Burglary Insurance Policies; Reasonable Expectations; Unconscionability; Application of Implied Warranty of Fitness; C & J Fertilizer, Inc. v. Allied Mutual Ins. Co.

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THE IOWA SUPREME COURT handed down a landmark decision in C & J Fertilizer, Inc. v. Allied Mutual Ins. Co., 227 N.W.2d 169 (Iowa 1975), in holding that insurance policies carry implied warranties that they are fit for their intended use. The impetus for this decision was a clause in a burglary and robbery policy which defined "burglary" as:

. . . the felonious abstraction of insured property . . . from within the premises by a person making felonious entry therein by actual force and violence, of which force and violence there are visible marks made by tools, explosives, electricity or chemicals upon, or physical damage to, the exterior of the premises at the place of such entry . . . .

The C & J Fertilizer Co. had requested insurance coverage from the defendant insurance company. During the negotiations that followed, the defendant's agent had pointed out that there had to be visible evidence of any burglary, but had not informed the plaintiff that such evidence had to be located at the exterior of the premises at the place of entry. The insurance was purchased after this negotiation between the two parties, but the policy, with its restrictive definition of burglary, was not delivered until sometime later.

Subsequent to this transaction, C & J did suffer a loss by burglary when equipment and farm chemicals worth almost $10,000 were stolen from an interior locked room located in its warehouse. The problem was that although there was evidence of a burglary—there were truck tire tread marks in the mud leading up to the exterior door of the warehouse, and the interior door to the room where the chemicals were stored had been broken into and visibly marked by tools—there were no visible marks on the exterior door. The outside door had apparently been opened by a clever manipulation of the locked handle. The insurance company refused to cover the loss, and the trial court, relying on the language in the policy, ruled in favor of the insurance company.
The trial court's holding followed the mainstream of insurance cases dealing with similar limitations. Such a provision is rather common and is inserted for the protection of the insurer. Even though the clause "clearly favors the insurer over the insured," courts in the past have upheld the limitation on the grounds that insurance companies would be subject to fraudulent claims without it, or that they have the right to pick good risks to insure. Even when the courts have been more sympathetic to the claimant, they have pointed out that the clause is unambiguous, and, therefore, there is no opportunity to construe language in favor of the insured.

In a 5-4 decision, the Iowa Supreme Court reversed the trial court's


7 Typically there are three different types of clauses by which insurance companies attempt to achieve this result:

1. A provision to the effect that the evidence produced by the insured must be "direct," "affirmative," or "conclusive;"
2. A stipulation that the mere disappearance of the insured article shall not be deemed evidence of burglary or theft;
3. A provision, as in the instant case, that there be "visible marks" or "visible evidence" of the use of violence.


10 Insurer understandably might be quite willing...

11 See cases cited note 6 supra.

holding. Its decision was based on three separate grounds:

1) Such a construction of the policy terms would go against the reasonable expectations of a person buying burglary insurance.  

2) The limitation on coverage, which was inserted as a definition of burglary under the BURGLARY section rather than in the section under EXCLUSIONS, where it would have been more apparent, was unconscionable. 

3) The insurance company breached an implied warranty to deliver a policy which would be "reasonably fit for its intended purpose," i.e., to provide the bargained-for protection.

The holding on the basis of reasonable expectations was not unforeseeable as recent cases have used that concept as a standard by which to measure insurance coverage. The Iowa Court itself recognized the doctrine in 1973 in an automobile insurance case. There the court said:

The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations.

In C & J Fertilizer the court directly applied that language and found that the holding of the trial court should have been affirmed primarily because its findings that the terms of the policy had not been complied with was supported by substantial evidence. It thought that the plain meaning of the contract words should apply.

14 Id. at 177. The minority thought that the doctrine of reasonable expectations ought not to apply in this case because an officer and director of the plaintiff corporation "knew the disputed provision was in the policies." Id. at 183.

15 Id. at 179-81. The minority would not apply the doctrine of unconscionability because "the great majority of courts" have not found such a provision to be against public policy. Id. at 184.

16 Id. at 177-78. The minority found the theory of implied warranty to be unacceptable because there is no case authority for it. Id. at 184.


