



Spring 3-1-1961

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Recommended Citation

Fraud As A Defense To Insurance Contracts, 18 Wash. & Lee L. Rev. 172 (1961).

Available at: <https://scholarlycommons.law.wlu.edu/wlulr/vol18/iss1/23>

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FRAUD AS A DEFENSE TO INSURANCE CONTRACTS

With the growing number of insurance policies being written each year and the increasing collections by beneficiaries under such policies, an interesting problem has grown in importance. The problem arises under statutes requiring the insurer to attach a copy of the application for insurance to the policy when issued. When the insurer has not complied with the statute the question is presented as to whether the application can nevertheless be used to prove the defense of fraudulent procurement.

This problem arose in Virginia in the recent case of *Southland Life Ins. Co. v. Donati*,¹ and presented the Virginia Supreme Court of Appeals with its first opportunity to construe and apply the appropriate Virginia statute.² The husband of the beneficiary applied for and was issued a policy of insurance on his life. When the insured died, his wife, as beneficiary, brought an action on the policy. The company admitted issuance of the policy but denied that it was effective on the ground that it was obtained by fraud, claiming that the insured procured the policy by intentionally making false and fraudulent answers as to his health in his written application.³ The company contended that if the questions had been answered truthfully, the policy would never have been issued.⁴

The court held that the statute was remedial and that it was enacted solely for the protection of the insured.⁵ By stating what shall constitute the contract between the parties, the act was held to have eliminated any defenses available to an insurer who has not fully complied with the law.⁶

Under similar legislation the majority of courts have adopted a contrary view to that of the Supreme Court of Appeals. They have held that while an unattached application is not considered a part of the contract of insurance and is not admissible as evidence thereof, it is nevertheless admissible to show fraud in the procurement.⁷ The

¹201 Va. 855, 114 S.E.2d 595 (1960).

²Va. Code Ann. § 38.1-393 (Repl. Vol. 1953).

³201 Va. at 855, 114 S.E.2d at 595 (1960).

⁴Ibid.

⁵Id. at 857, 114 S.E.2d at 596 (1960).

⁶Id. at 860-61, 114 S.E.2d at 599 (1960).

⁷*Carrigan v. Massachusetts Benefit Ass'n*, 26 Fed. 230, (E.D. Pa. 1884); *Empire Life Ins. Co. v. Gee*, 171 Ala. 435, 55 So. 166 (1911); *Mutual Life Ins. Co. v. Allen*, 166 Ala. 159, 51 So. 877 (1909); *Coutch v. National Life & Acc. Ins. Co.*, 34 Ga. 593, 130 S.E. 596 (1925); *Johnson v. American Nat'l Life Ins. Co.*, 134 Ga. 800, 68 S.E. 731 (1910); *Holden v. Prudential Life Ins. Co. of America*, 191 Mass. 153, 77 N.E. 309

important distinction, recognized by the majority of courts, is that breach of warranty is based on the terms of the contract while fraud in the procurement is not.⁸ Breach of warranty assumes an existing contract while fraud questions whether or not there has been a creation or formulation of a contract in the first place.⁹ In the case of *Johnson v. American Nat'l Life Ins. Co.*,¹⁰ the Georgia Supreme Court made this differentiation, stating that:

"The legislative enactment, which declares that, under certain circumstances, an application for insurance shall not be considered a part of the policy or contract between the parties, does not prohibit one of such parties from showing that, whatever the contract was, it was procured by the fraud of the other."¹¹

Due to the serious consequences of proof of fraud—complete nullification of a transaction between two parties—courts have been reluctant to place limitations upon the ways by which fraud can be proved.¹² At common law fraud was always a proper ground for the avoidance of a contract.¹³ Even where the majority rule is not followed as to the admissibility of an application to show fraudulent procurement, it is recognized, as to fraud generally, that any statutory provision limit-

