available for the life insurance contract. These options are intended to tailor the policy to fit the needs of the individual. Here is a summary of some of the options available.

◎Nonforfeiture Options- These are ways in which a cash value life policy can be taken when it is surrendered. State laws require insurers to provide a minimum nonforfeiture value to policyowners. Options include cash value, reduced paid-up insurance, and extended term insurance.

◎Settlement Options-These are methods by which life insurance policy proceeds con be paid other than in a lump sum. Options include fixed-period, fixed-amount, and life income.

◎Guaranteed Insurability Option- A life or health insurance option that allows the policyholder to periodically purchase additional amounts of insurance at future dates without evidence of insurability.

◎Waiver of Premium Option- This benefit provides for a waiver of all premiums coming due during a period of total disability for the insured.

◎Double Indemnity Option- Under this provision, double the face amount of the policy is payable when the insured dies. It is subject to certain conditions but normally refers to accidental death before a specific age. Death must occur within 60-90 days after the accident.

Distinctive Features Of The Insurance Contract

The insurance contract has the basic elements of any other contract. Those elements are summarized (not in correct order) by the acronym COALL. It stands for Consideration, Offer, Acceptance, Legal capacity to contract, and Legality of subject matter. Notice should be given to the fact that in writing is not an element that must be present to have a valid contract. This is important where the concepts of waiver and estoppel are concerned. Here are the features that make an insurance contract different from other contracts.

Aleatory Contract

With this type of contract, the values that are exchanged are not equal. The insured may receive a value out of proportion to the value given. Most contracts are commutative contracts. Commutative contracts involve an equal exchange of money for goods or services. This represents an even exchange, the goods change hands at the market rate or there is some bargaining involved. The insurance contract is an aleatory contract. Its performance depends upon the occurrence of a chance event in the future. That event is the insured peril. If it does not occur, no performance on the part of the insurer is required.

Risk and the Contract

Risk is measurable. Uncertainty, by definition, is not measurable. Insurance is the financial yardstick of risk. Insurance is akin to the manufacturing process, producing certainty as the finished product and using risk as the raw material. The basic nature of the insurance contract is to put a dollar value on the chance occurrence of some fortuitous event. The insurance contract is not a gambling contract. Gambling involves a speculative risk that is created with the transaction. Insurance, on the other hand, is a way to deal with a risk or peril that already exists. The risk of financial loss due to dying or an automobile accident existed before the contract was formed. Insurance and gambling can both be described as aleatory in nature. With the insurance contract no new risk is created. With insurance, the insurer takes the chance of being required to pay the sum agreed upon; and the insured takes a chance by paying the premium or consideration without receiving anything for it if the contingency does not happen.

Time is the governing factor in gambling. Risk and time are opposite sides of the same coin. If there were no tomorrow, there would be no risk today. Time changes the perception we have of risk. Risk and its characteristics are fashioned by the time horizon. For risk practitioners, be they gamblers or insurance professionals, the future is the playing field. The gambler thinks he or she is betting on a full house, a can’t-lose football team, or the best doggone dog at the track, but what the gambler is really betting on is the clock. They appeal to lady luck to suspend the law of averages so winning streaks will continue and make the reverse appeal so that losing streaks will come to a speedy end. Risk managers at insurance companies are making the same plea. Premiums are set to cover losses over the long run, but insurers maintain sufficient capital and reserves to carry on during those unavoidable periods of bad luck

Adhesion Contract

This legal concept says buyers must adhere to the preexisting terms of a standard contract. The terms signify an inequality of bargaining power as the buyer has no say concerning rates or terms. This concept often arises with any standard form printed contracts submitted on a take-it-or-leave-it basis. It got its start long ago in the process of drawing treaties between nations. When a nation wanted to join in on a treaty already drawn up by other nations, the state wishing to join would sign the treaty and adhere to the existing provisions. The entire contract must be accepted, with all of its terms and conditions. The contract may be altered by the addition of endorsements or forms, but those instruments are also always drafted by the insurer.

As a result of the forced acceptance nature of the insurance contract, if there are any ambiguities, the general rule is that the insured gets the benefit of the doubt. Ambiguities in the document are construed against the party who drew up the paperwork. This is the rule of strict construction of contracts.

Reasonable Expectations-It was pointed out in Chapter 3 that when terms and agreements in a contract are not made perfectly clear, the problem is called ambiguity. As a buttress to the rule concerning ambiguities, the <u>principle of reasonable expectations</u> states that an insured is entitled to coverage under a policy that they reasonably expect it to provide, and that it be effective. Exclusions or qualifications must be conspicuous, plain, and clear. Contracts of insurance are construed according to the terms that the parties have used. The terms are used, in the absence of ambiguity, in their plain, ordinary meanings. The noted jurist, Justice Learned Hand, put it this way, “Insurers who seek to impose upon words of common speech an esoteric significance intelligible only to their craft, must bear the burden of resulting confusion.” [Gaunt v. John Hancock Mutual Life, 160 Fed. 2nd 599 (1947)]. Justice Hand rightly observes that the insurance policy is complex. Most policyholders do not read their policies or understand the terms. The policyholder usually relies on the knowledge and ability of the agent, and this has given rise to the principle of reasonable expectations. Unfortunately for insurers, this doctrine has no clearly defined limits.

Fundamental Rules of Contract Interpretation

This section looks at the interpretation rules of contracts as they are generally accepted in the legal forum. We said an adhesion contract, when ambiguous, is interpreted by the courts in favor of the person who did not promulgate the contract terms. There follows here some basic rules of contract interpretation, very basic but very important. These rules are alluded to time and again in court cases, in the media, and by those who have corner offices and speak legalese. Everyone should be familiar with these rules. Where the written words or language in which the parties embodied their agreement or contract may not be changed by parol evidence, the ascertainment of the meaning to be given to the written language is outside the scope of the parol evidence rule. The written words are sacrosanct. They are the terms of the contract. However, words are but symbols. If their meaning is not clear, it may be made clear by the application of rules of interpretation or construction, and by the use of extrinsic evidence for this purpose where necessary. As stated in one case:

"The great object of construction is to collect from the terms or language of the instrument, the manner and extent to which the parties intended to be bound. To facilitate this, the law has devised certain rules, which are not merely conventional, but are the canons by which all writings are to be construed, and the meaning and intention of men to be ascertained. These rules are to be applied with consistency and uniformity. They constitute a part of the common law, and the application of them, in the interpretation and construction of dispositive writings, is not discretionary with courts of justice, but an imperative duty." Johnson County v. Wood, 84 Mo.489 (1884).

Where the language in a contract is clear and unambiguous, extrinsic evidence tending to show a meaning different from that which the words clearly import will not be received by a court. It is the function of the court to interpret and construe written contracts and documents. Rules of interpretation are adopted in order to apply a legal standard to the words contained in the agreement by which to determine their sense or meaning.

Among the rules which aid interpretation are:

1. A writing is interpreted as a whole and all writings that are part of the same transaction are interpreted together.
2. All circumstances accompanying the transaction may be taken into consideration.
3. The ordinary meaning of language throughout the country is given to words unless circumstances show a different meaning is applicable.
4. Conduct of the parties subsequent to a manifestation of intention indicating that all of the parties placed a particular meaning upon the manifestation may require the adoption of such meaning.
5. Technical terms and words of art are given their technical meaning unless the context or a usage which is applicable indicates a different meaning.
6. The principal apparent purpose of the parties is given great weight in determining the meaning to be given their manifestation of intentions.
7. An interpretation that gives a reasonable, lawful, and effective meaning to all manifestations of intention is preferred to an interpretation which makes a part of such manifestations unreasonable, unlawful, or of no effect.
8. Where there is an inconsistency between general provisions and specific provisions, the specific provisions qualify and control the meaning of the general provisions.
9. Where written provisions are inconsistent with printed provisions, an interpretation is preferred which gives effect to the written provisions.
10. Where a public interest is affected an interpretation is preferred which favors the public.

In an action for breach of a written sales contract the subject matter was described as "Season's output of cotton linters for season 1915-1916, about four hundred (400) bales." The defendant seller shipped to the plaintiff buyer 155 bales of linters which was the total output of its mill for the season. The buyer sued for failure to deliver 245 bales. Cotton linters were a by-product of defendant's cottonseed oil mill. The Court construed the contract as one for season's output and not for 400 bales, upon the ground that the specific language controlled the general, and held for defendant. McKay & Spier v. Yorkville Cotton Oil Co., 109 S.C. 462, 96 S.E. 524 (1917).

Words contained in a document prevail over inconsistent figures and numerals. In Schorzman v. Kelly, 71 Wash.2d 457, 429 P. 2d 217 (1967), the plaintiffs on September 20, 1955, leased from defendant landlord certain farm lands. The lease recited that "the landlord hereby leases to the tenants for ten years commencing on January 1, 1956, and ending December 31, 1966." On February 3, 1965, the landlord gave plaintiffs written notice that the lease would expire on December 31, 1965, and would not be renewable thereafter, and in April, 1965, leased the land to defendant Schorzman who in the fall of 1965 commenced plowing and seeding for a crop to be harvested in 1966. Plaintiffs filed suit to enjoin defendant's landlord and the successor tenant from using the land for a 1966 crop on the ground that the lease did not terminate until December 31, 1966. The Court held for defendants stating that the words of the commencing date "January 1, 1965", and of the term "ten years" would prevail over the figures "December 31, 1966". The Court therefore concluded that plaintiffs had a ten-year lease that commenced with the 1956 crop year and terminated with the 1965 crop year.

A determination of the scope of coverage provided by a public liability automobile policy may involve distinguishing the word "use" from the word "occupy". Allstate Insurance Company had issued a policy to Edwin Boesken which covered both Boesken and his daughter Carol. Employer's Group Insurance Company had issued its policy to William O'Brien covering an automobile owned by O'Brien which while being driven one evening by Carol Boesken collided with another car causing injury and damage to third persons. O'Brien had given permission to his daughter Mary to drive his car that night, and knowing that Carol would be a passenger in the car told Mary not to let Carol drive. Contrary to this instruction Mary allowed Carol to take the wheel. Allstate admitted that its policy protected the Boeskens while driving another car, but contended that its coverage was in excess of that provided by Employer's under its policy issued to O'Brien and covering the O'Brien car. This would be true if Carol were within the coverage of Employer's policy. This policy protected O'Brien, the named insured, and any other person "using" the car with his permission. Although Carol had O'Brien's permission to "occupy" the car as a passenger, she did not have his permission to "use" it in the sense of operating it. The Court held that Mary had no authority to delegate permission to use the car to Carol, and Carol was therefore not within the protection of Employer's policy. Allstate Ins. Co. v. Employer's Group Ins. Co., 18 Ohio Misc. 62, 246 N.E.2d 924 (1969).

In an action by the owner of truck-tractors and trailers to recover from defendant common carrier additional compensation for the transportation of freight pursuant to a written contract, the court held that the terms of a written contract may be changed by subsequent oral agreement between the parties. The contract provided that plaintiff would furnish trailer and tractor, employees for the unit, and pay all license fees and taxes, and would receive a certain percentage of the revenue received by defendant carrier on the hauls. During the period of the contract plaintiff made 28 trips hauling missiles or high-explosive radioactive materials which defendant had accepted for transportation under a contract with the government. On all regular hauls the plaintiff was furnished a bill of lading which indicated the revenue being paid to defendant carrier. There were no bills of lading on any of the 28 trips. These trips required a special trailer which plaintiff was unable to furnish and which was provided either by defendant or the government. Plaintiff contended that no new agreement was made with respect to his compensation for making these 28 trips. Defendant's office manager testified that before the first such trip was made, plaintiff agreed on $1 per loaded-mile. Plaintiff accepted compensation at this rate on the 28 trips over a period of 15 months, and did not complain of any underpayment on any of the trips until four months after the last trip was made. He then ascertained the amount of revenue which defendant had received for the 28 hauls and claimed the percentage thereof specified in the written contract, an additional $14,390. The Court held for defendant on the ground that under the evidence the 28 trips were not included within the written contract but were handled pursuant to subsequent oral agreement. Jenkins v. Watson-Wilson Transportation System, Inc., 183 Neb. 634, 163 N.W.2d 123 (1968).

The rule of construction in an insurance contract is based on the premise that the insurer's legal staff promulgated the language and terms in the contract. As such, it can be believed that the insurance company had every opportunity to serve its own best interests. Legal counsel and concise understanding of the policy are usually lacking on the part of the insured. This party has simply adhered to the agreement without comprehending its terms. The insurer, as a result, must pay the penalty for any ambiguity the contract creates.

Statutory law in many instances requires insurers to use standardized policy forms. As a result, it is the insurance commission, as well as the insurer, who have chosen the policy language. Insurance contracts are now required to include terms and conditions mandated by the regulatory authority, seemingly undermining the notion of strict construction against the insured in the event of ambiguity. It remains to be seen if this trend will affect the rule of strict construction against the insurer.

Here is a case that illustrates examines the relationship between the insurance contract and public policy. It also looks at the poorly named feature of "double indemnity" for accidental death. A life insurance contract is not a contract of indemnity. Public policy and indemnity are topics are examined in the sections following.

Karl v. New York Life Insurance Co.

Superior Court of New Jersey
139 N.J. Super. 318, 353 A.2d 564 (1976),
154 N.J. Super. 182, 381 A.2d 62 (1977)
STANTON, J.C.C., Temporarily Assigned.

This is an action to recover under the accidental death benefit (double indemnity) provisions of two life insurance policies. Defendant insurance company has refused to pay these benefits on the ground that the insured died 11 months after the accident that allegedly caused his death, whereas the two policies in question provided that death must occur within 90 days or 120 days of the accident for accidental death benefits to be payable.

There is no reported New Jersey decision in point. The rule in almost every jurisdiction which has considered the question is that the time limitations set forth in the policy are controlling and that recovery must be denied in a case such as the present one. *See* Appleman, *Insurance Law and Practice* (2d ed. 1963), § 612....

Edward J. Karl suffered severe brain and skull injuries in a criminal assault made upon him in Madison, New Jersey, on January 6, 1969. Without ever having regained anything remotely approaching normal physical or mental functioning, he died in Morristown Memorial Hospital, Morristown, New Jersey on December 6, 1969. At the time of his death Karl was covered by two life insurance policies issued by defendant New York Life Insurance Company which contained accidental death benefits in addition to ordinary death benefits. One of the policies had been issued in 1955, the other in 1963. The insured's wife, plaintiff Rosemary M. Karl, was the beneficiary under each policy. Defendant insurance company has paid the $10,000 face amount of each policy to the beneficiary, but has refused to pay the accidental death benefit. Its refusal is based primarily upon the time limitation for the period between date of accident and date of death in each policy. The limitation is 90 days for the 1955 policy and 120 days for the 1963 policy. The refusal to pay is also grounded upon a secondary factual argument that death was not caused solely by the accident but was also partially the result of an intervening lung infection.

The 1955 policy provided in pertinent part that

The Company will pay to the beneficiary . . . an additional amount (the Double Indemnity Benefit) equal to the face amount of this policy upon receipt of due proof that the Insured's death resulted directly, and independently of all other causes, from accidental bodily injury and that such death occurred within 90 days of such injury ....

The 1963 policy provided in pertinent part that

. . . the Company will pay the Accidental Death Benefit, as part of the policy's death benefit proceeds, upon due proof that the Insured's death resulted directly, and independently of all other causes, from accidental bodily injury and that such death occurred within 120 days after such injury....

The insured suffered severe brain and skull injuries when he was criminally assaulted in the early evening of January 6, 1969. He was admitted promptly to Morristown Memorial Hospital. Within hours after his admission to the hospital, he underwent drastic brain surgery. Four additional surgical procedures were per-formed on the insured between the date of his admission and April 22, 1969. Karl remained in Morristown Memorial Hospital until June 13, 1969, when he was transferred to the Morristown Rehabilitation Center, a nursing home. He remained at the Rehabilitation Center until August 13, when he was readmitted to Morristown Memorial Hospital. He died in the hospital on December 6, 1969.

From the date of the accident to the date of his death Karl was totally paralyzed, except that he occasionally was able to squeeze with one hand in response to command or by way of primitive communication. A tracheotomy was necessary to permit breathing. The insured never was able to speak. He could never feed himself and, indeed, could never eat anything approaching a normal diet. So far as could be observed, the insured never achieved anything approaching full consciousness or normal intellectual functioning....

Having reviewed the medical testimony in this case, I am satisfied that it has been clearly and convincingly established that Karl died on December 6, 1969 as the direct result, independently of all other causes, from accidental bodily injury received by him on January 6, 1969. I am equally satisfied that the infection existing at the time of Karl's death was a normal part of the pathology resulting from the massive traumatic brain damage and does not amount in any legally significant sense to an independent cause of death. Hence, there has been an accidental death within the meaning of both policies upon Mr. Karl's life.

We turn now to the time limitations upon recovery for accidental death imposed by the policies. As a matter of fair linguistic analysis, there is no ambiguity about the time limitations imposed by these policies. The clear, unequivocal thrust of the language in both policies is to exclude coverage where death does not occur either 90 days or 120 days after the date of accident. Read in a literal and straightforward way, the policies would exclude recovery in this case.

The vast majority of courts construing time limitations such as the ones contained in the present policies have enforced the policies as written and have denied recovery where death did not occur within the time period set forth in the policy. *See* Appleman, *op.* cit., § 612. They have done so because such a result is clearly called for by the language of the applicable policy, and because, as a matter of basic legal philosophy, there is a great deal to be said for giving straightforward effect to clear contractual language. Nevertheless, the fair application and development of law is more than a matter of good linguistic analysis, and a legal result should not be accepted merely because it is called for by contractual language. This fundamental proposition was recognized by the Pennsylvania Supreme Court in *Burne v. Franklin Life Ins. Co.,* [451 Pa. 218, 301 A.2d 799 (1973)].

In *Burne* the court held that time limitations such as these are unenforceable because they violate public policy in that they introduce into the agonizing, difficult and delicate deliberations of the treating physicians and family of a mortally injured person a potentially sinister economic factor suggesting non-treatment. The problem is that as the patient's life is prolonged by treatment, insurance death benefits to his family may be decreased. Although there may be many cases where simple love for the patient and the underlying medical realities and expectations may suggest that certain forms of treatment not be undertaken, or that they be abandoned at some point after they have been started, this most difficult of human decisions should not be influenced by the crass thought that death benefits will be reduced if the patient lives beyond a certain number of days. This is the public policy foundation of the Pennsylvania Supreme Court's decision.

The court also noted in *Burne* that the time limitations in policies such as the one before us were developed in an age when medicine was much less advanced than it is today and when causation was much less traceable than it is today. Also, the development of these time conditions predated the present ability of medicine to prolong life. The Pennsylvania court viewed the purpose of this time condition as being the elimination of doubt as to the cause of death. Where the cause of death is clear, there is no reason for the condition, and the condition should simply be dropped from the policy. As the court said:

Under the life insurance contract the specific hazard indemnified is premature death resulting from an accident. Recovery for that loss should not be forfeited by the arbitrary and unreasonable condition that payment will be made only if the accident victim dies within ninety days but not if he survives beyond that point. On this record it is obvious that to enforce the ninety-day condition would serve only "as a trap to the assured or as a means of escape for the company in case of loss." [451 Pa. at 226, 301 A.2d 799 at 803.]

I am persuaded that the public policy position of the Pennsylvania court in *Burne* is sound. I also believe that in a case such as the present one where the cause of death is clear, the enforcement of a 90-day or 120-day time limitation would be arbitrary and unreasonable.

There is another, perhaps more basic, reason for allowing recovery in this case. It is a reason which I have not seen enunciated in any decision dealing with the interpretation of an insurance policy, but it is a reason which underlies much of the judicial approach to the whole problem of insurance coverage. That reason is founded upon the recognition of the enormous social utility of having losses covered by insurance. Because of the enormous social utility of insurance coverage, whenever there is a reasonable coverage, the court should find coverage if the terms of the policy (read broadly in light of the general social and economic factors surrounding the policy) afford any fair and reasonable basis for finding coverage. In short, as a matter of basic public policy, courts should find coverage wherever it is possible to do so on a fair basis. Such an approach would lead to the conclusion that time conditions contained in an insurance policy should be read in terms of broad purpose and function in cases in which a literal reading would defeat coverage.

It should be noted that I am not suggesting that all time terms in an insurance policy are to be read in a broad functional sense. Surely, some time terms must be read literally. For example, the time terms setting forth the period during which the policy is in force would almost always have to be read literally because any other reading of them would destroy any fair and reasonable basis for defining and limiting the period of coverage....

The Insurance Contract and Public Interest

A conflict exists between the right of the insurer and the insured to "freely" contract on one hand, and the right of the state to protect the insured from any "unconscionable advantage" the insurer might have in such transactions.
With auto insurance, for example, most state insurance departments want to provide broad coverage for members of the public who are injured in motor vehicle accidents. This holds true even though the insurance company may be unwilling to provide coverage to high-risk drivers. In spite of this, the state legislature can make insurance companies assume the unwanted risk distribution. In any conflict between the insurer's policy terms and state public policy, the state's statutory mandate will prevail.

