

April 1963

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### Repository Citation

Avery Thomas, *Insurance - Excess Liability Resulting from the Use of a Non-Waiver Agreement on an Insurance Contract Allegedly Void Ab Initio*, 4 Wm. & Mary L. Rev. 236 (1963), <https://scholarship.law.wm.edu/wmlr/vol4/iss2/14>

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## INSURANCE

*Excess Liability Resulting From the Use of a Non-Waiver Agreement On An Insurance Contract Allegedly Void Ab Initio.*

In *Milbank Mutual Insurance Company v. Schmidt*,<sup>1</sup> the insured filled out an application for liability insurance coverage which contained material misrepresentations. He in fact had a glass eye, had been canceled by other carriers, and had had a previous recent accident. A policy was issued based on the application and an accident occurred shortly thereafter. A judgement rendered in favor of the third party resulted in liability by the insurer of an amount in excess of the policy limits.

When the company's investigation revealed the material misrepresentations, the home office wrote to its agent indicating its desires that the agent cancel and pick up the policy. Before the agent had an opportunity to act, the accident occurred.

In light of the misrepresentations, the company proceeded to investigate under a non-waiver agreement. The injured party offered to settle, within the policy limits. The company realizing this to be a reasonable offer indicated its willingness to settle if the insured would secure its payment pending the outcome on the issue of the validity of the insurance contract. The insured refused, and judgement was ultimately rendered against him in excess of the policy limits.

The jury, in considering the contract issue, found that the company was liable for the limits of the policy for its failure to cancel within a reasonable time, and also liable for the excess on the ground that its failure to settle within the limits was "bad faith".

What legal justification do the Courts point to in allowing one the benefits of a contract obtained by false representation? Clearly the company acted with reasonable dispatch in writing to the agent of its findings, and requesting him to pick up the

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<sup>1</sup> 304 F.2d 640 (8th Cir. 1962).

policy. The weight of authority allows the jury to decide what is a reasonable length of time in effecting cancellation. Two days had elapsed from the time that the company became aware of the misrepresentations until the accident occurred, and the company had already put into motion correspondence to effect cancellation. Where then, the unreasonable delay?

The company apparently made two errors; (1) issuing a policy prior to verification of the statements of the application, (2) failure to reject immediately the application upon finding the material misrepresentations.

The issuance of the policy implies that coverage is in force. If any good reason should later come to light to warrant a cancellation, the company may cancel the existing coverage. The company assumes the risk of having to cancel a policy once issued rather than to reject the application before issuing the policy, and after a routine investigation on the application is made. Once it is established that there is a policy in force, the material misrepresentations render the policy voidable rather than void.

The Court determining that the policy was in force looked at the letter of the company to its agent and interpreted the letter as an indication of its desire to cancel, *not that it then and there did in fact cancel*. Once it was recognized that the policy was in effect the termination of the coverage was subject to ten days advance notice, bringing it well within the date of the accident. This seems to have been the sufficient grounds on which the jury found a valid contract.

The finding of "bad faith" on the part of the company, and holding it to excess liability is even more difficult to comprehend. To justify a recovery of a judgement in excess of the policy limits, the insured is held to a high degree of proof, to show fraud or bad faith on the part of the insurer.<sup>2</sup>

The company's position after the accident seems obvious. They felt that the policy was void ab initio, because it was

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<sup>2</sup> Lemmons v. State Auto. Mut. Ins. Co., 171 F.Supp. 92 (E.D. Ky. 1959).

obtained by false representations.<sup>3</sup> Because they are later found to be in error as to their position, can this be held as bad faith? Something more than a mere error in judgement is necessary to constitute bad faith, and the insurer cannot be required to predict with exact certitude the result of a closely contested lawsuit.<sup>4</sup> The gift of prophecy has never been bestowed on ordinary mortals, and as yet their vision has not reached such a state of perfection that they have the power to predict what will be the verdict of a jury—.<sup>5</sup> Insurers have been deemed to be free of bad faith in refusing to settle where there is considerable evidence of collusion and failure to cooperate,<sup>6</sup> a most serious violation, as well as minor violations, such as, where the insured has neglected to notify the company of a changed address and paying the higher premium.<sup>7</sup> It would seem evident that the insured in this instance fell somewhere between these two extremes, and that the company's failure to settle should not be deemed "bad faith".