(1906); *Brunjes v. Metropolitan Life Ins. Co.*, 91 N.J.L. 296, 102 Atl. 693 (Ct. Err. & App. 1917); *Prudential Ins. Co. of America v. Niland*, 111 N.J. Eq. 347, 162 Atl. 605 (Ct. Err. & App. 1932); *Continental Gas Co. v. Owen*, 380 Okla. 107, 131 Pac. 1084 (1913); *Lindsey v. Metropolitan Life Ins. Co.*, 10 Tenn. App. 293 (1929); *First Texas Prudential Ins. Co. v. Pedigo*, 50 S.W.2d 1091 (Tex. Com. App. 1932); *Bowyer v. Continental Cas. Co.*, 72 W Va. 333, 78 S.E. 1000 (1913).

⁸Courts are in unanimous agreement that the claim of breach of warranty, as distinguished from the claim of fraudulent procurement of an insurance policy, cannot be relied on when a statutory requirement that the application be made a part of the contract or that the policy contain the whole contract has not been complied with. *Mutual Life Ins. Co. v. Allen*, 166 Ala. 159, 51 So. 877 (1909); *Couch v. National Life & Acc. Ins. Co.*, 34 Ga. 593, 130 S.E. 596 (1925); *Arnold v. New York Life Ins. Co.*, 131 Tenn. 720, 177 S.W. 78 (1915); *Bowyer v. Continental Cas. Co.*, 72 W Va. 333, 78 S.E. 1000 (1913). See also, *Annot.*, 93 A.L.R. 374 (1934) and 29 Am. Jur. Insurance § 281 (1960).

⁹*Metropolitan Life Ins. Co. v. Whutler*, 172 F.2d 631 (7th Cir. 1949); *Hayes v. Durham Life Ins. Co.*, 198 Va. 670, 96 S.E.2d 109 (1957); *Wheelock v. Clark*, 21 Wyo. 300, 131 Pac. 35 (1913). "The application itself is not the contract but is a mere offer or proposal for a contract of insurance. It is merely a step in the creation of the insurance contract." 29 Am. Jur. Insurance § 197 (1960). "An action for fraud is not an action on a contract but is an action for inducing the execution of the contract." 37 C.J.S. Fraud § 68 (1943).

¹⁰134 Ga. 800, 68 S.E. 731 (1910).

¹¹*Id.* at 732.

¹²*Empire Life Ins. Co. v. Gee*, 171 Ala. 435, 55 So. 166, 168 (1911); *Holden v. Prudential Life Ins. Co. of America*, 191 Mass. 153, 77 N.E. 309 (1906).

¹³*New York Life Ins. Co. v. Buchberg*, 249 Mich. 317, 228 N.W. 770, 772 (1930), admitting an unattached application for reinstatement of a policy of life insurance.

ing or destroying the right to prove fraud is in derogation of the common law.¹⁴ Any such provision should, therefore, not be extended beyond its plain meaning.¹⁵ This does not mean that parties to written agreements have been given an easy means of avoiding their obligations, nor that the burden of proving fraud is less than at common law. The title of the applicable section of the Virginia statute reads "Policy constitutes entire *contract* . . ."¹⁶ It would thus seem clear that the statute is to apply only to what shall constitute a contract and the terms thereof, and not to whether or not a contract exists to begin with.

While a statute such as that of Virginia protects the insured by making the entire contract available to him, it does not state that the application has no value as evidence to show the fraudulent procurement of the policy. In the absence of mandatory language to that effect the unattached application should be admissible to show fraud.¹⁷ This seems to be a common sense construction¹⁸ and false statements, intentionally made in an application, inducing the issuance of a policy are certainly none the less false because not attached to the policy.¹⁹

It is not clear from the statute itself that, as the court said in the *Donati* case, the intent of the General Assembly was to protect the insured alone and not the insurer as well.²⁰ No documents or reports of the formulating committee are available from which to determine the intent of the General Assembly.²¹ It would not seem unreasonable, however, to assume that the intent was to protect both parties, since the act provides for both parties to have a copy of the entire contract.²²

¹⁴*Id.* at 772.