The courts see the insurance contract as different from other economic transactions. Insurance is a matter of necessity rather than a matter of choice. Again, we allude to the difference between a market/demand economy, where the individual is expected to make purchase and economic decisions himself, and a socialist/command economy, where the state makes the economic decisions and (theoretically) provides economic security for the individual. The socialist model did not work, nor did the laissez faire style of capitalism in an industrialized economy. Often the insurance product, such as liability insurance, involves both the interests of the insured and the society as a whole. Insurance is a business affected with the public interest.

What is the public interest? By the nature of things, this is up to individual courts. No objective evaluation exists, even though jurists will state that an objective eye has been cast on the proceedings. There is inherent difficulty in drawing clear lines or predicting the outcome of cases involving unique fact situations. This area of law is dependent on the individual court's concepts of public good. It will vary among jurisdictions and regions of the nation. Against the public good, there must be weighed the various views on the freedom of contract. Insurance contracts are, after all, merely an agreement between the insured and the insurer to cover a peril.

Concept of Indemnity
This involves the obligation to make good any loss or damage another person has incurred or may incur. Insurance contracts are intended to provide compensation for losses sustained by an insured. The insured should be in the same financial position after the loss as before the insured event took place. However, it is not intended that the insured should profit from the insurance coverage.

Life insurance, replacement cost insurance, and valued insurance are not actually contracts of indemnity. Life insurance cannot be considered one because the monetary value of the loss sustained cannot be objectively measured. Before 1820, for example, the courts in France had declared that life insurance contracts were void because they "set a price upon the life of a freeman, which is above all price." Such noble thoughts do not stop underwriters today from avoiding the overinsuring of any individual. Insureds cannot contract for more life insurance than their financial position warrants. Otherwise, an unacceptable moral hazard would be created. The insureds would be worth more dead than alive.

Replacement cost insurance is typically found in homeowners' policies. The insurance company pays an amount equal to the full cost of repairing or replacing the property without deduction for depreciation. Such a policy has the potential for moral hazard, so conditions are set up to reduce the potential for problems.

A policy that pays the face amount whenever a total loss occurs is called a valued insurance policy. This is also an exception to the rule of indemnity. A total loss to the property insured may cause more or less damage than the amount originally agreed. Only this stated amount from the policy will be paid in the event of a total loss. Such policies are used with objects for which market value is difficult to determine (art, rare coins, etc.).

The underlying philosophy of insurance is that a transfer of loss from the insured to the insurer takes place. Involved in the transfer is the concept that the value of the benefit to be received will not exceed the loss incurred. The same idea applies to liability insurance. It is not the purpose of liability insurance that an injured party should make a profit or be better off, after a loss than before it.

Moral Hazard- This concept refers to any person who deliberately causes a loss to defraud an insurer. A person will exaggerate the size of a claim to defraud an insurer. Personal habits, living environment, or lifestyles can increase the chance of loss for an individual rather than the nature of property covered or its location. The possibility of making a gain from a property loss adds to the ills of wagering and inducements to destroy property. Any time an insured can destroy property and obtain an amount greater than its value, the moral hazard will be the possibility of deliberate harm caused by the insured in order to obtain the policy proceeds.

There are three important insurance concepts closely related to the principle of indemnity; subrogation, insurable interest, and actual cash value.

Subrogation

Generally defined, subrogation is the substitution of one party (the insurer) to another party’s (the insured’s) rights. The substitution occurs because the first party has made a payment for which another is responsible. In insurance, subrogation occurs when the insurer pays a claim while the insured possesses a right of action against a third party for causing a loss. The idea is that if a person pays a debt for which another person is liable, that payment should give the debt-paying person a right to collect the debt from the liable party.

A good example of subrogation is the automobile insurance collision policy. Mr. Smith is responsible for a collision with Mrs. Wilson. Mrs. Wilson may sue Mr. Smith for damages, or she may collect under her own auto collision insurance policy. If she decides to collect her own insurance, the insurer will be subrogated for Mrs. Wilson’s in the right to sue Mr. Smith. The insurance company will “step in the shoes” of the insured so as to recover from an accountable third party, in tort or contract, for the payments made by the insurer to cover the losses of the insured. Typically, an automobile insurance policy provides that in the event of any payment under the policy, the company shall be subrogated to all the insured's rights of recovery. The insured is obligated to do nothing after loss to prejudice such rights.

Normally found in property and liability insurance contracts, subrogation clauses are also found in other types of casualty insurance. Subrogation does not apply to life or accident insurance. Subrogation can be brought about by contract or by operation of law. Unless a contract specifically provides otherwise, equitable principles apply even when a subrogation is merely the usual equitable right that would have existed in any event in the absence of a contract.

In the context of insurance, the right of subrogation is based on two premises: 1.) an insured should not be allowed to recover twice for the same loss, which would be the result if the insured recovers both from their insurer and the tortfeasor, and 2.) a wrongdoer should reimburse an insurer for payments that the insurer has made to the insured. An insurance policy reaffirms the rights of parties relative to subrogation but, in the absence of an express provision to the contrary, does not alter fundamental principles pertaining to subrogation.

Note also that when an insurer receives more from a lawsuit it pursued by way of subrogation than it paid its insured, the difference generally goes to the insured. <u>There is no subrogation in life insurance because life insurance is not a contract of indemnity.</u> Mr. A is killed as a result of B’s negligence. The survivors of A can pursue a wrongful death claim against B. The survivors of Mr. A can also collect life insurance proceeds (assuming one or more of them are listed as beneficiaries). The life insurer is not subrogated to the claim.

Insurable Interest

A concept that requires the insured event to be capable of causing a financial loss to the person owning the insurance policy. A corollary to the principle of indemnity, no person may secure insurance on a property or life in which there is no insurable interest. The individual must stand in some relation to the property that would result in economic loss upon the property’s destruction. If such was not the case a person could insure the property or life of another and collect later upon demise or destruction of the subject. Insurance becomes gambling in a situation like this. It runs against public policy, is against the law, and it creates a moral hazard. It infringes on the principle of indemnity in that the insured would show economic gain as a result of the loss.

Development of the Concept- By the middle of the 18th century, insurers had developed the practice of writing insurance on ships and cargoes with the stipulation that they would not demand proof of any interest of the insured in the subject matter of the insurance. The results of this practice were at times disastrous for insurers. To keep insurance agreements from devolving into wagering contracts, the principle needed to be installed as a rule of law. The British government addressed the situation in an Act of Parliament in 1746:

"[I]t hath been found by experience that the making insurances, interest or no interest, or without further proof of interest than the policy, hath been productive of many pernicious practices, whereby great numbers of ships with their cargoes, hath either been fraudulently lost or destroyed, or taken by the enemy in time of war: * * * and by introducing a mischievous kind of gaming or wagering, under the pretense of assuring the risque on shipping, and fair trade, the institution and laudable design of making assurances, hath been perverted ...."

".......[B]e it enacted........That.......no assurance or assurances shall be made by any person or persons, bodies corporate or politick, on any ship, or ships belonging to his Majesty, or any of his subjects, or on any goods, merchandizes, or effects, laden or to be laden on board of any such ship or ships, interest or no interest, or without further proof of interest than the policy, or by way of gaming or wagering, or without benefit of salvage to the assurer; and that every such assurance shall be null and void to all intents and purposes." Act of 1746, St. 19 Geo. 2, c. 37 § 1.

In 1774 came a second act of Parliament that created sanctions against the issuance of insurance on "the life or lives of any person or persons, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering. * * *" Act of 1774, St. 14 Geo. 3, c. 48.

These statutes made policies issued without some form of insurable interest unenforceable, yet it did not eliminate the practice of issuing such policies. Not only has it proven nearly impossible to quench gambling instincts entirely by legislation, but there were also any number of legitimate commercial situations in which the interest of the insured would be difficult to prove by legal standards. An example of the latter would be the issuance of insurance on "anticipated freight," whereby the insurance policy is issued prior to sailing, but the contract for the cargo is not entered into until it is taken on board at some distant port. Policies issued under these circumstances, therefore, simply moved, in terms of enforcement, from forums of law to forums of "honour", in that they depended for the payment of proceeds upon the honor of the insurer who could have pleaded the defense of lack of insurable interest in an action at law. Phrases commonly found in these policies include "policy proof of interest" or "P.P.I." (i.e., no further proof of insurable interest required than the existence of the policy), "interest or no interest", and "without benefit of salvage to the insurer" (because the insured had no benefit of salvage to give).

The English courts enforced the insurable interest statutes with a vengeance, holding a policy that contained any of the offending phrases listed above to be unenforceable even though the insured actually had an insurable interest. The very making of such a policy became a criminal act under the Act of 1909. American courts have taken a somewhat more lenient view, holding that while such phrases are themselves unenforceable, they do not affect the enforceability of the rest of the policy.

The American version of the insurable interest doctrine originated in court decisions following English precedent based on the Statutes of George II and George III referred to above. Subsequently, a number of states codified the general rules into statute.

<u>Property insurance</u>- The purchaser of insurance on property must have some form of ownership or financial interest in the property. Title, deed, a loan or mortgage outstanding show an interest. Insurance proceeds cannot be collected unless a person can show that loss to the property would affect them. Interest in the property must exist at the time the loss occurs. So an individual can buy insurance before the purchase of an interest in property with the intent of having the insurance in force when title passes.

<u>Life insurance</u>- There must be an interest in the life being insured. This is shown by close family relationships. It is assumed that individuals have an insurable interest in their own lives. Husbands and wives have an interest in each other’s life. So do parents and children. These types of relationships are assumed to be unlimited interests. That is, you can purchase as much insurance as an underwriter cares to issue. There are other interests that can be demonstrated; Employers and their key employees, and business partners. Creditors have interest in the lives of debtors, generally up to the amount of the debt. With life insurance, the insurable interest must be demonstrated when the contract is joined. Divorce removes the insurable interest of husband and wife, but the rule requiring an insurable interest only at the start of the policy means that the owner of the policy can lose the insurable interest during the life of the policy without affecting the insurance or the ability of the beneficiary to collect proceeds at the time of loss.

There are 33 states with statutes requiring an insurable interest in order to take out a life insurance policy on someone other than the owner of the policy. The relationships of family or affection provide extra protection against deliberate loss of life. Thus the relationship has been extended to fiancées in many jurisdictions. Aunts, uncles, cousins, nieces and nephews are generally regarded as too remote to support an insurable interest. This blood bond could make a difference if a person was raised by one or more of these relatives. It is difficult to draw clear distinctions, but the closer the family relationship, the easier it is to prove an economic relationship. The same applies with in-laws or step-children and parents. If an economic interest does not exist, there may be a creation of moral hazard.

Murderers- These malefactors are not allowed to profit from their crimes. Courts will generally instruct the insurer to pay proceeds to heirs or beneficiaries with the exception of the killer. Beneficiaries are usually free to collect insurance proceeds on the state ordered termination of the life of the condemned.

As mentioned above, people who are not close family must have an "economic interest" in the life being insured. Here is a classic case that says it all

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Rubenstein v. Mutual Life Insurance Co. Of New York

United States District Court, Eastern District of Louisiana
584 F. Supp. 272 (1984)
Charles Schwartz, Jr., District Judge
FINDINGS OF FACT

Plaintiff, Alan M. ("Mike") Rubenstein, instituted this action to recover the proceeds of a $240,000 credit life insurance policy issued by defendant, The Mutual Life Insurance Company of New York (MONY), insuring the life of Harold J. Connor, Jr. Connor died on November 6,1979. Plaintiff is the beneficiary and owner of said policy; MONY claims that plaintiff is not entitled to recovery under the policy for reasons that are the subject of this suit, and refunded to plaintiff the premiums paid by plaintiff.

Plaintiff is a resident of Louisiana; defendant is a corporation incorporated and domiciled in New York, authorized to do and doing business in Louisiana. Prior to, during, and after July, 1979, plaintiff was employed as a fulltime owner and operator of a taxicab associated with the United Cab Company of New Orleans. After attending a local seminar, he purportedly became interested in starting and developing "TV Journal," a publication similar in concept to "TV Facts," to be circulated free of charge in St. Tammany Parish. Revenues were to be derived solely from paid advertisements contained in the publication. In late July, 1979, Connor contacted plaintiff through the Louisiana Unemployment Commission in Slidell, where plaintiff had placed a notice requesting assistance in developing and operating the "TV Journal." On August 7, 1979, shortly after their initial meeting, plaintiff and Connor entered into a partnership agreement making Connor a 25% partner in the "TV Journal" business until January 1, 1980; thereafter, plaintiff would "grant" Connor a franchise for the publication of a tabloid in the St. Tammany Parish area to be entitled "TV Journal." Under the franchise aspect of the agreement, Connor was required to pay plaintiff $1000 per month for 20 years beginning on February 1, 1980, but could terminate the agreement at any time upon 60 days notice without penalty.

Also on August 7, 1979, plaintiff and Connor met with Earl Moreau, a MONY agent, regarding life insurance on Connor. Based on discussions between plaintiff, Connor and Moreau concerning plaintiff's newly established business relationship with Connor, Moreau recommended, and plaintiff applied for, a $240,000 credit life insurance policy on Connor's life, who was then 23 years old.[1] As of the date of application, Connor had done little if any work for the "TV Journal" business; and no edition of it had been published, and no advertisements sold. No evidence was introduced to demonstrate the need for this fledgling and undercapitalized business to expend its limited resources for insurance on the life of an apparently healthy 23 year old man.

In providing information for the insurance application, plaintiff and Connor represented that Connor's annual income at the time of the application was $26,000 when in fact Connor's sole source of income was the "TV Journal" business, from which he received approximately $100 to $150 a week. Had MONY known Connor's actual income, it would not have issued the policy herein since an insured earning such limited income has no reasonable prospect of repaying a debt of $1000 per month for twenty years without the life insurance.

[Plaintiff and Connor also failed to disclose to Moreau the 60-day termination provision of the agreement, which effectively limited Connor's potential maximum debt to $2000. The court found that plaintiff and Connor knew of the falsity of their representations regarding Connor's income and termination provision and that they knew that these misrepresentations were material.] '

The evidence further establishes that when plaintiff applied for the insurance policy, and when Connor died on November 6, 1979, Connor was not at all indebted to plaintiff because Connor was not obligated to begin making payments to plaintiff until February 1, 1980.

Based on the information before it, MONY agreed to issue the policy on September 28, 1979; it was thereafter delivered to plaintiff on October 6, 1979.

According to plaintiff's testimony, Connor was to do all the work in preparing the "TV Journal" for publication, while plaintiff was to provide the capital. However, Connor's education was limited to high school, and prior to August 7, 1979, he had no experience in publishing and only limited experience in sales, having worked for approximately two months without success as a furniture salesman, according to Paula Andrus, Connor's girlfriend at the time. Ms. Andrus also attested to Connor's inability to balance his own checking account, further evidence of his lack of business skill.

Plaintiff, too, had no prior experience in publishing or in selling advertisements, his only sales experience of any nature having occurred "years" ago, by his own admission. Plaintiff did observe the operations of "TV Tempo" for the purpose of learning the operations of such a weekly, and prior to August 7, 1979, had taken some preliminary steps in furtherance of the "TV Journal" (e.g. contacting printers, obtaining proofs and TV listings, and figuring possible advertising rates). But, after that date, plaintiff's involvement in the operations of the "TV Journal" was nominal at best; he testified that he did not even know whether Connor had sold a single advertisement, and plaintiff himself had made only a few calls for that purpose. Plaintiff also stated that he was not aware of what bills Connor was paying, or how much he was paying Connor in salary. As further evidence of his own lack of business acumen, plaintiff explained the origin of the provision requiring Connor to pay him $1000 per month beginning February 1, 1980, by saying that they "both came up with the idea of $1000," with no further justification for the projection.

Regarding the financing of "TV Journal," plaintiff explained that he bought some furniture for the office, which was located in Connor's apartment, and that he paid Connor's salary and "whatever" else Connor needed. The evidence indicates, however, that *at most* $5000 was available as of late August, 1979, to develop the "TV Journal" until it became profitable or generated significant advertising revenues. Most of the $5000 apparently originated from a $5433 loan issued by the Bunkie Bank & Trust Company on August 22, 1979, for which *Connor* signed the note and plaintiff provided the collateral. Of the $5433, however, $1400 was used by plaintiff to pay off a previous personal loan from Bunkie Bank & Trust, and $1000 was given to Connor for his personal use. Disposition of the remaining $3000 is unclear, although it appears that the money was deposited in plaintiff's personal account with the Hibernia National Bank, which account he used to pay Connor's salary. This account showed a balance of $1246 on November 7, 1979, which was immediately before Connor had planned to print the first issue. Plaintiffs only other account was one he maintained with Bunkie Bank & Trust from November, 1976 to November, 1979. It had an average balance of $1500 to $1800 before it was closed. The "TV Journal" account at the Fidelity Bank & Trust Company shows a balance that was overdrawn twice in a two-month period.........

In addition, the failure of "TV Journal" to presell any advertisements or to obtain any advertising contracts further impaired any likelihood of success; without presold advertisements, the business would have incurred substantial losses during its first six months, from which it would have had little chance of recovering. Given this slim chance of reaching the breakeven point, Connor would have had no realistic possibility of being able to cover the $1000 monthly payment to plaintiff.

The bizarre circumstances surrounding the tragic death of Harold J. Connor, Jr., even after lengthy testimony from five witnesses who were present when Connor was shot, are still largely in dispute and somewhat irreconcilable. What was established conclusively at the trial was as follows: Connor was part of a deer hunting party that included plaintiff, plaintiff's step children, David and Darryl Perry, and the Perrys' first cousin, David Kenney. They left the New Orleans area on November 5, 1979, and arrived at plaintiff's parents' home in Bunkie later that day. Thereafter, plaintiff's brother, Larry Rubenstein, and a friend of his, Michael Fournier, also arrived at the home of plaintiff's parents. Plaintiff claims that he had no prior notice of his brother and Fournier's visit. The latter joined the hunting party early the following morning. The group traveled in plaintiff's car on a dirt road surrounded by woods to a location selected the previous evening when plaintiff visited his uncle and cousin.

When the party arrived at the location, plaintiff distributed the firearms, ammunition, and orange hunting vests to each member of the group. Thereafter, Kenney locked the car keys inside the car, and the group searched for wire with which to open the door lock. Soon after Connor was able to open the front door on the passenger side, Fournier, who was standing less than 10 feet behind Connor, discharged his gun, a single shot, 12-gauge shotgun. The pellets struck Connor in the back, slightly above the waist, and traveled generally in a lateral path through his body.

Fournier claims that the gun discharged when he tripped, and Darryl Perry, in corroborating his testimony, claims that the gun discharged about when the butt was close to the ground and while the barrel was pointed diagonally upward in the direction of Connor. This testimony, however, was flatly contradicted by the forensic scientist and pathologist, who concluded that in view of the lateral path of the pellets through Connor's body above his waist, the barrel of the gun must have been parallel (horizontal) to the ground and at waist level at the time of discharge. Further, because of its safety device, in order for the gun to have been discharged, it must have been loaded, cocked, and the trigger pulled. The firing pin could not have been activated just by the gun striking the ground. (Testimony of forensic scientist Ronald Singer and pathologist Dr. Tom D. Norman.)

The testimony of the witnesses raises more questions than it answered, in particular: why did Connor go deer hunting when according to his mother, girlfriend and cousin, he had never been hunting before and was disgusted by the idea of killing animals, and did not pack the proper clothing? And why did Fournier load his gun, cock it, have his finger on the trigger, and have it pointed at Connor? We conclude that examined in *the light most favorable* to the plaintiff, his handing a shotgun and ammunition to an individual who was, according to the plaintiff, previously unknown to him, and who was, it was later learned, a convicted felon then on probation[2] and prohibited from carrying firearms, constitutes conduct falling well below the standard of care required of a reasonable person in possession of firearms. Examining the evidence not in the light most favorable to plaintiff but instead with the slightest circumspection leads to the distasteful conclusion that Harold J. Connor, Jr. was killed under highly suspicious circumstances, circumstances that suggest something far more sinister than a mere "accident."

CONCLUSIONS OF LAW

This Court has jurisdiction under 28 U.S.C. § 1332.

Defendant interposes three separate and independent defenses to plaintiff's claim that he is entitled to recover under the $240,000 credit insurance policy insuring the life of Harold J. Connor, Jr.: (1) that defendant was induced to execute the policy by material misrepresentations made with the intent to deceive the insurer; (2) that plaintiff as the beneficiary lacks an insurable interest in the life of the insured; and (3) that plaintiff was culpably negligent in contributing to the death of the insured, and that such negligence bars his recovery under the policy. For the purposes of this decision, we need only consider defendant's first two defenses, and make no ruling on the third.

Under Louisiana law, a life or health insurance policy is null and void if the insurer is induced to execute the policy by misrepresentations in the application that were made with the intent to deceive and if the misrepresentations materially affected the insurer's decision to accept the risk or increased the hazard assumed by the insurer.

La. R.S. 22:619(B) . . The insurer has the burden of proving the elements of La. R.S. 22:619(B).

