

5.3.4: Insurer's Defenses

Learning Objectives

1. Understand the principal defenses available to insurers when claims are made.
2. Recognize that despite these defenses, insurance companies must act in good faith.

Types of Defenses

It is a common perception that because insurance contracts are so complex, many insureds who believe they are covered end up with uninsured losses. In other words, the large print giveth, and the small print taketh away. This perception is founded, to some extent, on the use by insurance companies of three common defenses, all of which relate to a duty of good faith on the part of the insured: (1) representation, (2) concealment, and (3) warranties.

Representation

A **representation** is a statement made by someone seeking an insurance policy—for example, a statement that the applicant did (or did not) consult a doctor for any illness during the previous five years. An insurer has grounds to avoid the contract if the applicant makes a false representation. The misrepresentation must have been material; that is, a false description of a person's hair coloring should not defeat a claim under an automobile accident policy. But a false statement, even if innocent, about a material fact—for instance, that no one in the family uses the car to go to work, when unbeknownst to the applicant, his wife uses the car to commute to a part-time job she hasn't told him about—will at the insurer's option defeat a claim by the insured to collect under the policy. The accident need not have arisen out of the misrepresentation to defeat the claim. In the example given, the insurance company could refuse to pay a claim for any accident in the car, even one occurring when the car was driven by the husband to go to the movies, if the insurer discovered that the car was used in a manner in which the insured had declared it was not used. This chapter's case, *Mutual Benefit Life Insurance Co. v. JMR Electronics Corp.*, (see [Section 19.4.1 "Misrepresentation to Insurer"](#)), illustrates what happens when an insured misrepresents his smoking habits.

Concealment

An insured is obligated to volunteer to the insurer all material facts that bear on insurability. The failure of an insured to set forth such information is a **concealment**, which is, in effect, the mirror image of a false representation. But the insured must have had a fraudulent intent to conceal the material facts. For example, if the insured did not know that gasoline was stored in his basement, the insurer may not refuse to pay out on a fire insurance policy.

Warranties

Many insurance policies covering commercial property will contain warranties. For example, a policy may have a warranty that the insured bank has installed or will install a particular type of burglar alarm system. Until recently, the rule was strictly enforced: any breach of a warranty voided the contract, even if the breach was not material. A nonmaterial breach might be, for example, that the bank obtained the alarm system from a manufacturer other than the one specified, even though the alarm systems are identical. In recent years, courts or legislatures have relaxed the application of this rule. But a material breach still remains absolute grounds for the insurer to avoid the contract and refuse to pay.

Incontestable Clause

In life insurance cases, the three common defenses often are unavailable to the insurer because of the so-called **incontestable clause**. This states that if the insured has not died during a specified period of time in which the life insurance policy has been in effect (usually two years), then the insurer may not refuse to pay even if it is later discovered that the insured committed fraud in applying for the policy. Few nonlife policies contain an incontestable clause; it is used in life insurance because the effect on many families would be catastrophic if the insurer claimed misrepresentation or concealment that would be difficult to disprove years later when the insured himself would no longer be available to give testimony about his intentions or knowledge.

Requirement of Insurer's Good Faith

Like the insured, the insurer must act in good faith. Thus defenses may be unavailable to an insurer who has waived them or acted in such a manner as to create an estoppel. Suppose that when an insured seeks to increase the amount on his life insurance policy,

the insurance company learns that he lied about his age on his original application. Nevertheless, the company accepts his application for an increase. The insured then dies, and the insurer refuses to pay his wife any sum. A court would hold that the insurer had waived its right to object, since it could have cancelled the policy when it learned of the misrepresentation. Finally, an insurer that acts in bad faith by denying a claim that it knows it should pay may find itself open to punitive damage liability.

Key Takeaway

Some claims by insured parties can be legally denied by insurance companies where the insured has made a material misrepresentation. Some claims can be legally denied if the insured has deliberately concealed important matters in applying for insurance coverage. Because insurance coverage is by contract, courts often strictly construe the contract language, and if the language does not cover the insured, the courts will typically not bend the language of the contract to help the insured.

Exercises

1. Amir Labib gets a reduced rate from his auto insurance company because he represents in his application that he commutes less than ten miles a day to work. Three years later, he and his wife buy a new residence, farther away from work, and he begins a fifteen-mile-a-day commute. The rate would be raised if he were to mention this to his insurance company. The insurance company sees that he has a different address, because they are mailing invoices to his new home. But the rate remains the same. Amir has a serious accident on a vacation to Yellowstone National Park, and his automobile is totaled. His insurance policy is a no-fault policy as it relates to coverage for vehicle damage. Is the insurance company within its rights to deny any payment on his claim? How so, or why not?
2. In 2009, Peter Calhoun gets a life insurance policy from Northwest Mutual Life Insurance Company, and the death benefit is listed as \$250,000. The premiums are paid up when he dies in 2011 after a getaway car being chased by the police slams into his car at fifty miles per hour on a street in suburban Chicago. The life insurance company gets information that he smoked two packs of cigarettes a day, whereas in his application in 2009, he said he smoked only one pack a day. In fact, he had smoked about a pack and a half every day since 1992. Is the insurance company within its rights to deny any payment on his claim? How so, or why not?

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