CHAPTER - IV

LEGAL FUNDAMENTALS OF INSURANCE CONTRACT

In the previous chapter, chapter three, we have seen the basics of insurance contract such as: meaning, function, characteristics, cost and benefits of insurance. Moreover, we tried to difference between insurance, speculation and gambling. In this chapter we will see the legal part and parcel of insurance contract including the legal principles, legal requirements and legal unique characteristics of insurance contract.

Chapter objectives:

Upon successful completion of this chapter, students should be able to:

- Describe the legal principles of insurance contract.
- Observe the interdependence that exists between these legal principles
- Appreciate the purposes of each legal principles of insurance
- Realize the legal requirements of insurance contract.
- List and explain the characteristics that makes insurance contract different from others
- Differentiate the application of these legal principles in different insurance contracts

4.1 LEGAL PRINCIPLES UNDERLYING INSURANCE CONTRACTS

4.1.1. PRINCIPLE OF INDEMNITY

The principle of indemnity is one of the most important legal principles in insurance. Most property and liability insurance contracts are contracts of indemnity the principle of indemnity *states that the insurer agrees to pay no more than the actual amount of the loss; stated differently, the insured should not profit from a loss*. If a covered loss occurs, the insurer should not pay more than the actual amount of the loss.

The principle of indemnity has two fundamental purposes. The **first** purpose is to prevent the insured from profiting from a loss. For example, if Alex's home is insured for $100,000, and a partial loss of $20,000 occurs, the principle of indemnity would be violated if $100,000 were paid to him. He would be profiting ($80,000) from insurance.

The **second** purpose is to reduce moral hazard. If dishonest insured could profit from a loss, they might deliberately cause losses with the intention of collecting the insurance. If the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced.

Actual Cash Value

The concept of *actual cash value* underlies the principle of indemnity. In property insurance, the basic method for indemnifying the insured is based on the actual cash value of the damaged property at the time of loss. The courts have used three major methods to determine actual cash value:

- ♠ REPLACEMENT COST LESS DEPRECIATION
- ♠ FAIR MARKET VALUE
- ♠ BROAD EVIDENCE RULE

1. Replacement Cost Less Depreciation

Under this rule, actual cash value *is defined as replacement cost less depreciation.* It takes into consideration both inflation and depreciation of property values over time. Replacement cost is the current cost of restoring the damaged property with new materials of like kind and quality. Depreciation is a deduction for physical wear and tear, age, and economic obsolescence.

For example, Alex has a favorite couch that burns in a fire. Assume he bought the couch five years ago; the couch is 50 percent depreciated, and a similar couch today would cost $1000. Under the actual cash value rule, Alex will collect $500 for the loss because the replacement cost is $1000, and depreciation is $500, or 50 percent. If he **were** paid the full replacement value of $1000, the principle of indemnity would be violated. He would be receiving the value of a new couch instead of one that was five years old. In short, the $500 payment represents indemnification for the loss of a five-year-old couch. This calculation can be summarized as follows:

Replacement cost = $1000

Depreciation = (couch is 50 percent depreciated)

Actual cash value = Replacement cost - Depreciation

$ 500 = $ 1000 - $ 500

2. Fair Market Value

Some courts have ruled that fair market value should be used to determine actual cash value of a loss; Fair market value is the price a willing buyer would pay a willing seller in a free market.

The fair market value of a building may be below its actual cash value based on replacement cost less depreciation. This difference is due to several reasons, including a poor location, deteriorating neighborhood, or economic obsolescence of the building.

In one case, a building valued at $170,000 based on the actual cash value rule had a market value of only $65,000 when a loss occurred. The court ruled that the actual cash value of the property should be based on the fair market value of $65,000 rather than on $170,000. There is also a chance for market value to be higher

3. Broad Evidence Rule

Many countries now use the broad evidence rule to determine the actual cash value of a loss. The broad evidence rule means that the determination of actual cash value should include **all relevant factors** an expert would use to determine the value of the property. Relevant factors include replacement cost less depreciation, fair market value, and present value of expected income from the property, comparison sales of similar property, opinions of appraisers, and numerous other factors.