Consistent with the foregoing findings, wherein we found that plaintiff and Connor misrepresented Connor's salary and failed to disclose the termination provision; that they knew of the falsity and the materiality of their misrepresentations; and that each of said misrepresentations materially affected the insurer's decision to accept the risk; we find that the insurance policy in question is null and void under La. R.S. 22:619(B). We further conclude that each of the misrepresentations constitutes a separate and independent ground for invalidating the insurance policy under said statutory provision.

Louisiana law also requires that a beneficiary who procures an insurance policy upon the life of another have an insurable interest in the life of the insured. La. R.S. 22:613(A). The absence of any insurable interest on the part of the beneficiary who procures the policy invalidates the policy, and the insurer's only liability is to return the premiums paid.... The beneficiary has the burden of proving the existence of the insurable interest.

A beneficiary who is not related by blood or marriage to the insured does not have an insurable interest unless he has a reasonable expectation of pecuniary gain from the continued life of the insured, or reasonable expectation of sustaining loss from his death.

Where the beneficiary's insurable interest is a debt allegedly owed by the insured, as is herein claimed, the amount of the life insurance at the time the policy was written and at the time of the insured's death must be proportionate to the debt actually owed by the insured; if the value of the life insurance is grossly disproportionate to the amount actually owed, the beneficiary lacks an insurable interest, and the policy is null and void.... Since we earlier held that Connor was not indebted to plaintiff either when the policy was written or when he died, the amount of the insurance is grossly disproportionate to the amount of the debt. Even if we consider the amount that Connor could have owed under the terms of the partnership agreement-$2000- this too is far exceeded by the face value of the policy. Accordingly, we conclude that plaintiff lacks an insurable interest in the policy herein considered.

Should we characterize the beneficiary's expectation as a pecuniary gain arising from his business partnership with the insured, rather than as a debt arising from their relationship,[3] our findings of fact lead to only one reasonable conclusion: that an expected pecuniary advantage of $240,000 in profits over 20 years derived from "TV Journal" is grossly disproportionate to the amount Connor could have paid plaintiff on a monthly basis given the inexperience of Connor and plaintiff and the vast undercapitalization of the venture. We therefore hold that plaintiff lacks an insurable interest under this theory too....

Because an insurable interest is required by law in order to protect the safety of the public by preventing anyone from acquiring a greater interest in another person's death than in his continued life, the parties cannot, even by solemn contract, create insurance without an insurable interest; further, the insurance company cannot waive or be estopped from asserting lack of insurable interest by its conduct in issuing the policy.. . .

Considering the foregoing, we hold that the insurance policy from which plaintiff claims he is entitled to recover is null and void, and thus that his claim against defendant is hereby

Dismissed.

Footnotes to the case-

1 Credit life insurance is to be distinguished from a "key man" business insurance policy. With the former, the insurer risks that the debtor-insured will die before he can repay the creditor-beneficiary an existing debt. Under the latter, the insurer risks the death of someone whose loss would be highly detrimental to the business. From his discussions with plaintiff and Connor, Moreau correctly concluded that plaintiff was ineligible for "key man" insurance on Connor's life.

2 After the shooting Fournier's probation was revoked and he was incarcerated, since as a convicted felon he was not allowed to possess a firearm; he is presently incarcerated as a result of his conviction for burglary.

3 Since the policy is a credit life insurance policy and not a "key man" life insurance policy based on the partnership relationship between plaintiff and Connor, we need not consider whether plaintiff had an insurable interest arising from an expectation of pecuniary gain from the "TV Journal" partnership. We do so, however, for the purpose of making the record complete.

Uberrimae Fidei	This is a Latin term meaning utmost good faith. The standard of behavior imposed on all parties to an insurance contract. Parties are required to deal with each other without making material misrepresentations or concealing material facts. A higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts. The insurance contract is a personal contract; that is, it is a contract between the insured and the insurer. A property insurance policy does not really insure the property; it insures the property owner against economic loss. The insurance applicant must be acceptable to the insurance company and meet certain underwriting standards regarding credit, lifestyle, and morals. As the case from Louisiana indicated, the failure to disclose important information, or outright fraud, will cause the courts to void the insurance contract. The principle of utmost good faith is supported by three important legal doctrines: representations, concealment, and warranty. We will examine these concepts in chapter 7.

Chapter 6: Insurance Coverages

As pointed out in the previous chapter, risk is measurable. Uncertainty, by definition, is not measurable. Insurance is the financial yardstick of risk, putting a dollar value on the chance occurrence of some fortuitous event. The law prohibits using insurance contracts for insuring property or lives in which one has no insurable interest. The insured should have a reason for wanting to prevent loss to the property or person being insured. Some sort of insurable interest must be present for the insurance contract to operate correctly.

Various academic disciplines look at risk differently. The perspective of an economist will be different from that of a psychologist from that of an actuary. They all see risk differently; yet define it in terms of uncertainty. People in the insurance industry often use risk when talking about the property or life being insured. What is being insured? Who is covered? When it gets down to the bottom line, who will the check be made out to? These questions seem simple, but they have to be answered.

Insurance is just one of several possible ways to deal with the problem of risk. This text is not intended to teach the fundamental principles of risk management. However, a review of the basics is necessary so the reader can understand the idea of “insurance coverage”, where does it start, where does it end, and how it relates to everyday business and personal dealings. People in the insurance business often refer to risk as the “exposure to loss.” Risk is correctly seen as the variation in possible outcomes of an event based on chance. The greater the variation around an average expected loss, the greater the risk. The degree of risk is a measure of the accuracy with which the outcome of an event based on chance can be predicted. The more accurate the prediction of the outcome of an event based on chance, the lower the degree of risk.

Defining the Risks

The predictability of loss is a basic result of an insurance company’s operations. Consider, for a moment, the probability of a house catching fire. For example, if you chose 1,000 houses randomly throughout the United States, you might see an average of 10 house fires with $15,000 damage per year. Change the conditions. If you chose 1,000 homes in good condition within three miles of a fire station, with at least 60% masonry exterior, your incident of fire and loss would probably decrease. The additional information has reduced the degree of risk. Accurate statistical tallying of past losses allows increased accuracy in the prediction of losses. The same is true of life insurance. Maintaining data on the longevity of men and women, smokers and non-smokers allows the insurance company to predict death rates in various age categories. From the data a loss ratio can be constructed and hence, an insurance premium.

Objective risk is the relative variation of actual loss from expected loss. The chance of loss should not be mistaken with objective risk. Continuing with the example concerning house fires, assume an insurer has 5,000 homes insured in Portland. Another (or the same) insurer has 5,000 houses insured against fire in New Orleans. The chance of loss in each city is 1%, so 50 homes can be expected to burn annually. The annual variation in losses is between 45 and 55 houses burned each year in Portland. In New Orleans between 40 and 60 houses burn. The objective risk is greater in New Orleans even though the chance of loss is the same. Thus, the mean, or average is the same but the standard deviation is greater

Without insurance, in our legal system the economic cost that accompanies any type of accident would fall on one of the following;
-The person suffering the mischance
-Any person who intentionally or negligently causes the misfortune to occur
-Whoever is seen by statute as the most suitable from society’s point of view

There is no way to transfer the costs of pain, suffering or regret under an insurance scheme. Negating the economic loss is the purpose of insurance. The particular risks that affect individuals and businesses are addressed by the insurance industry. This includes life, health, property, and liability risks. There are five general ways to avoid risk;

1 Risk Avoidance- Simply staying away from risky conditions cuts down on the probability of them occurring. Exposure avoidance is acting so as not to create the particular loss exposure being avoided or to eliminate completely any existing exposure. Staying out of high crime areas cuts down on the chance of being robbed. Avoiding the water eliminates the possibility of drowning. The reality is that crime seems to be everywhere these days and if one avoids water, they would stink. Risk avoidance must be thought of in narrower, task specific terms, such as only allowing qualified personnel to perform plant maintenance.

2 Risk Retention- A person or business may want to retain part or all of a given risk. This is the case with deductibles for insurance. The higher the deductible is found to be, the greater the risk retention. This is known as active retention. There is also passive retention of risk. Certain risks may be retained due to ignorance or indifference. An example of this would be the failure to inoculate children or the elderly against disease.

3 Risk Transfer- Insurance is the primary means of risk transfer. We will look at it separately. Other forms of risk transfer include transfer by contract. An extended warranty purchased for a new television or other consumer product is an example of this sort of transfer. Price hedging is another. Hedging is the systematic purchase of one or more types of financial instruments to offset price movements in another.

4 Loss Control- Reducing the severity and frequency of losses is another method for handling risk. Defensive driving courses are used to reduce accidents. Good diet and exercise help reduce health problems. These are examples of ways to prevent personal loss. With businesses, regular maintenance programs and security systems are methods of controlling loss.

5 Insurance-This is the most practical method of handling risk for most people and businesses. It also employs several risk management techniques. It is a contractual transfer of risk most appropriate when the chance of loss is low and the severity of a potential loss is high. Businesses and individuals face many situations meeting both these criteria. Insurance allows the purchaser to substitute a small certain premium for a large uncertain loss. Once insurance is purchased, who is covered, who has an interest in the policy and what are the duties of the insurance company become questions searching for answers.

Who or What is Covered

After a kitchen fire damaged part of the house, here is how the insurance proceeds check was made out for the neighbor down the street:
“Joe Smith and Keystone State Mortgage Co.”

When a co-worker’s automobile was parked on the street, it was totaled by an out-of-control Bexar County maintenance vehicle. The check from the insurance company was styled like this:

“Ann Marie Hrbacek and Garza Auto Finance Corp.”

It is not uncommon to see people go ballistic when they see how the insurance proceeds check from a covered loss are made payable. The “insured” can be identified as the person whose loss causes the payment of proceeds by the insurer. That is not always the same as the person to whom the proceeds are paid. With life insurance, the person who is the named insured is not the same as the person who receives the proceeds when death occurs. With property/casualty insurance, the insured person, who has nominal title to the property that is being insured, often is not the beneficiary in the event of loss. The person with an insurable interest assigns the benefits to a third party. This is the case when a mortgagor signs over benefits to the mortgagee. The mortgagee (a bank or savings and loan) will often have a much greater financial stake in the property subject to loss than the homeowner. The same is true with liability insurance. For example, if someone is injured in a retail establishment due to the retailer’s negligence, the injured third party can bring a suit directly against the insurer for the proceeds of the policy

Causation

The insured events mentioned above, a fire and a collision, are both the result of certain causes (a grease fire, someone driving recklessly) and the cause of certain results (damage to property and liability). The next chapter will discuss insurance warranties, representations, and concealment. They are basically determined under the legal theories of materiality. Insurance coverage and limitations (or exclusions) are generally determined under theories of causation.

Negligence is not actionable unless it results in actual damage. Such damage may consist of personal injury, property damage, or economic loss. But if the injury qualifies for protection against negligence under the concept of ‘duty owed,’ it must still pass the test of whether it was 'caused' in the legal sense by the defendant's negligence, besides raising the question of how to assess compensation for it.

One of the most important elements in the attribution of legal responsibility for negligence, as for any other tort, is the causal relation between the defendant's fault and the plaintiff's injury. Unfortunately 'cause' has become a much-overworked concept, a shelter for a wide spectrum of ideas. Do not forget that legal techniques and doctrines are only tools, and that the only standard for judging their worth is the extent to which they help us reach a decision.

Scientist v. Jamming- Causal problems are of course not unique to insurance related legal inquiries; yet there is a big difference between a scientific and a legalistic discourse about 'cause' that is calculated to spare the latter many of the former's difficulties. This difference is due to the discrete purposes of their respective inquiries; the scientist's being explanatory, and the lawyer's attributive. In chapter 1, Justice Cardozo of the U.S. Supreme Court expounded on the theory of law. The “theory of causation” is an excellent example of his ideas at work. The scientist’s concern is to isolate all antecedents of a given consequence so as to be able, for example, to reproduce an experiment. By contrast, the lawyer's task is much less pretentious; being focused solely on whether a particular person's negligence or culpable conduct was a responsible factor in causing another’s injury. There may be a hundred and one causes of a certain occurrence, in the sense of all the conditions that make up a set sufficient to produce it, but for legal purposes it is enough to be satisfied with merely establishing that the defendant's contribution was one of these causal events. It is not a question of what was the cause (or causes) of an accident or injury. The question at law is, 'Was the defendant's tortuous conduct a responsible cause?'

It is as well also to notice in this connection that, even confined to purely legal contexts, the focus of causal inquiry may differ vitally from one to the next. Sometimes, a choice must be made from among several alternatives as *the* cause of a particular event. For example, an insurance claim in Great Britain became a well-known insurance case. A ship, sailing in convoy during the Norwegian campaign in 1940, was ordered to follow a zigzag course with dimmed lights and eventually, after encountering an unexpected tide, was swept upon the rocks. The question for decision was whether the loss was covered by the insurance against marine perils or fell into the exception of 'all consequences of hostilities or warlike operations' (*Yorkshire Dale S.S. Co.* v. *Minister of War Transport,* [1942] A.C. 691). Tort claims do not present any either/or issue like that. For, though it was once fashionable to ask whether the defendant's tort was *the* cause of the plaintiff's injury, it is now freely allowed as sufficient that it was only *a* cause and that there might well be other legally responsible causes besides-in other words, that there can be more than one tortfeasor liable for the same damage, thus dispensing with any malicious selection of one of them as the only liable defendant.

‘But-for’ Causality- the first screening of all claims is invariably addressed to whether the defendant's tortuous conduct was a causal factor leading to the plaintiff's injury. The accredited test for this purpose is to ask oneself whether that injury would not have happened 'but for' such conduct. If it would have happened just the same, the defendant's lapse is causally irrelevant. This test of causality works except for when there happens to be some other 'cause' present that would by itself also have been sufficient to produce the same loss. For example, when two fires merge and together destroy a house. Here the inquiry whether it would also have been destroyed but for fire A or B would elicit an affirmative reply and might thus lead to the exoneration of both. This would of course be quite absurd, at any rate if both were of culpable origin. For just as it is no excuse that one's own negligence would not have been sufficient to produce the injury without somebody else's negligence combining, no more is it an excuse that the latter would by itself have been sufficient to produce it. More debatable is the case where the other sufficient cause is of innocent origin, because it is then arguable that to allow recovery would confer a windfall on the claimant.

The 'but for' test, it will be noticed, calls for an answer to a hypothetical question, an inquiry not into what did happen but into what might have happened. This injects a certain element of speculation. For who could say with assurance that, had the lifeguard been present, the toddler would have been saved from drowning; that the woman would not have developed cancer of the breast two years after being bruised in a collision, or, being pregnant when injured, that her child would not have been born deformed? But the standard of proof on this issue, as on all others in civil litigation, is not proof beyond all reasonable doubt as in the criminal courts, but only proof on a balance of probabilities.

Another relevant question is whether the causal link is with the whole of the defendant's conduct or just that segment of it which is wrongful. According to one view, espousing the latter alternative, what is called for is the setting up of a parallel case as close to the real facts as is compatible with just making the relevant conduct lawful. Thus, if a motorist exceeded the speed limit by driving at 35 instead of 30 M.P.H. and a child ran in front of the car, the proper question is thought to be whether, on a balance of probabilities, he would have avoided the child at the lesser speed. If an unlicensed driver is involved in a collision it may be pertinent to ask whether the same accident would not have occurred if the motorist had a current driver’s license.

This argument assumes of course that what must be proven is nothing more nor less than that the collision was caused by the individual's incompetent driving, and that merely driving without a license, in defiance of a rule aimed at assuring minimum competence and thus aiding safety, is not enough. Still, one cannot ignore the dominant fact that, driving being so easy a skill to acquire and so prevalent, we have reason to doubt whether the lack of a license increases the risk of accidents sufficiently to warrant the drastic remedy of holding a violator liable for any accident even in the absence of independent proof of incompetence (like repeatedly failing the driving test). Much stronger, of course, are cases of unlicensed medical practice or drinking and driving, because the risks involved are so great and the probabilities of incompetence so high that we may well feel justified resolving any doubt against the culprit.

What this discussion goes to show is that the problems so far discussed are by no means capable of mechanical solution. While cause-in-fact seems to concern itself solely with a 'scientific' or 'fact' relationship between an action and consequence, it is yet far from untainted by value or normative considerations. These do, however, play a much more circumscribed and subdued role than in the congeries of problems customarily associated with the heading of 'proximate cause' or 'remoteness of damage'.

Scope of Coverage

Fire and casualty policies offer coverage to the insured against loss or damage by fire. The aftermath of a fire finds damage cause by smoke, scorching, water, and efforts to fight the fire. Are these perils covered by the policy? When a policy includes wording that indicates coverage of all loss proximately caused by a fire, how far does that go? Proximate cause has been defined as when the loss "has been caused by a force set in motion by fire, without the intervention of any new and independent force." *Vance on Insurance,* (3d ed. 1951). Here is a concept of proximate cause from a court decision:

We have defined "proximate cause" as that cause which, in a natural and continuous sequence, unbroken by any new, independent cause, produces the event, and without which that event would not have occurred....Where a peril specifically insured against sets other causes in motion which, in an unbroken sequence and connection between the act and final loss, produce the result for which recovery is sought, the insured peril is regarded as the "proximate cause" of the entire loss.... It is the efficient or predominant cause that sets into motion the chain of events producing the loss that is regarded as the proximate cause, not necessarily the last act in the chain of events.

Graham v. Public Employees Mutual Ins. Co., 98 Wash. 2d 533, 656 P.2d 1077

The point is, the definition of proximate cause, or perils covered, or named insured will vary slightly among jurisdictions. Even when the courts separate direct causes from other, more remote causes, questions remain concerning the causal issue in determining coverage when the insured loss results from multiple concurrent causes. The courts have not been uniform in how they have analyzed insurance coverage involving multiple concurrent causes.

Causation plays a crucial role in insurance coverage issues. As the previous discussion pointed out, basic test is of the "But for" variety. But for the gas can being negligently left too close to the water heater... But for the drunk running the stop sign... The additional requirement of a proximate cause is also necessary. Keep in mind that insurance law is based upon contract law principles. The standard for proximate cause is frequently a less strict standard than proximate cause requirements under tort law. This is especially true in cases involving the question of whether certain enumerated causes in the insurance policy were direct, dominant or remote causes of the event triggering the insurance policy. The definitions of all terms are similar enough that conclusions can be drawn from them and insurance business, policy, and preparation crafted accordingly. The following case examines the question of cause and how it does or does not trigger coverage

Marshall Produce Co. v. St. Paul Fire & Marine Ins. Co.

Supreme Court of Minnesota
256 Minn. 404, 98 N.W.2d 280 (1959)

NELSON, JUSTICE.
[Plaintiff, Marshall Produce Co. is a processor of milk and eggs. It converts milk into dehydrated milk, and eggs into powdered eggs. It also sells eggs in the shell. For many years it has processed eggs for the United States Army. It had insurance policies with seven insurance companies, including defendant St. Paul Fire & Marine Ins. Co., protecting itself "against all loss or damage by fire."

On March 13, 1956, a house located some 75 feet from plaintiff's plant caught on fire and heavy, black smoke penetrated every room of plaintiff's plant. At that time there were large quantities of powdered milk and powdered eggs, including military powdered eggs, in the plant, packed according to the exacting requirements of the U.S. Army.

The insurance companies denied liability on the ground that the loss was not due to fire. Plaintiff sued on the policies and the trial court allowed recovery for loss on shell eggs, milk powder and egg powder packed in drums, but denied recovery on the military egg powder on the ground it was "not damaged by fire."

Plaintiff and the insurance companies appeal. Plaintiff's assignments of error, *inter alia,* include a request to strike paragraph 6 of the findings of fact which reads "the egg powder in cans was not damaged by fire," and to substitute the following requested findings as numbers 6 and 7]:

6. The United States Quartermaster Corps had contracted to purchase the egg powder in cans, and it was prepared and placed in such cans in accordance with government specifications. The Quartermaster Corps rejected and refused to accept said powder in cans on the ground that the smoke which entered the plant as aforesaid contaminated the plant and the containers in which said powder was packed. There is no evidence that the decision as to reject and refuse was arbitrary or capricious or so grossly erroneous as to imply bad faith, or that it was of a kind which the Quartermaster Corps was without authority in law to make.

After and by reason of such rejection and refusal, said egg powder in cans could not be sold for more than $1,168.20 and did not have a value in excess of said amount. By reason of smoke entering the plant as aforesaid, the plaintiff sustained loss and damage in respect of said egg powder of $53,910.00.

While the court below found that the egg powder in cans was not damaged, the findings are silent on whether there was damage to the containers or cans in which the egg powder had been packed for shipment pursuant to government specifications and requirements. We specifically, again, note here that the St. Paul Fire & Marine and Fidelity-Phenix policies provide that the merchandise in the plant, "including filled containers," is insured against "all loss or damage by fire originating from any cause except invasion, or any military or usurped power whatever."