19 Id. at 906, quoting R. KEETON, INSURANCE LAW—BASIC TEXT § 6.3 (a), at 351 (1971).
that under the circumstances the plaintiff could have reasonably anticipated
that coverage would be denied in the case of an "inside job", and that visual
evidence would be required to indicate that the burglary was indeed an
"outside" job. It was not reasonable to anticipate, however, that the visual
evidence had to be on an exterior rather than an interior door. The court
did no more than apply a previously articulated concept to burglary insurance
policies, where only the literal language of the contract had previously been
taken into account.

Nor was the holding on unconscionability totally unexpected. Even
though courts have not directly applied the doctrine of unconscionability
—which is normally used in connection with the sale of goods—to insurance
contracts, it has probably been recognized silently in many cases which were
decided in favor of the insured apparently on the theories of waiver or estoppel or
by a "process of pseudo 'interpretation'."

The Supreme Court of Kansas approached direct recognition of the
principle of unconscionability in a case which was very similar to C & J
Fertilizer. In that case, the policy in question provided that there must be
visible marks of force and violence upon the exterior of a safe for burglary
insurance to be effective. The combination lock on the exterior door was
manipulated so that there were no "visible marks" on it, but the inside door,
which was fastened with a lock, did bear visible marks of violent entry.
The court held that the plaintiff's loss was covered by the policy because,

. . . the assertion of such rule by the insurance carrier, beyond the
reasonable requirements necessary to prevent fraudulent claims against
it . . . contravenes the public policy of this state. This becomes apparent
when the statement of the rule in the policy itself, or its assertion by
the insurance carrier, is designed to prevent recovery on an obviously
justifiable claim.

In short, it would be unfair to deny coverage when the substantive terms
of the policy had been met.

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20227 N.W.2d at 177.
21 Uniform Commercial Code § 2-302(2) provides:
   If the court as a matter of law finds the contract or any clause of the contract to have
   been unconscionable at the time it was made the court may refuse to enforce the contract,
   or it may enforce the remainder of the contract without the unconscionable clause, or
   it may so limit the application of any unconscionable clause as to avoid any unconscion-
   able result.
22 This is probably the only way to explain such cases where there was in fact no voluntary
   relinquishment of a known right or detrimental reliance on the part of the insured. Keeton,
   supra note 12, at 963.
23 6A. A. Corbin, Contracts § 1376, at 21 (1962) [hereinafter cited as Corbin].
25 Id. at 470-71, 370 P.2d at 387.
Once the situation is recognized as basically unfair, it is but a short step to apply the doctrine of unconscionability directly. Such an application would fall into the normal stream of cases concerning contract construction. Courts have often shown suspicion of standard form contracts which contain several pages of small type and which are designed to favor the drafter. This is particularly true in cases where there is a disparity of bargaining power between the parties. Insurance policies fall into this category in that they are long standardized forms drawn up by powerful commercial units, namely the insurance companies. Typically, the insured bargains for the coverage limits and the premium amount, but has no say as to the volume of fine print accompanying his bargain. In addition, it is common practice for the policy to be delivered after the insurance has been purchased, at which time there is little motivation to study all the many provisions. In C & J Fertilizer, the court recognized such factors and said that it was better to point out clearly why it would not enforce the provision in question than to bury its reasons in a distorted application of traditional rules.

It was the third basis of recovery—that insurance policies carry an implied warranty that they are reasonably fit for their intended purposes—which was innovative and perhaps controversial. That holding totally ignored prevailing insurance case law and instead looked to Section 2-315 of the Uniform Commercial Code. That section was drafted to cover sales of goods and has no direct application to insurance contracts. The Iowa Court evaded the problem by saying that it did not need a statute to imply a warranty, but that the standard of the U.C.C. was valuable in that