Is the company acting in "bad faith" when it admits that an offer of settlement is reasonable and asks the insured to secure any payment that it might make after advising him that it considers that the insurance contract may ultimately be found void? Although there is some conflict as to whether paramount consideration should be given to protect the insured<sup>8</sup> or the insurer,<sup>9</sup> as a test of "bad faith", the great weight of authority takes the position that the insurer must give equal thought to the end that both the insured and the

<sup>3</sup> *Standard Accident Ins. Co. v. Pratt*, 130 Cal. App.2d 151, 278 P.2d 489 (1959).

<sup>4</sup> APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4712 (1962).

<sup>5</sup> *Georgia Casualty Co. v. Mann*, 242 Ky. 447, 46 S.W.2d 777 (1932).

<sup>6</sup> *State Auto. Mut. Ins. Co. of Columbus, Ohio v. York*, 104 F.2d 730 (4th Cir. 1939).

<sup>7</sup> *Kleinschmidt v. Farmers Mutual Hail Assn. of Iowa*, 101 F.2d 987 (7th Cir. 1939).

<sup>8</sup> *Tygers River Pine Co. v. Maryland Casualty Co.*, 170 S.C. 286, 170 S.E. 346 (1933).

<sup>9</sup> *Wisconsin Zinc Co. v. Fidelity and Casualty Co.*, 162 Wis. 39, 155 N.W. 1081 (1916); *Hilker v. Western Auto Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930); *American Fidelity and Casualty Co. v. G. A. Nichols Co.*, 173 F.2d 830 (1949).

insurer shall be protected.<sup>10</sup> "Bad faith" on the part of the insurer would be an intentional disregard of the financial interest of the insured, in the hope of escaping the full responsibility imposed upon it by the policy.<sup>11</sup> It would seem apparent that the company did give equal consideration to both interests in suggesting the settlement and asking for security. Certainly there was no intentional disregard of the insured's financial interest.

Where then the "bad faith"? Is the Court's keen sense of justice dulled by the deep pockets of the insurance company? It would at first seem so.

Notwithstanding the very strong foregoing arguments, the Court very properly looked at two acts of "bad faith" on the part of the insurer in holding it responsible for the excess liability. The company said that no coverage was in force due to the false representations, and that it was therefore cancelling the policy. How can it cancel that which it deems to be void *ab initio*? In proceeding with the investigation of the accident, the company operated under a non-waiver agreement. How can it say, "We by the operation of the non-waiver agreement do not waive any of our rights under the contract", and in the same breath say "there is no contract"? Herein lies the "bad faith" for which the Court found the company answerable in an amount in excess of liability provided under the policy.

Where the company assumes the position that one of the terms or conditions of the policy has been violated, the use of the non-waiver agreement seems perfectly acceptable. Where, however, the company alleges that there is no policy in force, because it was void *ab initio*, the use of the non-waiver would tend to destroy rather than to protect its rights, by admitting that the policy does exist.<sup>12</sup>

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<sup>10</sup> *National Mutual Insurance Co. v. Britt*, 203 Okl. 175, 200 P.2d 407 (1948).

<sup>11</sup> *Johnson v. Hardware Mutual Casualty Co.*, 109 Vt. 481, 1 A.2d 817 (1938); APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4712 (1962).

<sup>12</sup> *Western Casualty and Surety Co. v. Herman*, 209 F.Supp. 94 (E.D. Mo. 1962)—"The non-waiver agreement includes a paragraph which makes it clear that the policy is to remain in force, since the Company expressly refuses to waive any of its defenses . . . Under the agreement it seeks to affirm and disaffirm at the same time. It cannot do this."

In this era of high pressure selling of insurance through the media of radio, T.V. and news periodicals, the keynote has been "low rates and fast efficient service". In many instances, policies are issued within twenty four hours of the receipt of the application at the company home office. Just as frequently, policies are issued *immediately* by the local agent when the application is made out. In their zealous efforts to remain competitive in this highly competitive business, they seem to have lost sight of the very purpose the application is intended to serve.

Companies issuing policies prior to investigations bear the burden of having to cancel the coverage issued to unacceptable drivers. They also run the risk of being exposed to a claim during the time it takes to effectively cancel the coverage.

In view of the apparent attitude of the Courts, a reasonable approach would seem to suggest no issuance of a policy until it is determined that the applicant is acceptable. If not acceptable then insurers need only to reject the application. This would not require cancellation for there is nothing to cancel.

A. T.