. .
We think that the three related questions of law involved in this action, suggested by the plaintiff, are more or less determinatives of its outcome. (1) Where a fire insurance policy insures merchandise and the owner thereof against "loss or damage" by fire, is there such "loss or damage" if there is a loss in value to the merchandise and to the owner as the result of a fire, or must there be physical damage to the merchandise itself, as well? (2) Where a fire insurance policy insures merchandise in containers and the owner thereof against "all loss or damage by fire" is there such "loss or damage" if there is a loss in value to the merchandise in containers and the owner as the result of fire damage to the containers alone? (3) Where government officials, in the course of their duties, determine that goods processed for delivery under a government contract are so damaged by fire that they are not acceptable to the government, and accordingly reject the goods, which consequently become practically worthless (a) is this official decision conclusive in the sense that it is binding on the insurance companies or (b), if not conclusively binding, does it satisfy whatever burden of proof rests on the insured to show that the insured suffered "loss or damage" by fire where, as here, there is no proof by the insurer negating the existence of facts which could possibly support such determination?....

At the outset we may rightly assume that the contracts of fire insurance here involved are contracts of indemnity. This is the rule in Minnesota and it is the rule in other jurisdictions. These fire insurance policies constitute personal contracts with the insured, and unless so expressly stipulated they are not contracts *in rem* and do not run with the insured property. In the instant case the St. Paul Fire and Marine and Fidelity-Phenix Fire Insurance policies are not alone personal contracts with the insured, but they also run with the insured property. Since a contract for insurance against fire ordinarily is a contract for indemnity, it follows that the insured is entitled to receive the sum necessary to indemnify him, or to be put, as far as is practicable, in the same condition pecuniarily in which he would have been had there been no fire; that is, he may recover to the extent of his loss occasioned by the fire, but no more, and he cannot recover if he has sustained no loss. The basis of recovery is therefore the loss in value to the insured, not necessarily physical damage to the property. Being merely personal contracts between the insurer and the insured, they appertain to the person or party to the contract, and not to the thing which is subject to the risk against which the owner is protected. The fact that the aforesaid insurance policies also run with the insured property only adds to or broadens the risk of the coverage. Such a contract includes not only the premises set forth in express words, but, in addition all such implied provisions as are indispensable to effectuate the intention of the parties and such as arise from the language of the contract and the circumstances under which it was made. This is so for the reason that the law regards the substance and not the mere form of the contract-the ultimate purpose the parties had in view, rather than the manner agreed on for effecting the purpose....

Defendants' witness, William Schneider, who first indicated that he had buyers for the canned egg powder and then admitted that he was unable to produce on that score, made the general admission that there was a sizable loss in the value of the canned egg powder; a loss which obviously resulted from the fire. The defendants have stressed the claim that the egg powder itself packed within the cans was not physically damaged by the fire and therefore no recovery is permitted on any loss suffered to the merchandise in the plant, "including filled containers," from loss or damage by fire originating from any cause except invasion. We do not have to go outside of our own Minnesota authorities to find support for the proposition that the property insured need not have been physically damaged by fire to permit a recovery on the policies. It is well-established law in this state that fire insurance includes loss proximately resulting from fire although the fire itself does no injury to the object insured....; *Lipshultz v. General Ins. Co. of America,* Minn., 96 N.W.2d 880. It was held there that the word "direct" in the policy meant merely "immediate" or "proximate" as distinguished from remote, and the court further said that there is in the policy no limitation of coverage excluding this type of loss-one which the insurers might have inserted by an appropriate exclusionary clause....

We quote the following from 5 Couch, *Cyclopedia of Insurance Law, §* 1201, p. 4398:
Whatever may be held to be the meaning of the word "fire" in any particular case before the court, a policy insuring against losses by fire will cover every loss, damage, or injury to the insured property of which "fire" is the proximate cause. It includes every loss necessarily following from the occurrence of a fire, if it arises directly and immediately from the peril, or necessarily from judicially admissible and surrounding circumstances, the operation and influence of which could not be avoided. It is not necessary that the identical property, or even any part of it, be consumed, or burned, or even ignited.

We now come to the crux of the situation in the instant case. If the parties contracted with reference to the contingency of a fire occurring in or near the plant of the Marshall Produce Company during the performance of a contract for the Quartermaster Corps, did they not also contract with reference to what inevitably must follow such a fire as occurred if smoke therefrom filled the building-rejection of all products in the plant by the government inspector?

The facts are inescapable that a fire occurred as set forth in the record; that as a result of the fire smoke penetrated plaintiff's plant filling it with smoke-laden air due to which plaintiff suffered a loss. Plaintiff carried insurance in the defendant companies covering all loss or damage by fire.

Clearly it is not necessary that the fire occur in the insured's buildings. The presence of smoke from a fire, anywhere in the immediate neighborhood, resulting in smoke penetrating the building and depositing smoke-laden air in the building is enough. The question naturally follows: Was there loss or damage by fire within the coverage of the policy provisions?

In the case of *Jiannetti v. National Fire Ins. Co.,* 277 Mass. 434, 438, 178 N.E. 640, 642, the court said:
....It manifestly was nor the intention of the parties to policies that the property covered by the terms of the insurance contract must be itself on fire, since losses by smoke and water where the fire has not touched the object injured are familiar to all; and it is clear that it was their intention that any loss sustained by the plaintiff by fire, in the ordinary acceptance of that term, should be covered by the policies, provided the plaintiff should prove that the loss sustained, whatever its form, was proximately caused by fire. And "When it is said that the cause to be sought is the direct and proximate cause, it is not meant that the cause or agency which is nearest in time or place to the result is necessarily to be chosen.... The active, efficient cause that sets in motion a train of events which brings about a result without the intervention of any force started and working actively from a new and independent source is the direct and proximate cause."

Whatever the loss may have been, it is obvious that the fire was the proximate cause of the loss; that smoke and its resulting foul odors spread into the plant and its contents, which led the government officials to do what they might well be expected to do under the prevailing conditions; namely, to reject the merchandise and render the same valueless. It is not persuasive under all the circumstances to argue that the possibility was not at all times known to the insurance companies, or ought not to have been known to them, since they were from the inception of the policies aware of the fact that the plaintiff insured was processing eggs into powder under government contract. The Minnesota form of standard policy does not require as the cases indicate that the fire be the "direct" cause of the loss or damage, as does the so-called "New York form."

It is indisputable that in the instant case the fire involved set in motion a train of events which brought about the loss of which plaintiff complains, without the intervention of any force starting and working actively from a new and independent source.. . .

We have fully considered defendants' assignments of error. We think that the findings of the trial court in regard to the loss and damage by fire as to milk powder in drums, egg powder in drums, and shell eggs, find support in the evidence and they must stand....

As we view it, the finding of the trial court to the effect that the egg powder in cans was not damaged by fire is not sustained by the evidence since the insurance coverage involved on plaintiff's appeal included coverage of all merchandise in the plant including filled containers and furthermore, the government requirements in its contract with the plaintiff reserves the right to reject in case of foul odors due to fire and resulting smoke-laden air. The contract in force in March 1956, as well as prior contracts requiring a high standard of sanitation in connection with the processing and constant supervision and inspection by inspectors of the United States Department of Agriculture provide for and authorize the rejection of merchandise if violation of sanitary requirements occurs, cannot be construed in the limited sense that the fire here did not cause a loss to or damage to the filled containers of egg powder to the extent that the right to reject was unjustified under the insurance policies and that the defendant must bear the loss even in the face of the market value clause placed as an endorsement upon the policies. If the authorized representatives of the government were justified in refusing to accept or make use of the smoke-laden merchandise as unfit for military use, the loss then would be total, subject to such deductions as the contract provides and net salvage recovered.

We reach the conclusion that the trial court's finding of loss and damage to the shell eggs and egg and milk powder in drums is adequately supported by the evidence and that plaintiff is entitled to interest thereon from July 10, 1956.

We reach the conclusion that the plaintiff is entitled, additionally, to recover all loss on the merchandise in the plant described as cans of egg powder "including filled containers," the net loss after deductions and salvage shown to be $53,910. We therefore hold that the judgment should be affirmed on defendants' appeal but reversed on plaintiff's appeal with instructions to amend the judgment to include the amount of loss on the merchandise described as cans of egg powder "including filled containers," with interest thereon from July 10, 1956. The trial court is instructed to amend its findings of fact and conclusions of law so as to order judgment in favor of the plaintiff as herein indicated.

Contractual Rights

Named Insureds And Others

There are several ways to identify the insured in the insurance contract. Normally, the parties named in the contract are the only ones who can maintain an action on it in their own name. Sometimes a situation arises where persons who are not actual parties to the insurance contract still have an interest in it. One of the most frequently seen occurrences is that of the third-party beneficiary. Other third parties may also be affected by the contract. A general rule of contract law says that only those who are a party to a contract have rights under it. A third party may benefit from a particular contractual arrangement, but the third party has no *rights* under the contract. Two situations are recognized under law in which third parties have rights under contract; 1.) an assignment of a contract and, 2.) a third party beneficiary contract. The most frequently used methods of determining who has rights under an insurance contract are as follows:

I.

Life Insurance

① The Beneficiary- The owner of the life insurance policy has the right to change the beneficiary at any time up to the death of the *cestui que vie.* Often the policyowner will designate contingent or secondary beneficiaries in the event the primary beneficiary predeceases the named insured. That way the proceeds will go to the secondary beneficiary without the necessity of amending the policy. If all the named beneficiaries predecease the named insured, the estate of the owner is normally designated as the final contingent beneficiary. Of course, a beneficiary can be named irrevocably. In this case the owner of the policy has given up entirely the right to change beneficiaries. This right accrues to the irrevocably named beneficiary regardless of whether they are aware of it or not.

Rights of the beneficiary before the death of the named insured are statutorily protected in all states against attachment by creditors of the owner of the policy, as well as attachment by creditors of the beneficiary in some states. In most states, when a life insurance policy names more than one irrevocable beneficiary in common, when one beneficiary dies, that person's rights pass to the surviving beneficiaries. The benefit rights do not pass to the deceased person's estate Death of One or the Other**-** If the policyonwer retains the right to change the beneficiary, after the policyowner's death the power does not pass to the executor or estate. The beneficiary gains a vested right at that time. The interest of the beneficiary is protected against the claims of creditors of the policyowner. It is not uncommon for spouses to die simultaneously in an accident such as an auto collision or air disaster. Such a so-called "common disaster" brings up unique circumstances for the potential beneficiaries. Assume that the husband is the named insured and the wife is the primary beneficiary of a life insurance policy.

The couple's children are the secondary beneficiaries. Even if it is a question of a few seconds, if the husband survives the wife, the secondary beneficiaries receive the insurance proceeds. If it is the other way round, the wife surviving the husband for even a short period of time, the insurance proceeds go to the wife's estate. The proceeds would then be distributed by will or by statute of intestate succession. The proceeds could go to an unintended third party in this manner. As a result of this apparent inequity, many states have adopted the Uniform Simultaneous Death Act. This law tries to carry out the wishes of the insured by stating, "Where the insured and the beneficiary in a policy of life or accident insurance have died and there is no sufficient evidence that they have died otherwise than simultaneously, the proceeds of the policy shall be distributed as if the insured had survived the beneficiary." In this way, the interests of the secondary beneficiaries are protected...

Another avenue to insure the same outcome is for the policy to contain a clause addressing the situation. A "common disaster" clause can provide that the primary beneficiary is to receive the proceeds only if they survive the insured for a specific period of time.

Two scenarios can occur when a beneficiary predeceases the insured. One is when the beneficiary has given value to the insured in exchange for the designation as beneficiary. Such is the case when, in order to secure a debt, a person takes out a life insurance policy with him or herself as named insured and the creditor as named beneficiary. This situation concerns personal debt, not commercial debt. The same holds true when the beneficiary pays the policy premiums rather than the policyowner or the *cestui que vie.* The estate of the beneficiary would receive the policy proceeds in both instances. The second situation involves the donee-beneficiary. If survival of the named insured is a condition expressly called for in the insurance policy the vested interest of the beneficiary ceases if that person pre-deceases the named insured. This is true even if the policyowner relinquishes the power to change beneficiaries. When the language concerning the beneficiary is styled as to include successors (i.e. estate, heirs, assigns), the proceeds go to the beneficiary's estate for purposes of distribution. Such wording is seen as an implied condition of survivorship by most courts. They will lean toward the death benefit going to the estate of the beneficiary, if such has not already been statutorily mandated.

The situation can arise in community property states, where a spouse purchases life insurance on him or herself and names their estate as beneficiary. If premiums are shown to be paid with community property, upon death the policy proceeds are considered community property.

Divorce**-** Divorce of the insured and the beneficiary does not necessarily terminate the right of the beneficiary. Some states have enacted statutes to enforce such termination. Even if the spouse was named as irrevocable beneficiary, the policyowner can change it in some jurisdictions.

Creditors- The issue with creditors is whether or not the creditor-as-beneficiary was intended to take more than the amount of the outstanding debt from the death proceeds. When this becomes an issue the courts must make a decision based on the facts surrounding a particular case. As with any business arrangement it is always best to describe exactly how the proceeds should be apportioned before the need to do so arises. If the creditor is named as assignee of the policy rather than the beneficiary, this serves as an indicator for holding the creditor's share to the amount of the debt. The reason is that a policy is more frequently assigned as security for a debt than to change the beneficiary. The creditor normally keeps the entire death benefit when they pay the premiums. This is because the creditor retains the full interest in the policy.

Changing Beneficiaries- The mechanics of changing beneficiary are fairly simple. The policyowner sends a written request of beneficiary change to the insurer. The policy itself is also returned for the insurer's endorsement of the new beneficiary. If the policyowner has authority to change beneficiaries, notification of the current beneficiary is not required. If the policyowner is in agreement not to change the beneficiary, an equitable interest in the proceeds is vested in the original beneficiary. Courts will hold that this interest is superior to those of the subsequent beneficiary. Changes in beneficiary must comply with the formalities to do so laid out in the insurance contract. Two examples stand out; One is when a beneficiary has possession of the policy and refuses to relinquish same. In this case, if the policyowner does everything possible to demonstrate a change in beneficiary was desired (notifying the company, old and new beneficiaries) then the new beneficiary will be acknowledged. The other situation is when a policyowner tries to change the beneficiary by will rather than through the insurance company. This generally is not recognized as complying with the formalities in the insurance contract.

II Other Forms of Insurance

There are two meanings to the word "insured" in property/casualty contracts. In the strictest sense, this term refers to the person, persons or class of people named in the policy. More broadly speaking, the word "insured" means someone with an economic interest in the property being protected. So, not only does "insured" include the homeowner, it includes the mortgage holder as well. The same is true with other creditors and other types of property insurance. It is important that all contract formalities are complied with in order that everyone who should be, is protected.

Common Practice- A commonly used means of recognizing the named insured is a clause in the insurance policy specifically for this purpose. It will say something to the effect of, "The X Insurance Co. does insure John Doe....." There may be more than one insured, and these insured, in addition to being listed by name, may also be listed by their relationship to the property. Terms used include "owner," "mortgagee," "tenant," "remainderman". In the case of more than one insured, the names will be listed with the phrase "as their interests may appear." In this way, the insureds share in the proceeds in proportion to their economic interests in the property being insured. The parties may also be listed elsewhere in the policy as "additional insureds". If the positions are not defined in some way, the named insureds share equally in the insurance proceeds. It is also a good idea with fire/casualty insurance to list the attorney, estate executor, or other legal representative as well as the named insured. This way, the property will be covered during estate probation in the event of death of the insured. The other approach is to include the term "heirs and assigns" in the named insured clause. Property insurance does not run with the land. If the proper steps are not taken, the untimely death of the named insured will cause coverage of the property in question to cease.

Endorsement- An endorsement can be made to a policy after it is in effect. This is a method of adding other people as insureds. An endorsement is defined as a written provision that adds to, deletes, or modifies the provisions in the original contract. Because of this it can only be accomplished with the insurer's written agreement. The added parties to the contract gain status as insureds rather than assignees. As a result, the legal concept of insurable interest applies to these parties.

Omnibus Clause- This is another way of designating additional insureds. Instead of designating a person by name, the insureds are described by relationship. As an example, omnibus clauses in liability insurance policies commonly state that persons who drive the insured's vehicle with the permission of the named insured are considered additional insureds. Such language was developed for automobile policies as a way for policy owners to cover the various people who may end up driving a particular automobile. Each person covered by the omnibus clause has the full standing as an insured. They have the right to bring action against the insurer for losses they suffer. They are also immune from any action by the insurer in subrogation.

Others Insured Under a Policy- As discussed in the previous section, only those named in the policy can receive policy benefits. With insurance law, however, there are certain extra- contractual rights that give the status of insureds to other people not specifically named in the policy.

Assignments

Choses in Action Not Assignable at Early Common Law- A chose in action is the intangible right that the owner of a debt or contract has to bring an action at law against his obligor, reduce the debt or claim to judgment, and proceed to enforce the judgment. The words literally mean "thing in action." It is an asset. If A has $100 that he lends to B upon B's oral promise to repay, A has exchanged cash for a chose in action. A merchant selling goods on credit exchanges them for accounts receivable that are choses in action.

At early common law, the obligee of a chose in action could not assign it. At that time the law regarded the personal relationship between the obligor and the obligee as a vital part of the obligation. It could not be changed any more than any other term of the obligation. This view prevails today with respect to a revocable offer.

Because the assignees of choses in action had no remedy at law, courts of equity began to enforce assignments. Courts of equity were created in England for the purpose of providing relief where the remedy at law was inadequate or unavailable, and granting relief to assignees was one of the early tasks of courts of equity. Relief was allowed in equity so consistently that ultimately courts of law began to enforce assignments. For the past century or more actions by assignees to recover money have been exclusively in courts of law.

Assignment Defined- An assignment is generally considered as the transfer of a right. However, it is unlike the transfer of title to goods, merchandise, or tangible personal property. It is more in the nature of an irrevocable power of attorney to collect a debt or claim with the right of the assignee to retain the proceeds when collected.

No special form or particular words are necessary to an assignment. Any words which fairly indicate an intention to make the assignee the owner of the claim are sufficient, and the assignment may be oral or written. A distinction must be drawn between an assignment and a promise to assign. An assignment effectively extinguishes the obligee's right to receive performance from the obligor where a promise to assign does not. The promise of a creditor to pay a collection agency, or broker, or attorney, a percentage or portion of the monies collected by the promisee from the debtor is not an assignment. It may give the promisee a contract right, but does not make him the owner of any part of the claim or debt. Likewise, a check that is a written order drawn upon a bank for the payment of money is not an assignment of any of the funds which the drawer may have to his credit in the drawee bank. The order is not made payable out of a particular fund, and is a general order on the bank to pay irrespective whether money is owing by the bank to the drawer.

Option Contracts are Assignable- An option is a contract whereby an offeror is bound to keep an offer open for a stated period of time. Ordinarily, only the offeree may accept an offer. However, if performance by any person is equivalent to performance by the offeree, as in a contract that does not involve personal service or credit, an irrevocable offer to enter into such type of contract is assignable. Thus, if A gives B a thirty-day option to buy La-La Land Farms for $250,000, B may assign this option to C who, upon timely acceptance of the offer, enters into a contract with A for the purchase of La-La Land.

Rights v. Delegation

There is a difference between assignment of rights and delegation of duty. Only rights under a contract are assignable. Duties may never be assigned, but their performance may be delegated to a third person if they are not of a type which involves the personal service or individual attention of the obligor, an attribute known as delectus personae (choice of person). Thus, duties under contracts to perform personal services are never delegable. An assignment is also ineffective where performance to the assignee would be different in extent than performance to the assignor and would therefore change the duty of the obligor. Thus, an automobile liability policy issued to A is not assignable by A to B. The risk assumed by the insurance company was liability for A's negligent operation of the automobile. Liability for operation of the same automobile by B would be an entirely different risk and one that the insurance company had not assumed.

Where the rights and duties under a contract are of a highly personal nature, such rights cannot be assigned. An extreme example of such contract is a contract of two persons to marry each other. Obviously, the rights under such contract cannot be assigned by either party. A more common example of contracts of a personal character is a contract for the personal services of one of the parties. Whether the service is simple manual labor or is highly skilled or professional, the party having the right to the other's service cannot assign such right to another. Professional sports haw been wrestling with the concept of free agency for years. One has the right to serve or work for whom he will, and cannot have another thrust upon him without his consent. Nor can the party who is under the duty to perform the service delegate his duty to another, no matter how competent that other may be.

An obligor may never rid himself of the duties under a contract without the consent of the obligee. Any delegation of a duty to a third person nevertheless leaves the obligor bound to perform it. If the obligor desires to be discharged of the duty, it may be possible for him to enter into a third-party contract and obtain the consent of the obligee to substitute a third person in his place. This is a novation whereby the original obligor is discharged and the third party becomes directly bound upon a new promise to the obligee.

Assignment of Future Rights-. An assignment of rights expected to accrue in the future under a contract is enforceable to the extent that the rights arise. It is not operative as an assignment at the time of execution as the rights sought to be assigned do not then exist.