26 A. Corbin, Contracts § 128 (one vol. ed. 1952).
27 Keeton, supra note 12, at 963.
28 Corbin, supra note 23.
29 Slawson, Standard Form Contracts and Democratic Control of Lawmaking Power, 84 Harv. L. Rev. 529, 545 (1971) [hereinafter cited as Slawson].
30 Keeton, supra note 12, at 968.
31 227 N.W.2d at 181.
32 It should be noted that while five justices concurred in the holdings on reasonable expectations and unconscionability, only three agreed that implied warranties should be applied to insurance policies.
33 Uniform Commercial Code § 2-315 provides:
Where the seller at the time of contracting has reason to know any particular purpose for which goods are required and that the buyer is relying on the seller's skill or judgment to select or furnish suitable goods, there is . . . an implied warranty that the goods shall be fit for such purpose.
34 The U.C.C. defines "goods" at § 2-105 as meaning, . . . all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities . . . and things in action. "Goods" also includes the unborn young of animals and growing crops and other identified things attached to reality . . .
35 227 N.W.2d at 178. Since implied warranties were originally created by the common law, a
"[t]he typical applicant buys 'protection' much as he buys groceries,"\textsuperscript{36} and should not be deprived of "those remedies long available to purchasers of goods."\textsuperscript{37}

Ordinarily a court does not apply policies reflected by statutory law. Statutes have been narrowly construed and confined to their special areas,\textsuperscript{38} in spite of the fact that eminent legal writers have urged that statutory law be elevated to a status fully equal to that of case law and be used as a model from which to analogize in appropriate situations.\textsuperscript{39} This has occurred in the case of the U.C.C.\textsuperscript{40} Thus, although the Iowa decision is unique insofar as it pertains to insurance law, the extension of the policies of the implied warranty sections of the U.C.C. to transactions other than those involving the sale of goods is not.\textsuperscript{41}

Courts have implied warranties in cases of bailments for hire,\textsuperscript{42} the sale of new houses,\textsuperscript{43} the leasing of real property,\textsuperscript{44} goods supplied in connection with the rendition of a service,\textsuperscript{45} and occasionally even contracts for


\textsuperscript{37} Id.


\textsuperscript{39} Id.; Stone, The Common Law in the United States, 50 Harv. L. Rev. 4, 13 (1936).

\textsuperscript{40} Murray, Under the Spreading Analogy of Article 2 of the Uniform Commercial Code, 39 Ford. L. Rev. 447 (1971).

\textsuperscript{41} The drafters of the U.C.C. encouraged this result. Uniform Commercial Code § 2-313, Comment 2, reads:

\begin{quote}
... the warranty sections of this Article are not designed in any way to disturb those lines of case law growth which have recognized that warranties need not be confined either to sales contracts or to the direct parties to such a contract. They may arise in other appropriate circumstances ... [T]he matter is left to the case law with the intention that the policies of this Act may offer useful guidance in dealing with further cases as they arise.
\end{quote}


service. This has been accomplished either by calling the transaction in question a "sale", and then directly applying the U.C.C., or by saying that it is so analogous to a sale that the imposition of an implied warranty is justified.

The Iowa Supreme Court thought that insurance coverage could be analogized to a sale. An insurance company issues standardized policies so that it can predict its risks. Losses are reflected in premium rates. This is not so different from the modern manufacturer who mass produces standardized goods and is thereby enabled to "calculate the percentage which the risk of loss bears to each unit and . . . [to] reflect it in the sale price of the goods." Both groups make a profit from the sale of their products, and the Iowa court thought it particularly noteworthy that both depend on advertising in order to promote their "wares".

However, it is not enough to point out that the two types of transactions have similar characteristics. It is also important to examine the reasons behind the extension of the implied warranty concept and determine whether or not they are present in the transaction at issue.

Generally, implied warranties arise when "social policy requires that dealings be invested with minimum standards of responsibility." The factors most often considered are the following:

1. whether the public interest is affected;
2. whether the seller is better able than the buyer to determine the quality of the product;
3. whether the buyer normally relies on the seller's judgment and reputation; and,

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48 Slawson, supra note 29, at 552.


50 227 N.W.2d at 177.


52 Id. at 369.

Published by IdeaExchange@UAkron, 1976
whether the seller is better able to bear the loss and to distribute the risk of loss over all his customers.\textsuperscript{53}

These underlying policy considerations are all present in an insurance transaction. The insured agrees to pay his premium in order to be protected against an unexpected, but potentially devastating, loss.\textsuperscript{54} The public is affected in that society will have to bear the burden if the insured is not protected.\textsuperscript{55} It is the insurance company which drafts the contract, and it is well aware of the quality of the coverage it is offering. The buyer, even if he were to wade through the pages of small type, is usually unaware of the statistical frequency of various occurrences. In \textit{C \& J Fertilizer}, the court deemed particularly important the facts that the buyer must almost totally rely on the insurance company to sell him the coverage he needs, and that he does not even know what he is getting until after the transaction is completed.\textsuperscript{56} In addition, the insurance company can bear any loss more easily than can the individual purchaser; in fact, that is precisely the reason it is in business.\textsuperscript{57}