EXCEPTIONS TO THE PRINCIPLE OF INDEMNITY

- ♠ Valued policy - is a policy that pays the face amount of insurance if a total loss occurs. This kind of policy is issued for properties which are very difficult to determine their values.
- ♠ Valued policy law - is a law that exists in some states that require payment of the face amount of insurance to the insured if a total loss to real property occurs from a peril specified in the law.
- ♠ Replacement cost insurance - means there is no deduction for depreciation in determining the amount paid for a loss.
- ♠ Life Insurance - A life insurance is not a contract of indemnity but is a valued policy that pays a stated sum to the beneficiary upon the insured's death. The actual cash value rule is meaningless in determining the value of a human life.

4.1.2. PRINCIPLE OF INSURABLE INTEREST

The principle of insurable interest is another important legal principle. The principle of insurable interest states that the insured must be in a position to lose financially if a loss occurs. For example, Abebe has an insurable interest in his car because he may lose financially if the car is damaged or stolen. He has an insurable interest in his personal property, such as a television set or computer, because he may lose financially if the property is damaged or destroyed.

PURPOSES OF AN INSURABLE INTEREST

To be legally enforceable, all insurance contracts must be supported by an insurable interest. Insurance contracts must be supported by an insurable interest for the following reasons.

- ♥ To prevent gambling
- ♥ To reduce moral hazard
- ♥ To measure the amount of the insured's loss in property insurance

First*, an insurable interest is necessary to prevent* ***gambling****.* If an insurable interest were not required, the contract would be a gambling contract and would be against the public interest. For example, one could insure the property of another and hope for a loss to occur. One person could similarly insure the life of another person and hope for an early death. These contracts clearly would be gambling contracts and would be against the public interest.

Second, *an insurable interest reduces* ***moral hazard****.* If an insurable interest were not required, a dishonest person could purchase a property insurance contract on someone else's property and then deliberately cause a loss to receive the proceeds. But if the insured stands to lose financially, nothing is gained by causing the loss. Thus, moral hazard is reduced.

Finally, *in property insurance, an insurable interest measures the amount of the insured's loss*. Most property contracts are contracts of indemnity, and one measure of recovery is the insurable interest of the insured. If the loss payment cannot exceed the amount of one's insurable interest, the principle of indemnity is supported.

4.1.3. PRINCIPLE OF SUBROGATION

The principle of subrogation strongly supports the principle of indemnity. Subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance. The insurer is entitled to recover from a negligent third party and loss payments made to the insured. For example, a negligent motorist fails to stop at a red light and smashes into Ato Alemu's car, causing damage in the amount of 5000 Br. If he has collision insurance on his car, his company will pay the physical damage loss to the car and then attempt to collect from the negligent motorist who caused the accident, the insured gives to the insurer legal rights to collect damages from the negligent third party.

Purposes of Subrogation

Subrogation has three basic purposes. ***First****, subrogation prevents the insured from collecting* ***twice*** *for the same loss*. In the absence of subrogation, the insured could collect from the insurer and from the person who caused the loss. The principle of indemnity would be violated because the insured would be profiting from a loss.
Second*, subrogation is used to hold the* ***guilty person responsible for the loss***. By exercising its subrogation rights, the insurer can collect from the negligent person who caused the loss.

Finally*, subrogation helps to* ***hold down insurance rates***. Subrogation recoveries can be reflected in the rate making process, which tends to hold rates below here they would be in the absence of subrogation.

4.1.4. PRINCIPLE OF UTMOST GOOD FAITH

Insurance contract is based on the principle of utmost good faith that is, a higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts. Thus, the principle of utmost good faith imposed a high degree of honesty on the applicant for insurance.
The principle of utmost good faith is supported by three important legal doctrines: \

- REPRESENTATIONS,
- CONCEALMENT, AND
- WARRANTY.