Rights of the Assignee-. The assignee of a chose in action or claim stands in the shoes of the assignor. He acquires no new rights by reason of the assignment and takes the assigned claim with all of the defenses, defects, and infirmities to which it would be subject in a suit against the debtor by the assignor. This distinguishes an assignment from the negotiation of a negotiable instrument whereby new rights may be acquired by a transferee of the instrument. In a suit by the assignee against the debtor, the latter may plead fraud, duress, no contract, failure of consideration, breach of contract, or any other defense that he may have against the assignor. The debtor may also assert rights of set-off or counterclaim arising out of entirely separate matters which he may have against the assignor provided they arose prior to his obtaining notice of the assignment. The debtor may also set off claims that he has against the assignee for the reason that the latter is before the court as plaintiff in the suit.

The Uniform Commercial Code permits the buyer under a contract of sale to agree as part of the contract that he will not assert against an assignee who takes an assignment for value and in good faith any claim or defense which the buyer may have against the seller. Such provision in an agreement affords greater marketability to the rights of the seller.

An assignee will lose his rights against the debtor if the latter pays the assignor without notice of the assignment. The right of the assignee is essentially equitable and it would be unfair to compel a debtor to pay a claim a second time where he has paid it once to the only person whom he knew to be entitled to receive payment. Even after notice of an assignment has been given to an account debtor, the debtor and assignor may in good faith effect modification of or substitution for the contract where the right of payment thereunder has not already matured into an account receivable.

Standing in the shoes of the assignor permits the assignee to have the benefit of any outstanding securities for the claim, even though not expressly assigned. If the claim has any right of priority in the hands of the assignor, such as a wage claim in bankruptcy, the assignee is entitled to the same priority as he is enforcing the right of the assignor.

At common law the mere assignment of a contract right does not impose upon the assignee any duty of performance. He is regarded as having an irrevocable power of attorney to collect the proceeds of the assigned claim or right and to retain them for himself. Unless he expressly assumed the obligations of the assignor, he would not be liable for any breach of the contract out of which the assigned right arose.

Under the Uniform Commercial Code, an assignment of "the contract" or of "all my rights under the contract" or an assignment in similar broad general terms is also a delegation of performance of the duties under the contract, and unless the language or circumstances indicates the contrary an acceptance of the rights under the assignment constitutes a promise by the assignee to perform such duties.

Express Prohibition against Assignment- A contract may contain an express prohibition against any assignment of the rights created under it. The promisor may make his promise as narrow as he pleases and if the language in the contract clearly limits the rights thereunder solely to the promisee, an assignment by the promisee is ineffectual. The assignee of such a promise has a remedy only against the assignor for failure of consideration and breach of implied warranty. This narrowing of the right created by the terms of promise is to be distinguished from a contract that merely provides that the promisee agrees not to assign. In the latter case, an assignment gives the assignee rights against the obligor who may, however, hold the assignor liable for breach of contract.

The rights of an insured under a policy of fire or liability insurance, before loss occurs, are not assignable, and the policy may even provide for a forfeiture in the event of an attempted assignment. However, after loss has occurred, the duty of the insurance company to pay the amount of the loss has become fixed, and the right of the insured to recover such amount is assignable. The law favors assignability in the interest of free alienability of rights, thus permitting a person to sell or transfer something of value that he has. The law, however, will not remake a contract or change the character or extent of a right or duty from that which the contract created.

Partial Assignments- The owner of a claim may assign portions thereof or fractional interests therein to different assignees. He thereby makes partial assignments of his claim. An assignee of a part of a claim has no right to sue the debtor in an action at law. The debtor or obligor is not required to perform in installments unless he has expressly or impliedly agreed to do so

. Where his promise is to render a single performance, breaking it into piecemeal parts imposes a greater duty than he undertook. However, a partial assignee may sue in equity by naming as defendants not only the debtor or obligor but also all other partial assignees or persons having an interest in the claim. In such suit, the court of equity may enforce the liability of the obligor upon the entire claim as it has before it all parties in interest. It would be an undue hardship on the debtor to cause him to raise the same defenses in a number of suits brought in different courts by partial assignees.
Sub-Assignments- A chose in action or contract claim may be reassigned by the assignee. This is known as a sub-assignment. The sub-assignee may, in turn, become a sub-assignor and make a further reassignment of the claim. Every assignee or subassignee seeking to enforce the claim is subject to all of the defenses and rights of setoff which the obligor may assert against the assignor. In this respect, the position of any sub-assignee is similar to that of the original or first assignee. Assume that B owes A $500. A assigns the debt to C for value. C sub-assigns it to D in reliance upon a fraudulent statement by D. D later subassigns the claim to E, a bona fide purchaser for value who has no notice of fraud. May E enforce the claim against the debtor B, or does C have a superior right upon learning of the fraud and rescinding the transfer to D. It should be noted that both the rights of C and E are equitable rights. If E were regarded as having a legal ownership of the debt, the latent equity of C would be cut off. The majority view of the courts is that C would prevail and that his latent equity is not cut off by the equitable interest subsequently acquired by E. A minority view protects the rights of E as against C.

Gift Assignments- A gift of property is ineffective without delivery of the property to the donee. An intangible contract right cannot be delivered in the sense that tangible property may be physically delivered. Nevertheless, the gift of a contract right may be accomplished by assignment, the donee acquiring a power of attorney to collect. A gift assignment, however, is revocable by the assignor, and is revoked by the death of the assignor. Revocation is ineffective if prior thereto the gift assignee has received payment of the claim from the debtor or has obtained judgment against the debtor. Where a contract right is identified with a document, such as a savings bank book, a policy of life insurance, a negotiable note of a third person, or a certificate of stock, a delivery of the document to the donee with the intention of making a gift is an irrevocable effective assignment of both the document and the rights represented thereby.

Implied Warranties of Assignor- In the absence of an expressed intention to the contrary, an assignor who receives value makes certain implied warranties to the assignee with respect to the assigned claim. The assignor does not guarantee that the debtor will pay the assigned debt or that the obligor will perform, but he does warrant that the right exists and is free of defenses except these which are disclosed to the assignee.

If an assignment is for value, unless a contrary intention is shown, the assignor warrants to the assignee:
(1) that he will do nothing to defeat or impair the assignment,
(2) that the assigned right actually exists, and is subject to no limitations or defenses other than those stated or apparent at the time of the assignment,
(3) that any writing or evidence of the right delivered to the assignee or exhibited to him as an inducement to accept the assignment, is genuine and what it purports to be.

Third-Party Beneficiary to Contracts

Types of Beneficiaries- A contract in which a party promises to render a certain performance not to the promisee but to a third person is called a third party beneficiary contract. The third person is not a party to the contract but is a beneficiary of the promise. Such contracts may be divided into three types: (1) donee beneficiary; (2) creditor beneficiary; and (3) incidental beneficiary. A great majority of courts enforce both the donee beneficiary and the creditor beneficiary type of third party contract, but no court enforces the incidental beneficiary type.

Donee Beneficiary- A third person is a donee beneficiary if the purpose of the promisee in bargaining for and obtaining the promise was to make a gift to the beneficiary. The life insurance policy is of this type. The insured makes a contract with an insurance company that promises, in consideration of premiums paid to it by the insured, to pay upon the death of the insured a stated sum of money to a beneficiary named in the policy. The beneficiary need not even know of the existence of the policy in order to have rights under it. If the policy does not reserve to the insured the right to change the beneficiary, the beneficiary has vested rights under the policy of which he may not be deprived without his consent. In most policies a reservation by the insured of the right to change the beneficiary is a standard provision.

The desirability of allowing donee beneficiaries to recover on contracts made for their benefit is manifest. The promisee has no pecuniary interest in performance by the promisor and in case of a breach by the promisor and a suit against him by the promisee; the damages that could be established by the promisee would be nominal. Unless the donee beneficiary is given the right to recover against the promisor, even though he furnished no consideration and is not in privity of contract with the promisor, the purpose of the parties to the contract is defeated and the content of the promisor's consideration has lost its value. The donee beneficiary clearly has no right of action against the promisee, who is his donor, and a denial of his right of recovery against the promisor would frustrate the agreement between the promisee and promisor.

An illustration of the rights of a third party donee beneficiary is Shea v. Jackson, 245 A.2d 120 (D.C.App., 1968). The plaintiff was the widow of Simon J. Shea who had been employed by a certain Company for ten years prior to his death and was enrolled in a group life insurance policy issued to his employer. Defendant insurance broker induced the president of the employer Company to change the group life policy to another insurance company and represented to the president that all employees covered by the old policy would be covered by the new policy regardless of whether they were at work on the commencement date of the new policy. Shea enrolled under the new group insurance plan and named his wife as beneficiary. He died a few months later. The insurance company refused to pay on the ground that Shea was specifically excluded from coverage by the terms of the policy because he was not at work on the commencement date of the policy and had not returned to work prior to his death. The Court held that the widow was entitled as third party beneficiary to recover the principal amount of the insurance from the insurance broker for breach of his brokerage contract with the employer Company.

Creditor Beneficiary- A third person is a creditor beneficiary if no intention to make a gift appears in the contract and the performance of the promise will satisfy a duty owing by the promisee to the beneficiary. In this type of case the beneficiary is a creditor of the promisee, and the contract involves consideration moving from the promisee to the promisor in exchange for the promise to pay some debt or discharge some obligation of the promisee to the third person. The making of the contract does not in any way change or affect the obligation of the promisee to the beneficiary as it previously existed. Where the contract is enforceable, as it is by the weight of authority, the creditor beneficiary has both his rights against the promisee, based upon the original obligation, and rights against the promisor based upon the third party beneficiary contract. If neither performs, the third person can maintain separate suits against both and obtain judgments against both, although he can obtain satisfaction of only one of the judgments.

A title abstract company was held liable to the buyers of certain land for damages resulting from its negligent failure to include a public utility easement in the abstract of title that was prepared and certified by the abstracter and delivered to the buyers at the request of the sellers. Although the buyers had no contract with the abstract company, they were held to be third party creditor beneficiaries under the abstractor's contract with the sellers. The contract between buyers and sellers required sellers to furnish buyers with an abstract of title. Slate v. Boone County Abstract Co., 432 S.W.2d 305 (Mo.1968).

Rescission of the Contract. With respect to a rescission or discharge or variation of the contract between the promisor and promisee, and the effect thereof upon the rights of the third party beneficiary, as to donee beneficiaries generally the majority rule is that a right vests in the beneficiary at the time of the making of the contract, whether he has knowledge of it or not, of which right he may not be divested without his consent. As to creditor beneficiaries, the general rule is that the parties to the contract may rescind or make a variation in the contract if the creditor beneficiary has not learned of it or assented to it. If the creditor beneficiary has not brought suit upon the promise nor otherwise changed his position in reliance upon it before the parties to the contract have rescinded or altered it by agreement, such rescission or variation of the contract is effective as to the beneficiary. Where the third party beneficiary contract is executory on both sides a mutual rescission by the parties to the contract may be made at any time, and the beneficiary has no ground for complaint.

In an action by the beneficiary of a third party contract, the defendant promisor may assert any defense that would be available to him if the plaintiff in the action were the promisee. The rights of the third party are based upon the defendant promisor's contract. Any defense that seeks to show that no contract existed, such as illegality, or lack of capacity, mutual consent, or consideration, would be permitted. The defenses of fraud, duress, or failure of consideration, may also be pleaded by the defendant promisor.

Incidental Beneficiary- A third person who may be incidentally benefited by the performance of a contract to which he is not a party has no rights under such contract. It was not the intention of either the promisee or the promisor that the third person be benefited. Assume that for a stated consideration Mr. B promises Mr. A that he will purchase and deliver to Mr. A brand new Tesla automobile. Mr. A performs. Mr. B does not. Ms. C, the local exclusive Tesla dealer, has no rights under the contract although performance by Mr. B would produce a sale from which Ms. C would derive a profit. Ms. C is only an incidental beneficiary.

Assignments After Loss

As a general rule, after a loss occurs the policy represents a claim for money and may freely be assigned. The moral hazard has distinctly been reduced since the loss has already occurred, although there is the possibility that the assignee may collude with a corrupt contractor and submit a fraudulent claim. The insured's right to be paid for the loss is assignable without the consent of the insurer. Thus, if an insured's property is damaged by fire to the extent of $10,000, the right to collect that amount from the insurer under a fire policy may be assigned to a third party, even though the original policy could not have been assigned without the consent of the insurer. After the loss the insured has a mere claim for money that may be freely assigned. When, however, an attempt is made to assign an insurance policy prior to loss, the type of policy involved will control whether assignment is possible.

Loss-payable Clauses- An insured may provide in the policy for a future assignment of a claim for a loss. Such an arrangement is called an "anticipatory assignment," and is accomplished by including a loss payable clause in the policy. A loss-payable clause is only an assignment of the loss claim, if any, and is not an assignment of the policy.

Benefits of others- It is important that third-parties without an insurable interest not benefit from the insurance contract. After the obligations under a contract are completed, is either party still barred from transferring rights under the contract? Here it is just a debt being assigned This case illustrates the concept of assignment and how it relates to loss;

Ginsburg v. Bull Dog Auto Fire Ins. Ass’n of Chicago

(1928) 328 Ill. 571, 160 N.E. 145, 56 A.L.R. 1387.

PARTLOW, COMMISSIONER. Defendant in error, the Bull Dog Auto Fire Insurance Association of Chicago, a mutual and reciprocal insurance company, issued a policy of insurance to Nick D'Alassandro against loss by theft of an automobile. On January 17, 1920, the automobile was stolen and was never recovered. D'Alassandro assigned his claim under the policy to plaintiff in error, Elkin Ginsburg. The policy provided that "no assignment of interest under this policy shall be or become binding upon the association unless the written consent of the attorney is endorsed thereon and an additional membership fee is paid."

There was a verdict and judgment against defendant in error for $1,195.75.

The entire defense was based upon the failure to comply with the terms of the policy above quoted with reference to the assignment. There is a distinction between the assignment of a policy of insurance before loss and the assignment of a claim for loss after the loss has occurred. In the case of an executory contract, whether it is a policy of insurance or any other contract, the rule is well settled that the contract generally is not assignable without the consent of both parties thereto, where the personal acts and qualities of one of the parties form a material and ingredient part of the contract. [Citations.] This is upon the doctrine that everyone has a right to select and determine with whom he will contract, and he cannot have another person thrust upon him without his consent. In the familiar phrase of Lord Denman, "You have the right to the benefit you anticipate from the character, credit and substance of the party with whom you contract." After the contract has been fully executed and nothing remains to be done except to pay the money a different rule applies. The element of the personal character, credit and substance of the party with whom the contract is made is no longer material, because the contract has been completed and all that remains to be done is to pay the amount due. The claim becomes a chose in action, which is assignable and enforceable under section 18 of the Practice act, Smith-Hurd Stats.1927, c. 110, § 18. In Sloan v. Williams, 138 Ill. 43, on page 46, 27 N.E. 531, 12 L.R.A. 496, it is said: "It is true, that after the contract has been executed by the person agreeing to perform such personal services or exercise such personal skill he may assign the right to recover compensation.-3 Pomeroy's Eq.Jur. sec. 1275, note 2 supra." In May on Insurance (vol. 2, sec. 386,) it is said: "An assignment after loss is not the assignment of the policy but the assignment of a claim or debt-a chose in action. An assignment after loss does not violate the clause in the policy forbidding a transfer even if the clause reads before or after loss.

The reason of the restriction is, that the company might be willing to write a risk for one person of known habits and character and not for another person of less integrity and prudence, but after loss this reason no longer exists."

When the automobile was stolen and defendant refused to pay, a cause of action arose in favor of the insured. It became a chose in action and the policy became the evidence of the debt. The insured had the right to assign this debt, and when he did so, plaintiff in error had a right to begin this suit.

Judgment affirmed.

Insurance Policy Assignment	Sometimes circumstances call for the transfer to another of one’s interest in an insurance policy. In many kinds of insurance it is valid only with the consent of the insurer. It also refers to the transfer of one’s right to collect an amount payable under an insurance contract. The insurance contract is still a personal contract, but the law recognizes other factors that cause the restrictions on assignment to be lifted.

Life insurance- The four parties to a life insurance contract are the insurer, named insured, policyowner, and the beneficiary. It is generally agreed that an individual can get insurance on their own life and name whomever they please as beneficiary. It is an issue as to what extent a policy can be assigned to a person with no insurable interest. The most obvious problem is preventing the insurance policy from becoming a wagering contract, unintentionally or otherwise. Where does the concept of insurable interest end?

Generally, assignments must be made in good faith. *Mutual Life Ins. Co. v. Allen,* 138 Mass. 24, 30 (1884), is frequently quoted for giving insight:

We see nothing in the contract of life insurance which will prevent the assured from selling his right under the contract for his own advantage, and we are of opinion that an assignment of a policy made by the assured in good faith for the purpose of obtaining its present value, and not as a gaming risk between him and the assignee, will pass the equitable interest of the assignor; and that the fact that the assignee has no insurable interest in the life insured is neither conclusive nor *prima facie* evidence that the transaction is illegal.

It must be determined whether the assignment if a life insurance policy to one without an insurable interest in the insured life is a good faith transaction or a front for an illegal wagering contract. Still, the majority of courts have held that life insurance policies can be freely assigned to someone without an insurable interest in the named insured. The reasoning used is that the owner of the policy has an insurable interest in the named insured or *cestui que vie*. Because of this, prudence is assumed in the selection of an assignee. Strong evidence of a wagering scheme would be required. An example of this would be assignment of the policy right after the contract is written with all of the premium payments coming from the assignee.

Absent an express clause to the contrary in the policy, it is generally held that the consent of the insurer is not required for a fully effective assignment. If there is an irrevocable beneficiary, the owner of the policy cannot assign ownership without the consent of the beneficiary. There can be difficulty in defining the relative rights of a beneficiary and assignee to the proceeds of a policy. Who has the right to the proceeds and to what extents do those rights go? This is seen when less than the full interest in a policy is assigned, such as when the policy is assigned to secure a debt. When the assignment is made without following the formalities and guidelines in the assignment clause, things get even more difficult. Generally the assignments are honored

So it is that owners of life insurance policies may freely assign that policy to another person, who becomes the owner in control, without the consent of the insurer. This applies to policies taken out on the policyowner’s own life or on the life of another person in whom the owner has an insurable interest A specific provision, however, may restrict such assignment without the consent of the insurer or the beneficiary. In the absence of such a restriction the life policyowner may freely assign the interest. This transfer to a new owner may take place as the result of a contract, an assignment, or as a simple gift. However it occurs, the new owner becomes entitled to all rights of ownership and may borrow against the policy, cash it in, change the beneficiary, transfer it to still another owner, or do any of those acts that the owner of property may normally perform.

Exclusions Under the Insurance Contract

We looked at who is included in the insurance contract in the previous section. This section of the chapter deals with exclusions from the contract. Exclusions are one of the basic parts of an insurance contract. The three major types of exclusions are;

❶Excluded Perils- Certain causes of loss may be excluded from coverage. Catastrophic events are excluded. With the homeowners' policy, this means the perils of flood, earth movement, nuclear radiation or radioactive contamination. Losses associated with a moral or morale hazard are excluded. The insured cannot expect to collect insurance proceeds for the occurrence of excluded perils.

❷Excluded Losses- If certain perils are excluded from coverage, the losses from these perils are also excluded. Any but moral or morale hazards can be covered with the proper endorsement. For example, the losses from an earthquake can be covered by special insurance for that purpose.

❸Excluded Property- Limitations may be placed on coverage of certain property by the contract. Personal property that is excluded in a homeowner's policy would include automobiles, animals, jewelry and collectibles above a specific amount. The property of others in the care of the policyowner is usually excluded from liability insurance policies.

Liability and Exclusions

The most common type of third-party liability insurance is the Commercial General Liability (CGL) policy. They are intended to protect businesses from liability to third parties. The liability can arise out of any number of risks, but there are several uniform exclusions from coverage. CGL policies do not cover losses that are, “expected or intended from the standpoint of the insured.” This policy is also not intended to take the place of specialized coverages, as mentioned above. It does not cover employee injuries arising in the course of their employment (workers' compensation does that), losses arising from the use of an auto, damage to the insured’s own property, or damage to the insured’s product.

The growing field of environmental liability is another exclusion to the CGL policy. When pollution control became a front-burner issue in the 1970’s, pollution exclusion was incorporated into general liability policies. Pollution coverage was excluded except for such discharge of pollutants that was “sudden and accidental.” Litigation ensued in which the insured endeavored to prove that the discharge of pollutants over a lengthy period of time could be considered “sudden and accidental.” The U.S. Congress passed a series of anti pollution measures in the 1970’s, culminating with the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) in 1980. This Act had the effect of imposing strict liability on anyone owning property on which hazardous environmental discharges have occurred, even if the perpetrator was not the current owner. The net result has been that landowners are more eager than ever to seek coverage for environmental claims. The solution to these and any other gaps in coverage is to expand coverage by purchasing specialized insurance to cover the peril or add endorsements to the policy.