¹⁵*Ibid.*

¹⁶Va. Code Ann. § 38.1-393 (Repl. Vol. 1953). (Emphasis added.)

¹⁷*Empire Life Ins. Co. v. Gee*, 171 Ala. 435, 55 So. 166, 168 (1911).

¹⁸*Carrigan v. Massachusetts Benefit Ass'n*, 26 Fed. 230, 232 (E.D. Pa. 1884); *Brunjes v. Metropolitan Life Ins. Co.*, 91 N.J.L. 296, 102 Atl. 693 (Ct. Err. & App. 1917); *First Texas Prudential Ins. Co. v. Pedigo*, 50 S.W.2d 1091 (Tex. Com. App. 1932).

¹⁹*Bowyer v. Continental Cas. Co.*, 72 W. Va. 333, 78 S.E. 1000 (1913); *Prudential Ins. Co. of America v. Niland*, 111 N.J. Eq. 347, 162 Atl. 605 (Ct. Err. & App. 1932).

²⁰The statute does not specifically state, nor even imply, that either of the two parties is to be protected more than the other.

²¹Letter from John B. Boatwright, Jr., Director Division of Statutory Research and Drafting of the Commonwealth of Virginia, to Raymond R. Robrecht, Jr., October 28, 1960.

²²"The intent appears to be to protect both parties, so that the application which gives inception to the policy will be included as a part thereof." *Ibid.*

While the letter indicates that both parties are meant to be protected at the inception of the contract, it has been shown that the statute seems to have only a contractual application and it does not spell out any reason for the application being attached other than so as to form a part of the contract.

Interpreting the statute to allow proof of fraud, by an unattached application, does not mean that the insured should not be protected, but this protection is provided by other means. The insured is protected in that an application not attached to the policy cannot be used to contradict the terms of the policy. Additional protection is given the insured by the incontestability clause, required in each policy of insurance by the section of the Virginia Code immediately following the section under discussion.²³ This section provides that after two years from the date of issuance the policy is incontestable by either party.²⁴ Certainly, this should be ample protection against the sudden cancellation of a policy by the insurer after one has paid premiums over a long period of time. By this clause the insured is also protected against the company's waiting until an action is brought on the policy to make known for the first time any representational errors made by the insured in his application. Thus, under ordinary circumstances, the insured is well protected against being deprived of his rights under the policy. However, it has been shown that fraud is the exception to ordinary circumstances since it deals with the existence and not the construction of the policy. To assume that a contract exists and to say that after a certain period it shall be incontestable is a different matter from saying that no contract existed in the first place. That the defense of fraudulent procurement is not precluded by the incontestability clause was pointed out in *Prudential Ins. Co. of America v. Niland*,²⁵ where the court stated that in the usual situation such a clause has been upheld as both a legal and equitable safeguard. However, the court held that persons named as beneficiaries of one who procured an insurance policy by intentional fraud would have little equity as against the insurer even though the period of contestability had passed.²⁶

It would have been reasonable for the court in the *Donati* case to have adopted the majority view and admitted the unattached application as evidence of fraud in the procurement. The Virginia statute appears to apply only to the contract itself and not to the use of an unattached application to prove fraud. In view of this, and of the consequences of proving fraud, it would seem that the statute should not be applied beyond its actual scope so as to deprive one of the right to prove fraud. The insured is sufficiently protected, under the statute

²³Va. Code Ann. § 38.1-394 (Repl. Vol. 1953).

²⁴"In each such policy there shall be a provision that the policy shall be incontestable after it has been in force for a period of two years from its date" Ibid.

²⁵111 N.J. Eq. 347, 162 Atl. 605 (Ct. Err. & App. 1932).

²⁶Id. at 607.