Given that the purchase of insurance is not unlike the purchase of goods, and that the policy considerations for implying a warranty are met, the \textit{C \& J Fertilizer} holding can be regarded as a natural development of the case law which has extended the U.C.C. warranties to non-sale situations. Viewed in this light, the holding is not startling. What is unusual is that the court did choose to apply this body of law to an insurance case rather than to look to traditional precedent in the area of insurance law.

It should be noted that the Iowa court made its holding on implied warranties in a case where it would have been obviously unfair to deny coverage to the insured. If implied warranties on insurance policies are limited to like situations, there will not be much effect on insurance law. These kinds of cases can already be resolved on other grounds, as, for example, by application of the doctrine of reasonable expectations.\textsuperscript{58}

If, on the other hand, implied warranties come to be applied to insurance


\textsuperscript{54} 1 RICHARDS ON THE LAW OF INSURANCE § 1, at 2 (5th ed. 1952).


\textsuperscript{56} 227 N.W.2d at 178-79.

\textsuperscript{57} 1 RICHARDS ON THE LAW OF INSURANCE § 1, at 3 (5th ed. 1952).

\textsuperscript{58} See text accompanying notes 17-20 supra.
cases in general, the effect could be far-reaching. Although the court did not prescribe the coverage that an insurance company must offer,\textsuperscript{59} it did require that the policy which the insurance company later delivered "be reasonably fit for its intended purpose".\textsuperscript{60} The written terms must not be unreasonable or unfair, and they must provide the protection that the insured bargained for when he purchased the insurance.\textsuperscript{61}

The court insisted upon full disclosure of any limitations on coverage.\textsuperscript{62} Disclosure was seen as beneficial in that "technical policy provisions which tend to drain away bargained-for protection"\textsuperscript{63} would be eliminated. And if a purchaser deliberately elected limited protection for a lower premium, at least he would be fully aware of what coverage he was receiving.\textsuperscript{64}

In a society which has become increasingly complex, we have felt a need for Truth in Lending, Truth in Advertising, and labels that clearly identify the components of our food and clothing. If the \textit{C & J Fertilizer} holding is followed, we will have Truth in Insurance as well.

\textbf{JANICE GUI}

\textbf{TORTS}

\textit{Automobile Guest Statute} \cdot \textit{Unconstitutional} \cdot \textit{Equal Protection} \\
\textit{\textbullet} \textit{Due Process} \cdot \textit{Right to Seek Legal Redress}

\textit{Primes v. Tyler}, 43 Ohio St. 2d 195, 331 N.E.2d 723 (1975)

In July 1975, the Supreme Court of Ohio in the case of \textit{Primes v. Tyler}\textsuperscript{1} joined a small but growing number of states\textsuperscript{2} which have declared automobile guest statutes\textsuperscript{3} unconstitutional. The circumstances of the \textit{Primes} case are similar to those encountered in countless other suits brought by injured

\textsuperscript{59} Such a requirement, which would set forth general standards, would be more akin to the warranty of merchantability under \textit{UNIFORM COMMERCIAL CODE} § 2-314(2)(c).

\textsuperscript{60} 227 N.W.2d at 177. Probably the warranty of fitness for particular purpose was selected because the insurance purchaser relies on the agent to provide a policy which corresponds to the needs which the purchaser has communicated. \textit{See UNIFORM COMMERCIAL CODE} § 2-315, Comments 1 & 2.

\textsuperscript{61} 227 N.W.2d at 178.

\textsuperscript{62} \textit{Id.} at 179.

\textsuperscript{63} \textit{Id.}

\textsuperscript{64} \textit{Id.}

\textsuperscript{1} 43 Ohio St. 2d 195, 331 N.E.2d 723 (1975).


\textsuperscript{3} Ohio's statute is typical of those of states which have guest statutes. \textit{OHIO REV. CODE ANN.} § 4515.02 (Page 1973). Guest statutes have frequently been criticized for the harsh conse-