Policyowners face a liability loss whenever they expend money as a result of a legal claim brought against them. These expenses include defense costs, court costs, and any verdict, fine, or out-of-court settlement to which the claim ultimately may lead. They also may include expenditures to comply with an injunction or other court order.

The peril that causes these losses is the filing of a legal claim because this filing triggers these expenses. Even if the claim is resolved before formal court action is begun, the organization will have spent time money in response to the claim that otherwise would not have been spent.

Before a claim arises, a policyholder with an understanding of risk control techniques will often take steps to prevent losses-and neutralize the excluded perils. The cost of these precautionary actions, taken before an insurance claim (or legal claim) is filed, need to be objectively evaluated by the insured. The costs of the premiums are going to equal or exceed the expense of the precautionary measures, so it makes good economic sense to start and maintain some type of risk management program. Exclusions are necessary in an insurance policy because the named peril is considered to be uninsurable by the underwriters. The peril deviates from the requirements of an insurable risk;

- Large number of exposure units
- Must be able to calculate the probability of loss
- Loss cannot be catastrophic
- Loss must be determinable and measurable
- Loss must be accidental and unintentional
- The premium must be economically feasible

A hazard, peril or risk is the condition against which we insure. An important point to remember is the difference between liability loss exposures and the other exposures with which the insured must deal. Unlike almost any other type of risk, the peril causing liability losses is the adverse action of outsiders. The work of those who bring legal claims against an organization. Like all loss exposures, potential liability to others has three characteristics: 1) values exposed to loss 2) perils causing loss 3) adverse financial consequences of loss. The values exposed and financial consequences have liability exposures essentially parallel to other kinds of exposures; but the peril, a legal claim, is different. This difference and the aforementioned parallels are described below.

Exclusions are necessary because extraordinary hazards are present. Hazards are conditions that increase the probability of loss. If there is an extraordinary increase in hazard, a loss will have to be excluded. If an exposure faces an extraordinary hazard that is unique to it (not shared by the other exposure units) the premium charged will be too low. This results in an inadequate premium for the insurer and an inequity for the other exposure units. They are subsidizing the exposure unit faced with the extraordinary increase in hazard. Exclusions are also necessary because coverage for that type of peril is not usually needed by the typical policyowner. A unique peril might not be common to a large group of policyowners. It is inequitable for everyone to pay for coverage that they will not need or ever use. Coverage can be provided by other insurance. That is, an endorsement or rider for earthquakes, high priced art or collectibles, expensive home-based business equipment, etc. This way duplication of coverage is avoided. The best policy terms are included that will cover the largest potential group of insureds. Special items are excluded, but coverage can be tailored as needed.

Bad Faith Cause of Action

We now turn to an examination of what occurs when the insurer is slow to pay or decides not to pay. It is a normal, good business practice for one party to protect their position in a business or contractual relationship. This is why insurers carefully examine every claim. Every claim must be valid. To be such, it must meet the criteria as a loss covered under the contract. If it does not, the claim is rejected.

The insured has a different perspective. Claims are <u>always</u> valid. That is the reason they purchased insurance! This point of view may be obfuscated by a lack of objectivity, but it keeps an army of attorneys employed full time exploring the uncharted legal regions of where valid claim rejection ends and insurance company foot-dragging begins. The insurer-insured relationship is different from a traditional contractual relationship. Every insurance contract contains an implied covenant of good faith and fair dealing. This covenant imposes a duty on the insurer to act in good faith and fairly toward its insured in handling their claims.

<u>Bad faith cause of action </u>is a mixture of tort and contract principles. The rationale behind it is the theory of contract law that says there is an implied covenant of “good faith and fair dealing” implicit in every insurance contract. The intent is to see that the other party to a contract is not hindered in reaping the benefits of the contract. This implied covenant runs to both parties to a contract, but the courts have chosen to apply it solely as the foundation for a cause of action by insured against insurers. The cause of action can arise two ways;
1.) With third-party claims, in which the insured is seeking defense and indemnification from liability to a third party
2.) With first-party claims, where the insured is seeking indemnification from the insured for a loss suffered by the insured personally.

There is imposed upon the insurance company a responsibility to meet the reasonable expectations of the policyholder. “Unreasonable conduct” by the insurance carrier is the basic standard of liability in an action for breach of the covenant of good faith and fair dealing. Examples of unreasonable behavior include denial of benefits, paying less than what is owed, and delaying payments. However, there is no laundry list of acts constituting bad faith. Any act breaching the implied covenant of good faith and fair dealing will give rise to a bad faith cause of action. A common cause of action under bad faith is unreasonable delay. The courts have found the unreasonable delay in the investigation of a claim alone provides sufficient grounds to support a general and punitive damage award. An insurer has the duty to fully investigate claims, and must inquire into all possible bases that might support an insured’s claim. It cannot deny a claim without thoroughly investigating the basis for its denial. Even the filing of a lawsuit by an insured for “bad faith” reasons does not terminate the carrier’s duty of good faith and fair dealing for the particular claim in controversy. The same is true if the insurance company pays bills related to the claim in a first party case, or if the insurer eventually accepts the plaintiffs claim. The insured can still claim bad faith.

In many jurisdictions, if the victim of bad faith dies, it is possible that their estate may maintain an action for damages. Evidence of an insurer’s business practices is admissible in a bad faith action. They can be admitted to “show motive, opportunity, intent, preparation, plan, knowledge, identity or absence of mistake or accident.” (Evid. Code § 1101(b); Sprague v. Equifax, Inc. (1985) 166 Cal.App.3d 1012, 213 Cal.Rptr. 69). It is also important to point out that the insured does not need to prove that the insurer intended to cause harm in order to prove breach of the covenant of good faith and fair dealing. Intent to harm is not a prerequisite to establishing a breach of the insurer’s duty. The insurer is presumed to have knowledge of the insured’s emotional distress. When an individual purchases an insurance policy, the risks insured against presuppose that if a claim is made the insured will be under financial and emotional strain. In that scenario, the insured would be particularly vulnerable to oppressive tactics in the part of the insurance company. An insurance company is presumed to know that a denial of benefits may result in emotional distress to the insured.

As stated above, the courts use the implied covenant of good faith exclusively against insurers. The insurer has very little with which to counter attack. However, it has been held that an insured’s conduct that contributes to an insurer’s delay in investigation or processing a claim constitutes grounds for a “comparative bad faith” defense on the part of the insurer. It has also been held that an insurer can rescind a policy and refuse to honor a claim where the policyholder supplied incomplete or inaccurate information on the original insurance application. These conditions must hold true for the insurer to prevail in this point;
°The language of the insurance application is clear and unambiguous,
°No modifications in the application were made by an agent of the insurer
°The applicant had present knowledge of the facts sought, and appreciated their significance
°The insured intentionally misrepresented or concealed the facts
°The misrepresentation was a material one

The Combination

As stated earlier, the idea of bad faith in an insurance contract is a combination of tort and contract law. Only contractual damages are normally awarded for breach of contract. Contract damages do not include damages for mental anguish or compensatory damages arising out of the breach, or punitive damages. These kinds of damages have been awarded in tort actions for a long time. The recognition of bad faith as an independent tort is a recent development in the law created in response to the principle that for every wrong there should be a remedy.

<u>Additional Recovery</u>- The concept is that a person may recover additional damages in a breach of contract action if there is some independent tort associated with the breach that results in additional injury, and if the tortuous act indicates malice, fraud, or utter disregard for the rights of the insured. Bad faith damages are extra-contractual damages. The conflicting interest that led the courts to come up with the bad faith cause of action for the protection of insureds is shown in this example. Ms. Zuniga, the insured, has a liability policy with an upper limit of $65,000. One day, an action is brought against her to the tune of $125,000 by a third-party under a theory that falls within the coverage of the policy. The insurance company assumes control of the defense of the action, and, in the course of litigation, the third-party offers to settle the action for $65,000. We assume that the third-party has a good case on liability and damages, and that the offer of settlement is therefore an attractive one from the point of view of Ms. Zuniga, the insured cum defendant. This puts the onus on the insurer as to the course of action. From the perspective of the insurer, it would be better to decline the offer, since the insurer will lose no more if the jury comes in with a plaintiff's verdict for the full $125,000 than if the case is settled for $65,000.

Either way, the insurer's liability would be no more than $65,000 under the policy limits. If the case goes to trial, there is a chance that a jury will find for the defendant, or that plaintiff will be awarded damages less than the $65,000. From the insured's vista, to decline the offer of settlement within policy limits in order to gamble on a defendant's verdict is to gamble with the insured's money, since any verdict over $65,000 would come out of the insured's pocket. However, control of the defense of the action, including the right to decide to accept or reject a settlement offer, is rightfully assumed by the insurer under the terms of the policy. The big question (you might say, the $65,000 question) becomes whether or not a duty is owed by the insurer to give consideration to the interests of the insured in making its decision on settlement.

<u>Early legal opinions</u>- Courts found that the insurance company had the right to make the decisions concerning settlement. In 1923, a New York court said, "...there is nothing in the policy by which the insurance company obligated itself to settle, if an opportunity presented itself." Eight years later, the Massachusetts Supreme Judicial Court went the same route in observing that an insurance company, "....has an absolute right to dispose of an action brought against its assured.... in such way as may appear to it for its best interest." From that point, the courts began to recognize the concept of good faith and fair dealing as it applies to insurance contracts, culminating in the case of *Brown v. Guarantee Insurance Co.* (Cal.App.1957). This case used the idea of good faith and fair dealing as a springboard to promulgate the specific cause of action against an insurer for failure to consider the interests of the insured in refusing to settle an action by a third party. In the instant case, the insured had been sued in tort for $15,000 under an automobile policy. The insurer assumed the defense and rejected an offer of settlement at the policy limit of $5,000 without informing the insured of the offer. The insurer expressly took the position that unless some money could be saved on the settlement, the insurer had no reason to settle the case.

Differs from Contract Bad Faith Under contract law, the nonbreaching party to a contract owes a duty to mitigate the damages. When a contract breach is discovered, the injured party is required to do what reasonably be done to minimize the extent of the loss. Thus, when the buyer has breached a contract for the sale of goods, the seller must dispose of the goods at the best price possible. If the seller delivers a defective product and the buyer knows that the product is dangerous and may injure those who use it, the buyer must not permit it to be used. Similarly, if an employer, without cause, terminates an employee who has a one year employment contract, the employee must make a good faith effort to seek a similar position and thereby mitigate the employer’s damages. The employee may not go off on an extended holiday and expect the full remaining salary to be paid. If a lower paying job is found, the difference is the employee’s damages.
The concept of insurance “bad faith” does not follow this path. A number of courts have failed to classify the cause of action for bad faith as being either in the tort or contract domain. Those that have chosen to classify bad faith are split as to what it is. Some courts say that a cause of action that is based on an implied covenant in a contract must itself be an action in contract. Other jurisdictions have used the concept of good faith and fair dealing as a basis for defining the duty owed by the insurer to the insured, thus concluding the action is one in tort. If the bad faith action is seen as a tort claim against the insurer, it is usually held to be a matter of alleging negligent or intentional denial of claim or failure to process or to pay a claim without reasonable cause. Failure or delay in pursuing an investigation and settlement, and the delay of claim payment to coerce insureds into settling for less than the full amount due. Most states hold that if there is a reasonable cause for payment delay, there is no bad faith. In addition to claims practices, courts have also recognized causes of action for retaliatory cancellation and unfair increase in premium after filing a claim.

Almost all courts recognize that an insurer owes a duty to its insured to act in good faith and without negligence because, as in the example above, the insured has given up the right to settle or defend the action. The court may not raise the action to the status of an independent tort, but they will hold that failure to properly protect the insured’s interest makes the insurer liable for the full amount of the loss, even if the loss exceeds the policy limit. Not all jurisdictions recognize the independent tort in connection with breach of contract actions. Also, many states have now adopted standard laws imposing disciplinary actions for failure to properly settle insurance claims. As a response to this litigation trend, the individual states have adopted uniform laws designed to preempt the bad faith cause of action.

Chapter 7: More Insurance Coverage; Insurer Defenses

An applicant for insurance may have an insurable interest in chattel or a life, but this does not mean the insurance company desires to place a policy on what may be an undesirable risk. Over time, various control features have evolved to help the insurance industry protect itself from poor risks as well as misstatements or fraud on the part of insurance applicants. The insurance industry relies on warranties, representations, and concealment to bolster their position under the insurance contract. These tools also protect insurance consumers. Those who perpetrate fraud in order to collect under the terms of an insurance contract are only driving up the cost of insurance for other consumers.

The insured is expected to furnish to the insurer all information that may have a bearing on the risk being insured. This is done so that the insurer can properly estimate the risk it is assuming. This is also accomplished so as to leave as little doubt as possible as to exactly the nature of the particular perils against which the policy protects. This information is also important after a loss occurs. Once the insured event occurs, an orderly procedure must be followed to establish the amount of the loss. There are means of defense built into the insurance contract to protect the insurer when the insured fails to recognize their obligations under the contract. The tools available are concealment, misrepresentation, breach of warranty, breach of condition, and exception.

Insurer Defenses Gone Awry

First we will look at a report concerning the results of cases involving fraud on the part of the insured. With these cases, the incontestability clause of a life insurance contract plays a big role. Keep in mind the errors of the insurers pointed out by the court when later studying the tools available to protect insurers. The article is titled “Incontestability Laws Abet Fraud by Applicants.” It is from the *National Law Journal* edition of September 8, 1997, with a byline for Cynthia R. Koehler.

The article notes that a court's refusal to infer a fraud exception can expose to liability those carriers that waive medical exams. It is longstanding public policy that any insurance policy procured by material misrepresentation by the insured be subject to rescission by the insurance company. The gross and willful perpetration of fraud is particularly repugnant to the public interest, which dictates that such conduct be deterred at all cost. The article examines court decisions made recently in the states of Massachusetts, California, and Georgia that calls into question the depth of the courts’ commitment to combat fraudulent conduct by insurance applicants in the absence of specific legislative directive.

Case of Misrepresentation

The first case reported comes from the Massachusetts Supreme Judicial Court. In *Protective Life Insurance Co. v. Sullivan*, 425 Mass. 615 (1997), the court ruled that the commonwealth’s incontestability statute does not contain an implied exception for fraudulent misrepresentations by an insured. The appeal came from the 1st U.S. Circuit Court of Appeals, who certified two questions of state law to the Supreme Judicial Court seeking clarification of Massachusetts law pertaining to incontestability of insurance policies and fraud, the article notes.

The opinion was drafted by the Supreme Judicial Courts newest member, Justice Margaret Marshall. In it, the court declined to read a fraud exception into the incontestability statute. The article observes that the defendant in the case, Dennis J. Sullivan, was diagnosed with the human immunodeficiency virus, or HIV, and began a course of medical treatment that included the azidothymidine (AZT) drug in November of 1990. In September of 1991, Mr. Sullivan applied to Protective Life for an insurance policy on his life in the amount of $100,000. In the application he falsely stated that he was not taking any medication and omitted the names of doctors who were aware of his diagnosis.
He did authorize Protective Life to conduct medical tests, including a test for HIV. No medical tests were required of Mr. Sullivan by Protective Life, nor did it order an HIV exam. The insurance policy was issued November 8, 1991. It included an optional provision that, for an increase in premium, gave Sullivan the right to waive further premiums in the event he became disabled.

According to the report, Mr. Sullivan’s infection progressed to AIDS by 1992. By October of that year he stopped working and applied for disability benefits from another insurance company. Sullivan applied to Protective Life for a waiver based on his disability on November 8, 1993, exactly two years from the issuance date of the policy. Prior to that date, in October of 1993, Mr. Sullivan informed Protective Life that he wanted to assign the policy ownership to Dignity Viatical Settlement Partners, L.P. and a related entity. The payment for the exchange was $73,000 and in December of 1993 Protective Life approved the assignment. After this event, Protective Life initiated an action in federal court seeking rescission of the policy. A bench trial ensued (that means one without a jury, the judge is the trier of fact in that situation). The findings of the judge were that Mr. Sullivan had obviously committed fraud when he applied for the insurance. He knew he was HIV-positive at the time. Despite questions clearly calling for such information, Mr. Sullivan failed to disclose in his application that he was being treated for AIDs or a pre-AIDs condition. The new owner of the policy, Dignity Viatical, appealed the decision. On its own motion, the First U.S. Circuit Court certified two questions to the Supreme Judicial Court of Massachusetts.

The *Law Journal* goes on to report the legal questions and responses. Firstly; Does the Massachusetts law bar an insurance company from contesting the validity of a life insurance policy more than two years after its date of issuance on the ground that the insured made fraudulent misrepresentations in applying for the policy, given that the policy provided it was contestable for fraud at any time and the state insurance commissioner approved the policy form?

Legislative Action- In deciding whether the law permits an insurer to include a fraud exception to the required two-year contestability period for life insurance policies, the court looked first to the statutory language. Massachusetts General Law Ch. 175, Sec. 132(2), provides that no life insurance policy may be issued in the commonwealth unless it contains the following:
“...provision that the policy shall be incontestable after it has been in force during the lifetime of the insured for a period of two years from its date of issue, except for non-payment of premiums or violation of the conditions of the policy relating to military or naval service in time of war and except, if the company so elects, for the purpose of contesting claims for total and permanent disability benefits or additional benefits specifically granted in case of death by accident.”

The court's Justice Marshall observed, "...the legislature's omission of an exception for fraud...reflects its intent that there be no such exception." It is reported that Sec. 132 of the pertinent statute precluded the insurer from contesting the validity of the policy after it has been in effect for two years, except for three specific reasons (non-payment, wartime military, contesting disability claims). There is no exception for fraud in the wording of the statute and Justice Marshall observed, "The legislature's omission of an exception for fraud...reflects its intent that there be no such exception." A further illustration of the legislature's intent was pointed out by the court. Sec. 108(3)(a)(2) of the same statutory chapter sets forth the incontestability provision required in health insurance policies. That section specifically excepts "fraudulent misstatements." When the legislature wants to include a fraud exception to an incontestability statute, it knows how to do so.
The *Law Journal* article further reported Protective Life's argument concerning this inconsistency between statute Sec. 132 and Sec. 124. The insurer contended the statute language allowed those insurers to contest for fraud at any time policies issued without medical examination. The insurer held the view that life insurance policies issued without medical exams could be contested within two years of the date of issue if the insured made a material misrepresentation. After two years, insurers had to prove materiality as well as willful and fraudulent intent on the part of the insured. The Massachusetts court had a different outlook. They observed that Sec. 124 was enacted 15 years before any incontestability statute. The court said that Sec. 124's purpose was to raise the burden of proof an insurer must sustain when it contests a life insurance policy issued without a medical exam, not to create an exception to the incontestability statute that was enacted at a later time. The purpose of Secs. 124 and 132 when read together was to increase the insurer's burden of proof when it attempts to rescind, within two years, life insurance policies issued without medical examinations. The court said, "Neither the purpose nor the effect of General Laws Ch. 175, Sec. 124 was to create a fraud exception to the later enacted incontestability statute."

There is sound logic supporting the legislature's adoption of a requirement that life policies issued in Massachusetts contain incontestability provisions, according to Justice Marshall. The court quoted from an earlier case in supporting their decision. In *Metropolitan Life Ins. Co. v. DeNicola*, 317 Mass. 416, 418 (1944) the court found, "the incontestability clause is designed to require the insurer to investigate and act with reasonable promptness if it wishes to deny liability on the ground of false representation or warranty by the insured. It prevents an insurer from lulling the insured, by inaction, into fancied security during the time when the facts could best be ascertained and proved, only to litigate them belatedly, possibly after the death of the insured." When § 124 and 132 were enacted by the legislature, they were cognizant of the possibility that insured might obtain policies by fraudulent misrepresentation. Still, the court suggests, the fact that the legislature declined to include "as it surely could have" an exception to incontestability for fraud, "is evidence of the fact that no such exception was intended."

Toll Incontestability

Thus it was that the first question posed to the Supreme Judicial Court was answered in the affirmative, according to the article. The court then went on to answer the second question in the negative. Protective Life contended that the incontestability period was tolled (barred or defeated) in this case because Mr. Sullivan concealed his misrepresentation by delaying his application for a waiver of premiums on account of his disability for precisely two years or until the policy became incontestable. The court did not agree with this, saying that the doctrine of equitable tolling was applicable only if the prospective plaintiff did not have, and with the exercise of due diligence could not have had, the information necessary to bring suit. Mr. Sullivan had authorized Protective Life to conduct medical tests, including an HIV exam. The insurer would have discovered the fraud had it exercised reasonable diligence and not waived the medical tests. The Supreme Judicial Court disagreed with the district court's conclusion that Mr. Sullivan's delay in applying for a disability waiver of the premium amounted to an "ongoing course of fraudulent concealment." The court found that his delay in exercising his right did not constitute an "affirmative act," necessary for tolling incontestability on an equitable basis.

Health Insurance Incontestability

The *Law Journal* article goes on to report that courts in California, Georgia, and New Jersey have considered similar issues. *Blue Cross & Blue Shield of Georgia Inc. v. Sheehan* 215 Ga. App. 228 (1994) is a case in which the Georgia Court of Appeals was in accord with the trial court that an incontestability clause precluded the health insurer from challenging the validity of a policy based on the insured's fraudulent misrepresentations. Thomas J. Sheehan falsely denied that he had AIDS when he applied for a health insurance policy. The insurer, Blue Cross, never demanded under its contract rights that Mr. Sheehan submit to a medical exam.

More than two years went by before Blue Cross notified Mr. Sheehan that the policy was being rescinded based on fraud in the application. He then sued Blue Cross, saying that the insurer could not rescind because the period of incontestability had passed. The court agreed with Mr. Sheehan's contention. The lower court's decision was upheld by the Georgia Court of Appeals. Life and health insurance policies should be treated identically with respect to the incontestability clause. The appeals court went on to say that although the insured's conduct was fraudulent, it was the behavior of the insurer on which the court must focus. The insurer has an obligation "to be diligent in performing its duty to investigate within a specified period" according to the article.

Parallel Cases

The *Law Journal* article goes on to report two recent decisions in California that parallel the situations above. *United Fidelity Life Insurance Co. v. Emert* 49 Cal. App. 4th 941 (4th Dist. 1997) involves a life insurance policy issued by United Fidelity to Gregory D. Emert. When he applied for the policy, Mr. Emert falsely stated that he was not HIV positive, did not have an "immune deficiency disorder," and omitted any mention of physicians who had treated him for AIDS. With the elapse of the two-year incontestability period, he submitted a disability claim. On appeal from a lower court, the Court of Appeals referenced its longstanding rule that the incontestability clause prevented the insurer from contesting the claim based on fraudulent conduct. There were several steps that United Fidelity could have taken to investigate the validity of Mr. Emert's statements. The insurer failed to exercise its rights to demand blood or urine tests, and to conduct any medical examination. As noted in the case from Massachusetts above, the court declined to endorse equitable tolling of the incontestability statute based on the insured's fraud, noting that the legislature specifically excluded fraudulent statements in applications from the statutory bar. The court went on to say, "the incontestability clause required to be in life insurance policies does not provide for such exclusions or tolling periods. United Fidelity asks this court to create an exception for life insurance policies similar to that allowed by statute for disability policies. Such action is better left to the Legislature."

Double Fraud- The next case examined by the *Law Journal* article involves much the same question. The case is *Amex Life Assurance Co. v. The Superior Court of Los Angeles County and Slome Capital Corp.* 14 Cal. 4th 1231 (1997). In it, the Supreme Court of California confirmed that even gross fraud by an insured falls within the terms of the state's incontestability statute. Jose Morales lied concerning the state of his health when applying for life insurance. Amex issued him a life insurance policy containing the usual incontestability clause. With the exception of non-payment of premiums, Amex could not contest coverage after the policy had been in effect for two years during the life of the insured. On the application Mr. Morales lied about the fact that he was HIV positive and he failed to identify doctors treating him for the condition. The fraud was compounded by the fact that Mr. Morales had his brother take the exam in his place. The blood and urine samples obtained this way seemed to corroborate the good health of Mr. Morales. Amex issued the policy. Mr. Morales died a little more than two years after the insurance policy was issued. Death was due to an AIDS related illness. Shortly before his death, Mr. Morales had sold his policy to Slome Capital Corp., a Viatical settlement company. Prior to the policy proceeds being paid to Slome, an anonymous source told Amex that Mr. Morales had not appeared for the medical exam. An investigation by Amex showed that the applicant and the person tested were two different people.

The differences were borne out by handwriting samples and the fact that the person tested was more than four inches taller and over 30 pounds heavier than indicated in the application. Mr. Morales had engaged in gross and willful fraud. Both the California Supreme Court and the lower court agreed on this point. Had it been aware of Mr. Morales' AIDs condition, Amex would have never issued the policy in question. Still, the court held that the policy's incontestability provision barred Amex from rescinding it based either on misrepresentations in the application of the fact that Mr. Morales sent a *doppelganger* to take the medical exam. Justice Ming Chin pointed out that incontestability provisions were originally used by insurers to encourage a suspicious public to purchase life policies. The insurance companies came up with the idea of the incontestability clause. The selling point was that after an individual died, their estate would not have to contend with balking insurers who had trumped up a reason not to pay the insurance proceeds. The incontestability clause gives insurers the ability to detect fraudulent applications for insurance, but limits the time in which they can do so. The court said of the incontestability clause, "It is not a stipulation absolutely to waive all defenses and condone fraud. On the contrary, it recognizes fraud and all other defenses but it provides ample time and opportunity within which they may not be established."

In each of these cases listed above, the article goes on to observe, the court recognized the inequity resulting from its interpretation of the incontestability provision. The courts alluded to the fact that the acts of the insured in every case were fraudulent. The California court in the *Amex Life* case noted that, concerning the incontestability clause, the "sense of security given the great majority of honest policyholders by the presence of the clause in their policies makes it worth the cost."

The Massachusetts court in the *Sullivan* case said it will "recognize that Sullivan's willful concealment of his medical condition was deplorable and deserves condemnation. We do not pass judgment favorably or unfavorably on the balance that the legislature has struck between the competing policy interests...We simply conclude that the legislature was within its province in striking such a balance in the first instance." It remains to be seen whether decisions such as these will be an impetus to legislative activity on the issue. Massachusetts and California in the past have tried to balance competing public policies. This reduces premium cost in that it allows insurers to deny claims in cases of willful fraud, at the same time establishing a reasonable period in which to detect duplicity. The Sullivan and Emert courts noted a reluctance on the part of the state legislatures to take steps that might force beneficiaries to contend with insurance companies over the assertions made years ago by now-deceased insureds. It may be that legislatures will not intervene at all unless there is some powerful evidence that fraud of the magnitude managed by these three miscreants occurs on a regular basis.

Insurer's Means of Defense

As the cases above show, the insurer must pay the claim no matter how egregious the conduct of the insured. The time limit on the incontestability clause had lapsed. The courts refused to step in and modify what is in effect a job for the legislature. Still, the first line of defense for the insurer is to make certain that the applicant for insurance is aware that material misrepresentation will result in cancellation of the insurance policy. If the insured ultimately does take out a policy of insurance based on false information, there have been developed certain concepts that provide a line of defense for the insurer.

① <u>Warranty</u>- These are statements made by an insured that induces the insurer to enter into the insurance contract. The statement must be absolutely true, or the insurer can avoid its contractual obligations.

Affirmative warranties state conditions which must exist at the time the insurance contract is made. If the applicant says the premises to be insured are used as a grocery store, which is an affirmative warranty and needs to be true only at the time the policy is issued. If the statement is untrue as of that time, the policy is voidable from its inception.

Promissory warranties deal with something to be done during the period of the policy. If the applicant for a burglary policy states that a watchman will be on duty at all times, which is a promissory warranty.

The courts usually take the position that unless a warranty is clearly shown to be promissory, it will be presumed to be affirmative. There are four general statements that can be made concerning the courts' attitude towards warranties in insurance policies.

1.) The courts will sever a policy so that the breach of a warranty pertaining to one type of risk will not avoid the policy as to other risks or other parts of the subject matter. "Sever" in this context refers to a severable contract. That way, in the event of a breach by one of the parties, the contract may be justly considered as several independent agreements expressed in a single instrument. Where a contract is deemed severable, a breach of same may constitute a default of only part of the contract, saving the defaulting party from the necessity of responding in damages for breach of the entire agreement.

2.) At times a warranty may be only temporarily breached. If the insurer does not act to have the policy voided before the breach is cured, and if the risk is not substantially increased during the period of the breach, the court may hold that the policy is merely suspended during the breach and is revived when the breach is cured. This would allow the insured to collect on losses occurring after that point in time. Other courts continue to hold that once there is a breach, the policy remains voidable by the insurer after the breach is cured.

3.) The court can interpret a clause in a policy as something other than a warranty. A statement may not be expressly incorporated into a contract, or the insured's rights might not be clearly made to depend on the truth of the statement. In this instance, the statement will be interpreted as a representation rather than a warranty.

4.) The courts will render a warranty to be affirmative rather than promissory in the absence of clear language to the contrary.

<u>Breach of Warranty</u>- A warranty in an insurance policy is a clause in which the contract prescribes as a condition of the insurer's promise some set of conditions, either present or future, which affects the risk of the occurrence of an insured loss. Statements by the insured that are included as a part of the policy itself can be considered warranties. This is a different concept than representations, whose purpose is to persuade the potential insured to join in a contract with the insurer. In this sense, representations occur <u>before</u> the contract. Warranties, on the other hand, are an essential part of the issued policy. From the insurer's point of view, it is preferable that any contentious statement be considered a warranty rather than a representation. Reasons for this include the fact that a warranty must be strictly complied with by the insured whereas all that is required of a representation is that it be substantially true. If doubt exists as to whether a provision is to be considered as a warranty or a representation, it is normal for the courts to interpret such a provision more favorably to the insured. It will be seen as a representation breach.

So as to avoid such an interpretation, insurance companies have adopted the practice of labeling certain provisions expressly as warranties. It should be kept in mind that simply calling a provision a warranty does not necessarily make it one. A distinction between a warranty and a representation is that the warranty, in the absence of some sort of statutory modification, is categorized as being material. With a representation, the burden is on the insurance company to prove its materiality. This operation of warranty has been modified in most states by the adoption of legislation that usually provides that no breach of warranty will avoid an insurance contract or defeat recovery under the contract unless the particular breach materially increased the risk of loss or damage or injury. To avoid liability it is generally not necessary for the insurer to prove that the breach caused or contributed to the actual loss itself. If the fabrication pertinent to the warranty relates to an existing fact the policy is voidable from the creation of the contract. If the warranty relates to some future situation, the policy will become voidable upon the subsequent breach. If there has been a temporary breach of a warranty that has subsequently been rectified, the question arises as to whether the insurer can avoid liability on an ensuing loss. Courts are divided on the issue. Some will allow the insurance company to be relieved of liability while others consider the policy to have been no more than temporarily suspended during the period of the

<u>Breach of Condition</u>- It may be difficult to distinguish between the two terms “warranty” and “condition.” With insurance parlance, a condition is a provision of an insurance policy that relates to those circumstances required to exist in order to give the policy validity in the first place. They are provisions in the policy that qualify or place limitations on the insurer’s promise to perform, or those procedures that are required to be followed by the insured in the event of loss. An example is the provision in a life insurance policy which requires that the policy shall take effect only if it is delivered to the insured while he or she is in good health. Other conditions found in a contract include notifying the insurer if a loss occurs, protecting the property after a loss and filing a proof of loss with the insurer. If a car is damaged in an accident or a house damaged by fire, it is a violation of conditions to simply call the agent and inform them of the situation. “Call me at Aunt Rose’s when everything is back to normal,” is not the intent of the insurance contract. The insured must take a dynamic role in determining the amount of loss and making things whole again.

② <u>Representations</u>- Before a person concludes the purchase of insurance, certain questions will be asked of them by the insurer. The responses given to the insurer, usually in a formal application, are called representations**.** The general rule with respect to representations is that, if the consumer gives false answers and the answers are material to the risk, the insurer can void the contract. These are statements made by an applicant for insurance regarding, for example, occupation, state of health, and family history. It is a statement by an insurance applicant to induce an insurer to enter into a contract. The primary differences between representation and a warranty are as follows;

▫The insurer has the burden of proving the materiality of a misrepresentation before it will be grounds for avoidance but the materiality of a warranty or condition is conclusively presumed. Material means it is necessary, meaningful, and pertinent to a given matter. A material breach, in contract law, excuses further performance by the aggrieved party.

▫A representation will not be grounds for avoidance as long as it is substantially true, a warranty must be strictly complied with in order to preclude avoidance. All the insurer need demonstrate is that it has previously declined to accept at standard rates any insured with the same condition.

Misrepresentation- When an individual is in the process of purchasing insurance, they will be asked specific questions by the insurer pertinent to the type of risk being covered. The test of materiality is the question, “Would the insurer have written the policy at the same premium level if the truth concerning fact X been known?” It does not matter that the misstatement is innocent or made in good faith. Fraud is not necessarily an ingredient. It is only necessary that the insured misrepresented the facts, past or present, upon which the insurance company based its decision to issue the policy.

Some representations, like the type and year model of an auto, are easy to determine. Other facts are not quite so objective. A person might be asked to state whether they are in good health. Short of the outright lies illustrated in the cases above, a person may say they are in good health when in fact some form of cancer may exist in the body. Courts generally interpret statements that an applicant for insurance is in good health as a bona fide belief that he or she currently has no condition that would be considered a disease in the clinical sense. Such a representation does no more than convey to the insurer such information as the applicant might be expected reasonably to have, the applicant has not become aware of any symptom that their health has been impaired. Most states will permit an insurance company to avoid liability upon proof that the insured made a material misrepresentation. Several go beyond and require additionally that the misrepresentation be fraudulent.

③ Concealment- This is an act making more difficult the discovery of that which one is legally obligated to reveal or not to withhold. It is the failure of an applicant for an insurance policy to disclose information relevant to the insurer’s decision to insure the risk. Rather than the “Don’t volunteer nothin’,” attitude many people in business are taught, the insurance applicant must reveal all material facts. Silence in this situation is concealment. The test for the materiality of a concealment is the same as for a misrepresentation. The policy would not have been issued had all the facts been known. It is more difficult to void a contract for concealment than for misrepresentation. The insurer must demonstrate that the insured knew that a material fact was being concealed. The burden of proof as to fraud is on the insurer. Occasionally the insureds have been successful in arguing that they were led to believe by the insurer that the information was not material because it was not made a subject of inquiry in the application questions. Only when the insured conceals a fact in bad faith, knowing the fact to be material, will the policy be voided. Duty to disclose applies only to facts. It does not apply to concerns or opinions of the insured about his or her health or the subject matter of the policy. These rules taken together, work to the benefit of the insured.

This is silence when obliged to speak, any act that makes it more difficult to discover that which one is legally obligated to reveal or not to withhold. The insurance contract is one of utmost good faith. The applicant is required to reveal all material facts. The test question for materiality of a concealment is the same as for misrepresentation. Would the contract have been written in its current form had the facts been known? The willingness of the insurer to enter into a contract with the potential insured depends on the insurer having knowledge of all the facts affecting the risk involved. An applicant for insurance is charged with the duty to disclose to the insurer all material facts known to him or her. It is not necessary that the fact concealed contributes to the loss in order to enable the insurer to utilize the concealment as a defense against the insured. A fact is considered to be material knowledge if it would have caused the insurer to reject the risk or take it on at a higher premium rate.

One tactic used by insured to obtain information is to have the applicant answer specific questions. If the insured fails to answer a particular question After and by reason of such rejection and refusal, said egg powder in cans could not be sold for more than $1,168.20 and did not have a value in excess of said amount. By reason of smoke entering the plant as aforesaid, the plaintiff sustained loss and damage in respect of said egg powder of $53,910.00.

While the court below found that the egg powder in cans was not damaged, the findings are silent on whether there was damage to the containers or cans in which the egg powder had been packed for shipment pursuant to government specifications and requirements. We specifically, again, note here that the St. Paul Fire & Marine and Fidelity-Phenix policies provide that the merchandise in the plant, "including filled containers," is insured against "all loss or damage by fire originating from any cause except invasion, or any military or usurped power whatever." ., that omission is not considered a concealment once the policy is issued. The insurer could have noted the omission through inspection of the record of responses. The principle of concealment has as its purpose the acquisition of data pertinent to the insurance company in determining whether the policy should be issued, the duty of full disclosure exists only until the policy is issued or until the insurer is bound by contract to issue the policy. The insured does not need to disclose any knowledge acquired after the initiation of the contract with the insurer.

Importance of Related Clauses

The rules of warranty, representation and concealment are characteristics that set insurance contracts apart from other commercial transactions. When the insured acts in an underhanded manner, the insurer may be able to avoid the duty to indemnify the insured in the event of loss under the policy terms. As noted in the court decisions reported previously, the courts and legislatures are continually modifying contract interpretations to balance reasonable expectations with that which is equitable in the eyes of the law.

<u>Entire Contract & Incontestability</u>- These are two clauses in life and health insurance policies related to issues of warranty, representation and concealment. The entire contract clause requires that statements made by an insured in applying for life insurance be attached physically to the policy. The policy and the application together make up the entire contract of insurance between the insured and the insurer. The idea behind this is that it prevents the insured from maintaining in the future that the insurance company operatives recorded information in error. The insured is bound by the responses as recorded once the contract is signed.

The incontestability clause of an insurance policy is there by statute. After one or two years transpire, the insurer no longer has the ability to contest a policy and void the contract. If an insured makes a material misrepresentation, or outright lie, in applying for insurance, the insurer must discover the false statement within the time period or the lie becomes a type of legal fiction, it no longer affects the policy. Keep in mind that the insurance companies instituted the idea of incontestability clauses in the 19th century as a means of reassuring potential purchasers of insurance. The idea is to protect the insured or heirs from vapid claims of fraud on an application made twenty or thirty years ago by granddad. The incontestable clause is not designed to encourage fraud or incite people to cheat insurance companies. The idea is an insurance industry instituted method of balancing public policy needs against human nature. Some connivers collect on the insurance policies without depriving other insureds of their expected benefits

Duty Owed- When contracts involving a fiduciary duty are involved, a higher standard is required of the contracting parties. Most contracts entail no special requirements from one party or the other. Buying a pizza, renting a truck, or purchasing a piano are all arm's length transactions. Certainly, there are warrants of merchantability associated with each of these transactions, but the courts will not step in to remake contracts simply because of bad bargaining. There is no duty to advise the other party in a commercial transaction of all the facts we know. This never excuses fraud. Contracting parties cannot actively misrepresent the facts.

With insurance contracts, among the declarations will be a statement that the highest degree of good faith has been placed upon the parties. There must be full disclosure of all material information. Each party relies on the other in this personal contract and muddying up the waters only invites trouble. A lower level of truthfulness affords the insurer the right to void the contract. The following legal doctrines are related to the utmost good faith required in an insurance contract;

Theories of Materiality

No, not the new car, big screen TV, and trip to Vegas kind of materiality. Rather, that which is necessary, meaningful, and pertinent to a given matter is material. A material breach of contract excuses further performance by the aggrieved party. Conditions that arise under the concepts discussed above, warranty, concealment and misrepresentations; if material in nature, are grounds for breach of contract. In addition to the requirement that the misrepresentation be one of fact, it is necessary that it be material. It must relate to something of substance, something that induces the other to act as he did. In the sale of a race horse it may not be material whether the horse was ridden by a certain jockey his last time out, but the running time for the race probably would be. In determining the materiality of the representation, courts look to the impression made upon the mind of the other party. It is always material if, but for the misrepresentation, the other party would not have entered into the transaction. Many courts deem the misrepresentation to be material if in any substantial degree it influenced the other's decision, even though it was not the decisive factor.

Falsehood or an Intention to Deceive. To establish fraud it is not enough to show that the representation of fact was false; generally speaking, the misrepresentation must have been known by the speaker to be false and made with an intention to deceive. If the person acts reasonably and in good faith, fraud cannot be imputed, even though that party is in error. But in most jurisdictions, good faith alone will not protect a party to the contract. They may be honest in their belief, but unreasonable or negligent in so believing. One party to a contract may take at face value what was reported to them from a very unreliable source. In such case, fault or culpability can be ascribed to that individual, and he or she may be liable to the other party.

Moreover, many courts have implied knowledge to the representor and have held that person strictly responsible where the special situation or their means of knowledge was such as to make it their duty to know the truth or falsity of the representation. This frequently happens in business dealings or cases relating to sales of land or stock where the superior knowledge of the seller is usually apparent.

Reliance and Injury One is not entitled to relief unless they have justifiably relied upon the misrepresentation, to their own detriment or injury. Courts frequently speak of the requirement that the misrepresentation be the proximate cause of the action or change of position. If the complaining party's decision was in no way influenced by the misrepresentation, the complainant must abide by the terms of the contract. That person is not deceived if they do not rely. Moreover, if the complaining party knew or should have known that the representation of the defendant was untrue, but still entered into the contract, the courts will oftentimes not permit recovery of damages.

Silence on a Pertinent Matter- As a general rule, silence alone does not amount to fraud. There is no obligation on the part of a seller, for example, to tell a purchaser everything he knows about the subject of the sale, particularly if it is something that is reasonably apparent anyway. But there are exceptions. Many cases hold that if there is a latent (hidden) defect of a substantial character, one that would not be discovered by an ordinary examination, the seller is obliged to reveal it. Moreover, one may have a duty of disclosure because of prior representations innocently made but not in accord with existing facts. Here is an example; Ms. X in conversation with Mr. Y, states that X's land, known as La-La Farms, contains fifty acres. Ms. X supposes this statement to be true, and makes it with no expectation of selling the land. Subsequently Ms. X discovers that the land contains only forty-six acres, and after acquiring this knowledge, and having in mind her previous conversation, contracts with Mr. Y to sell him the land. Ms. X's lack of disclosure is fraud, and it is immaterial that Ms. X shows Mr. Y the boundaries of the land before the contract is made. The dominant party in a confidential or fiduciary relationship owes it to the other party to make a full disclosure of all facts relevant to the transaction. The party’s duty in this respect exceeds that of one who is dealing with another at arm’s length.

It is everywhere recognized that active concealment can form the basis for fraud. Truth may be suppressed by concealment quite as much as by active misrepresentation, and one must answer truthfully if asked a question by the other party. A denial of knowledge of a fact that one knows to exist, or the statement of a misleading half-truth, can form the basis for fraud.

Conditional Nature of the Insurance Contract

A condition is any operative event the happening or non-happening of which either limits, modifies, prevents, or precedes the duty of immediate performance under a contract, or terminates an existing obligation under a contract. A condition is therefore the natural enemy of a promise. It is inserted for the protection and benefit of the promisor. The more conditions to which a promise is subject, the less content the promise has. A promise to pay $5,000, provided that such sum is realized from the sale of an automobile, provided the automobile is sold within 60 days, and provided that the automobile which has been stolen can be found, is manifestly different from and worth considerably less than an unconditional promise by the same promisor to pay $5,000.

A fundamental distinction exists between the breach or non-performance of a promise, and the failure or non-happening of a condition. A breach of contract subjects the promisor to liability. It may or may not, depending upon its materiality, excuse nonperformance by the other party, the promisee, of his duty under the contract. The happening or non-happening of a condition prevents the promisee from acquiring a right, or deprives him of a right, but subjects him to no liability, as he has made no promise that the condition will or will not occur.

Conditions may be; express, implied in fact, or implied in law. They are also classified as conditions precedent, conditions concurrent, conditions subsequent.

These conditions are not external to the contract, that is, they do not relate to the formation or existence of the contract, but are either part of the contract as entered into between the parties, or arise by reason of events occurring subsequent to its formation. Consequently, none of the four essentials to the existence of a contract, offer, acceptance, consideration, legal capacity and subject matter, are treated as conditions.

◆Express Conditions. A condition is express when it is set forth in language usually preceded by such words as "provided that," "on condition that," "while," "after," "upon," or "as soon as". While no particular form of words is necessary to create an express condition, the operative event to which the performance of the promise is made subject is in some manner clearly expressed.

An illustration is the provision frequently found in building contracts to the effect that before the owner is required to pay the price, or the final installment thereof, the builder shall furnish a certificate of the architect that the building has been constructed according to the plans and specifications. The price is being paid for the building, not for the certificate, yet before the owner is obliged to pay, he must have both the building and the certificate, as the duty of immediate payment was made expressly conditional upon the presentation of the certificate. This condition is excused if the architect dies or becomes insane, or capriciously refuses to give a certificate, or if there is collusion between the owner and the architect.

The parties to a contract may agree that performance by one of them shall be to the satisfaction of the other who shall not be obligated to pay for it unless he is satisfied. This is an express condition precedent to the duty to pay for the performance. It is a valid condition. Assume that a tailor A contracts to make a suit of clothes to B's satisfaction, and that B promises to pay A $250 for the suit, if he is satisfied with it when completed. A completes the suit, using materials ordered by B. The suit fits B beautifully, but B tells A that he is not satisfied with it and refuses to accept or pay for it. A is not entitled to recover $250 or any amount from B by reason of the non-happening of the express condition precedent. This is so, even if the dissatisfaction of B, although honest and sincere, is unreasonable. Where satisfaction relates to a matter of personal taste, opinion or judgment, the law applies the subjective standard, and the condition has not occurred if the promisor is actually dissatisfied. The condition relates to the individual satisfaction of B and to no one else, including a reasonable man. However, if the contract were one for the sale of coal, steel, road building equipment, or items of everyday merchandise, the condition of satisfaction would be regarded as applying to the marketability, utility, or mechanical fitness of the subject matter, and the law would apply an objective standard. In such case, the question would not be whether the promisor was actually satisfied with the performance tendered to him by the other party, but whether as a reasonable man, he ought to be satisfied. Applying the objective standard, if the promisor reasonably ought to be satisfied, the condition has occurred.

◆Conditions Implied in Fact. Such conditions are similar to express conditions, in that they are understood to be part of the agreement, although not found in express language. They are necessarily inferred from the promise contained in the contract, and therefore must have been intended in order to give effect to the promise. Thus, if A for $800 contracts to paint B's house any color desired by B, it is necessarily implied in fact that B will inform A of the desired color before A shall commence to paint. The notification of choice of color is an implied condition of fact, an operative event that must occur before A is subject to the immediate duty of painting the house. Likewise, a promise to do plumbing or repair work at another's house is subject to the implied in fact condition that the promisor be given access to the house.

◆Conditions Implied in Law. A condition implied in law differs from an express condition and a condition implied in fact in that it is not contained in the language of the contract, or necessarily implied therefrom, but is imposed by law in order to make the performance of each party dependent upon performance or tender of performance by the other party, where such mutual dependency would not be inconsistent with the terms of the contract.

If A contracts to sell a certain horse to B for $2,000, and the contract is silent as to the time of delivery of the horse and payment of the price, the law will imply that the respective performances are not independent of one another. The law will treat the promises as mutually dependent, and therefore that a delivery or tender of the horse by A to B is a condition to the duty of B to pay the price and, conversely, payment or tender of $2,000 by B to A is a condition to the duty of A to deliver the horse to B. If the contract specified a sale on credit, and A gave B 30 days after delivery within which to pay the price, these conditions would not be implied as the parties by their contract have made their respective duties of performance independent.

The rationale of conditions implied in law is based upon the idea of doing fairness between the parties. Unless the parties have agreed otherwise, it is unfair that one party should be required to perform unless the other party performs. Conditions implied in law are imposed in order to do justice between the parties and to relieve against hardship. Where the performance by one party requires time, as in a contract by B to build a house for A, unless otherwise agreed, A is not obligated to make any payment to B until the house is completed. This is in fairness to A, as he should not be compelled to perform until B has performed. However, if B has substantially performed, that is, has completed the entire house except for one window in a bathroom, and sues A for the price, the court will not treat this failure of completion as ground for defeating B's action. B will recover the agreed price less an amount equal to the cost of installing the window and completing the house. It would be unjust to deny any recovery to B where he has substantially performed, and the law in such case will not impose complete performance by B as a condition to A's liability. It is fairer that A pay the price reduced by the cost of the window. B is allowed to recover because the condition, in this case satisfied by substantial performance, was implied by law and not created by the agreement between the parties. If the contract required an architect's certificate as a condition to A's duty to pay the price, and the architect refused to certify because of the missing window, by virtue of which he would be derelict if he did certify, B could not recover anything in his action against A. Such is the difference in effect between an express condition and a condition implied in law.

◆Conditions Precedent. A condition precedent is an operative event the happening of which precedes the creation of a duty of immediate performance under a contract. Where the immediate duty of one party to perform is subject to the condition that some event must first occur, such event is a condition precedent. A fire insurance policy usually provides that in the event of a loss by fire, the insured shall furnish the insurer with notice of the loss and a statement of the damage within 60 days from the date of the fire, and that a failure to give such notice will excuse the insurer from any liability for such loss. The required notice is an express condition precedent.

◆Concurrent Conditions. Where the proposed reciprocal and agreed performances of two mutual promisors are to take place at the same time, such performances are concurrent conditions. Such conditions can only exist where complete performance by both promisors can take place simultaneously. If A has contracted to sell B a watch for $100, with delivery and payment to take place concurrently, neither party may maintain an action against the other without first performing on his side or tendering performance. The party who is suing must have first placed the other party in default. In this respect concurrent conditions operate in the same manner as conditions precedent. However, where the conditions are concurrent, a tender of performance need not be absolute but may be made conditional upon receiving performance by the other party.

◆Conditions subsequent. A condition subsequent is an operative event that terminates an existing duty of immediate performance under a contract. Where goods are sold under terms of "sale or return," the buyer has the right to return the goods to the seller within a stated period, but is under an immediate duty to pay the price unless credit has been agreed upon. The duty to pay the price is terminated by a return of the goods that thereby operates as a condition subsequent. Insurance policies often contain a provision that in the event of loss and after due notice thereof has been given to the insurer, the insured must bring suit on the policy within twelve months from the date of the loss or be barred from recovery. The giving of proper notice of loss is a condition precedent, and upon its occurrence the insurer is under an immediate duty to pay the amount of the loss, which duty will terminate by lapse of time unless suit is brought with twelve months. The failure to bring suit within the stated period operates as an express condition subsequent which terminates the existing liability of the insurer.

As with warranties, conditions are of great importance in insurance contracts because they state what must exist before the contract is effective or before the insurer's promise to pay is enforceable. Failure of the condition to exist or to occur relieves the insurer from any obligation to perform its promise. A condition is simply an event the happening of which or its failure to happen precedes the existence of a legal relationship, or terminates one previously existing. Those statements in policies which the insurer looks upon as express warranties can be identified by the use of the words "warrant" or "on condition that..."

◆Conditional Receipt- This is an arrangement used in life insurance to provide coverage to an applicant before an actual contract can be issued. These agreements typically require the applicant to submit the first premium payment and are conditioned on the insured meeting all the requirements for acceptance by the insurer, including passing a medical examination. Conditional receipt is not a contract condition in the same context as the other "conditions" mentioned above. It is important that the agent is familiar with all the terms and can differentiate their meanings.

The terms, "warranty" and "condition" often seem to be used interchangeably in the insurance contract. The terms refer to representations or promises by the insured that are incorporated into the contract. Conditional provisions are always inserted in an insurance contract in order to qualify or place limitations on the insurer's promise to perform. The number of conditions and special phrasings required in those conditions have led to rules of construction of insurance contracts under rules that are highly favorable to the insured. All doubts with respect to meaning are resolved in favor of the policyholder.

Over the years many policy forms and conditions have become highly standardized. Legislatures and regulatory agencies alike require certain policy conditions in specific types of contract, and will permit only the prescribed language to be used. These restrictions have tended to limit the number of policy conditions that may be grafted onto coverages.

The many conditions and definitions as set forth in today's insurance policies are nearly identical language. This is due in large measure to legislative and regulatory control. This makes for standardization and affords the advantage of (hopefully) uniform court interpretations concerning the meaning of such standard provisions. Thus, the definition of an insured, the circumstances under which the vehicle must be used, and the policy exclusions are quite similar in automobile insurance. The same is true of the New York Standard Fire Insurance Policy of 1943 (Unit 5-1), which has been adopted in nearly all states in some form. Such uniform usage has contributed greatly to a general understanding of the policy conditions in fire insurance policies. The modern life insurance policy also contains very few exceptions, since regulatory authorities will refuse to approve policy language that is considered unnecessarily restrictive.

Policy conditions and exceptions are intended to, and do, define and demarcate the coverage of the insurance policy in a manner selected by insurers. The courts recognize this fact and interpret such provisions restrictively against the insurer.

Executory Contract

If a contract has been fully performed on both sides it is an "executed contract." To be correct, an executed contract is not a contract in the present tense. All of the duties under it have become discharged. The term "executed" is a handy term to describe a completed or fully performed contract. The term "executory contract" applies to the situations where there are one or more unperformed promises on one side or the other. The principal condition is the occurrence of the insured event. Until that event occurs, no obligation to perform exists on the part of the insurer.

With insurance contracts, the policyowner carries out their part of the bargain by paying the premium in a timely manner. The contract remains executory on the part of the insurer. Some act called for in the contract remains to be performed by the insurer. That is, the payment of a loss claim. The insurer does not execute its part of the agreement until the specified event occurs.

Discharge of Insurance Contracts

This last topic of the chapter deals with contracts and their termination. Offer, acceptance, consideration, legal capacity and subject matter are the elements needed for a person to be bound by a contract. When a contract is made, it is not intended that the duties thereby created shall exist forever. Contractual promises are made for a purpose and the parties reasonably expect this purpose to be fulfilled by performance. There are other ways a contract can be discharged. They generally fall into two categories, a.) by an act of the parties, and b.) by operation of law.

As stated previously, <u>conditions</u> are events that control the performance of contracts. The more conditions, the narrower the scope of the contract. Insurance contracts are normally ended by performance; the contracting parties do what was agreed. The insured pays premiums and abides by the conditions of the contract. The insurer stands ready to and then makes payment in the event of a valid claim. Insurance contracts may also be discharged if either side breaches their duty to perform. Failure to adhere to the conditions of the policy is a breach of the contract by an insured. This will allow the avoidance of the policy by the insurer. The concept of breach of duty or breach of conditions can become highly subjective in the eyes of one party to the insurance contract. Litigation is the result. Material breach of the contract by one party results in nonperformance by the other.

▪Performance. Undoubtedly, this is the most frequent method of discharge. If a promisor exactly performs his duty under the contract, he is no longer subject to that duty. Less than exact performance, such as substantial performance, does not fully discharge him, although it may provide him with rights against the other party to the contract by depriving such other party of an excuse for non-performance on his side. Where the contract is bilateral, a tendered or offered performance by one party to the other that is refused or rejected may be treated as a repudiation which excuses or discharges the tendering party from further duty of performance under the contract. So, when Mr. Smith dies, the contract is discharged when the insurer performs its duty under the contract by paying the death benefit to Mrs. Smith or whomsoever the designated beneficiary might be.

▪Prevention of Performance. If one party to a contract substantially interferes with or prevents performance by the other, such other party may be discharged. Prevention is usually asserted in connection with the non-occurrence of a condition. If a promisor whose duty of performance is subject to the happening of a certain operative event prevents the event from happening, he may not thereafter assert the condition as an excuse for his non-performance. For instance, A prevents an architect from giving a certificate that is a condition to A's liability to pay B a certain sum of money. A may not set up B's failure to produce a certificate as an excuse for A's nonpayment. Likewise, if A has contracted to grow a certain crop for B and after A has planted the seed, B plows the field and destroys the seedling plants, his interference with A's performance discharges A from his duty under the contract. It does not, however, discharge B from his duty under the contract.

▪Breach by One Party as a Discharge of the Other. Breach of contract always gives rise to a cause of action by the aggrieved party. It may, however, have a more important effect. Because of the rule that one party need not perform unless the other party performs, a breach by one party operates as an excuse for non-performance by the other party, and if the breach is material and goes to the essence of the contract, it discharges the other party from any further duty under the contract.

A slight breach, such as a three-day delay by a seller of goods in delivery to the buyer of the tenth installment under a twelve-installment contract, operates as a dilatory excuse for non-performance. The buyer may rightly take the position that he will not pay for or accept any more goods until the seller's breach is cured. He may not for such trivial breach take the position that he refuses to accept any more goods under the contract. However, if the seller fails to deliver the first installment, or completely misses two or three consecutive installments, the breach is more serious. This would be a material breach, and the buyer may assert it as an absolute excuse for non-performance discharging him from any duty to accept further deliveries of goods under the contract. The seller, however, would not be discharged from his duty to make compensation to the buyer for breach of the entire contract.

▪Anticipatory Repudiation. A breach of contract is simply a failure to perform it. It is logically and physically impossible to fail to perform a duty in advance of the date that performance is due. A party may announce prior to such date that he will not perform. This is a repudiation of the contract, informing the other party that a breach is in prospect. However, it cannot be an immediate breach, for if the repudiating party should later change his mind and fully perform on the appointed date, the contract would be both breached and performed. A repudiation of a contract prior to the date fixed by the contract for performance is called an anticipatory breach. The courts allow it to be treated as a breach and permit the non-repudiating party to bring suit immediately as if it were a breach.

▪Release and Covenants not to Sue. A release is technically a discharge under seal of an existing obligation. The term is also applied to any formal writing supported by sufficient consideration which recites a present relinquishment and termination of the rights therein described. A covenant or promise not to sue does not effect a discharge of the obligation, as does a release. It may be interposed as a bar to any suit brought in violation of the covenant and to this extent has the effect of a release. Covenants not to sue are usually employed where an obligee of joint obligors makes a settlement with one of them and wishes to preserve his rights against the others. A release of one joint obligor releases all of them. A covenant not to sue one or more but less than all obligors does not release the remaining ones.

▪Renunciation. A duty to make compensation in unliquidated damages for breach of a bilateral contract that is unperformed on both sides may be discharged by a manifestation of the obligee to treat his excuse for non-performance as a termination of the contract. Thus, if A contracts to employ B to work for one year at an agreed salary commencing July 1, and B on June 25 repudiates the contract by informing A that he will not work for him, A has an excuse for non-performance and may promptly fill the job by employing C. If this is all that happens, B would remain liable to A for breach of the contract. However, if when B repudiates, A tells B that he is satisfied and will regard the contract as terminated, both B and A are discharged by this act of renunciation.

▪Accord and satisfaction. An accord is a contract between an obligee and his obligor whereby the former agrees to accept and the latter agrees to render a substituted performance in satisfaction of the original obligation. Thus, if B owes A $500, and the parties agree that B shall paint A’s house in satisfaction of the debt, the agreement is an executory accord. The debt is not discharged by the accord. However, when B has performed the accord by painting A’s house, the $500 debt is discharged by accord and satisfaction.

▪Novation. A novation involves three parties and an agreement between them to substitute a new obligee in place of an existing obligee, or to replace an existing obligor with a new one. The effect is to discharge the old obligation by the creation of a new one in which there is either a new obligee or a new obligor. Thus, if B owes A $100 and A, B, and C agree that C will pay the debt and B will be discharged, the novation is substitution of the new debtor C for B. If the three parties agree that B will pay $100 to C instead of to A, the novation is the substitution of a new creditor C for A. In each instance the debt owing by B to A is discharged.

▪Cancellation or Surrender of Formal Contract. A contractual duty that is embodied in a contract under seal, or formal document, or negotiable instrument, may be discharged by a cancellation or surrender of the document or writing or instrument. Cancellation at common law refers to an act of the obligee that physically destroys or mutilates the document or consists in writing the word “cancelled” or a similar word on the face of the document. Surrender means a redelivery of the document by the obligee to the obligor or to someone on his behalf with the intention of relinquishing all rights therein.

An agreement of “cancellation” or “rescission” of a contract, under the Uniform Commercial Code, as in the case of “termination” or “cancellation” by unilateral action, applies only to the executory or unperformed part of the contract, and unless the contrary intention clearly appears, does not discharge any claim for damages for prior breach of the contract.

▪Res Judicata. A judgment entered by a court imposes an obligation of a higher degree than the contractual duty or duty to make compensation upon which it is based. Hence, such duty is discharged by a merger in the judgment. No further action may be taken with respect to such duty, and the rights of the obligee are confined to the judgment. If the adjudication by the court is in favor of the defendant, any obligation of the defendant asserted by the plaintiff and within the issues determined by the court is discharged and the plaintiff may not thereafter bring a new action to enforce any such obligation. The matter is *res judicata.*

▪Discharge of Sureties. In Chapter 4, we looked at the relationship between surety and insurance. A surety is one who is contractually bound together with another party known as the principal to pay a sum of money or render a certain performance to a creditor or obligee. The surety, unlike a guarantor, does not promise to pay if the principal does not pay. The promise of the surety makes him a primary obligor along with the principal. However, the relationship between the surety and principal is such that the latter should pay the creditor the whole amount that is due and hold the surety harmless. Any change in the obligation of the principal by agreement between the creditor and principal, such as an extension of the maturity of the debt or a change in the terms of the contract, discharges the surety.

▪Rescission can also terminate an insurance contract. This is the cancellation of a contract and the return of the parties to the positions they would have occupied if the contract had not been made. With an insurance contract, grounds for rescission may include original invalidity of the agreement, fraud, failure of consideration, or material breach or misrepresentation. When rescission is mutual, both sides voluntarily relinquish their rights and duties under contract. If the rescission is not mutual but one party feels that it has been the victim of fraud, it may ask the court to rescind the contract. This is the equitable remedy under common law.

▪Reformation. Policies may also be reformed. This is also an equitable remedy under common law. It consists of a revision of a contract by the court, in cases where the written terms of the contract do not express what was actually agreed upon. Reformation will generally only be decreed upon a clear and convincing showing of mutual mistake. If only one party was mistaken, reformation is not appropriate unless the mistake of one party resulted from the other party's fraud. For example, $1,000,000 is entered as the face value of a policy instead of $100,000. The policy can be reformed so that one party cannot take advantage of the other party's mistake. This is another example of the common law approach to striving for fair or equitable results under the law.

▪Mutual Rescission. A rescission is an agreement between the parties to a contract to terminate their respective duties under the contract. It is a contract to end a contract. All of the essentials of a contract must be present. Each party furnishes consideration in giving up their rights under the contract in exchange for the other party's relinquishment of rights therein. An oral agreement of mutual rescission is valid and will discharge a written contract unless the contract to rescind involves the retransfer of a subject matter which is within the Statute of Frauds, or unless under the Uniform Commercial Code the written contract provides that it cannot be modified or rescinded except by a signed writing. In such case, under the Code, an oral rescission or modification would be ineffective. A contract containing a provision, which is contrary to or inconsistent with a provision in a prior contract between the same parties, is a mutual rescission of the inconsistent provision in the prior contract. Whether the later contract completely supersedes and discharges all of the provisions of the prior contract is a matter of interpretation.