1. REPRESENTATIONS

Representations are statements made by the applicant for insurance. For example, if you apply for life insurance, you may be asked questions concerning you age, weight, height, occupation, state of health, family history, and other relevant questions. Your answers to these questions are called representations.
The legal significance of a representation is that the insurance contract is avoidable at the insurer's option if the representation is material, false, and relied on by the insurer. ***Material*** means that if the insurer knew the true facts, the policy would not have been issued, or it would have been issued on different terms. ***False*** means that

the statement is not true or is misleading. ***Reliance*** means that the insurer relies on the misrepresentation in issuing the policy at a specified premium.

For example, Alex applies for life insurance and states in the application that he has not visited a doctor within the last five years. However, six months earlier, he had surgery for lung cancer. In this case, he has made a statement that is false, material, and relied on by the insurer. Therefore, the policy is voidable at the insurer's option. If Alex dies shortly after the policy is issued, say three months, the company could contest the death claim on the basis of a material misrepresentation.

2. CONCEALMENT

The doctrine of concealment also supports the principle of utmost good faith. Concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer. Concealment is the same thing as nondisclosure; that is, the applicant for insurance deliberately withholds material information from the insurer. The legal effect of a material concealment is the same as a misrepresentation the contract is voidable at the insurer's option.

For example, Assefa Bekele is applied for a life insurance policy on his life. Five months after the policy was issued, he was murdered. The death certificate named the deceased as Assefa Alemu, his true name. The insurer denied payment on the grounds that Assefa had concealed a material fact by not revealing his true identity and that he had an extensive criminal record.

3. WARRANTY

The doctrine of warranty also reflects the principle of utmost good faith. A warranty is a statement of fact or a promise made by the insured, which is part of the insurance contract and must be true if the insurer is to be liable under the contract. For example, in exchange for a reduced premium, the owner of a liquor store may warrant that an approved burglary and robbery alarm system will be operational at all time. The clause describing the warranty becomes part of the contract.

A warranty creates a condition of the contract, and any breach of warranty, even if **immaterial,** will void the contract. This is the central distinction between a warranty and a representation. A misrepresentation does not void the insurance unless it is material to the risk, while under common law any breach of warranty, even if held to be minor, voids the contract.

(**For more information refer Jorge E Rejra. Risk management and insurance, Take the pleasure to read)**

4.2. VALID ELEMENTS OR REQUIREMENT OF AN INSURANCE CONTRACT

An insurance policy is based in the law of contracts. To be legally enforceable, an insurance contract must meet four basic requirements: offer and acceptance, consideration, competent parties, and legal purpose.

♠ Offer and Acceptance

The first requirement of a binding insurance contract is that there must be an offer and an acceptance of its terms. In most cases, the applicant for insurance makes the offer, and the company accepts or rejects the offer. An agent merely solicits or invites the prospective insured to make an offer.

♠ Consideration

The second requirement of a valid insurance contract is consideration the value that each party gives to the other. The insured's consideration is payment of the first premium (or a promise to pay the first premium) plus an agreement to abide by the conditions specified in the policy. The insurer's consideration is the promise to do certain things as specified in the contract. This promise can include paying for a loss from an insured peril, providing certain services, such as loss prevention and safety services, or defending the insured in a liability lawsuit.

♠ Competent Parties

The third requirement of a valid insurance contract is that each party must be legally competent. This means the parties must have legal capacity to enter into a binding contract. Most adults are legally competent to enter into insurance contracts, but there are some exceptions. Insane persons, intoxicated persons, and corporations that act outside the scope of their authority cannot enter into enforceable insurance contracts. Minors normally are not legally competent to enter into binding insurance contracts; but most states have enacted laws that permit minors to enter into a valid life insurance contract.

The insurer must also be legally competent. Insurers generally must be licensed to sell insurance in the state, and the insurance sold must be within the scope of its charter or certificate of incorporation.

♠ Legal Purpose

A final requirement is that the contract must be for a legal purpose. An insurance contract that encourages or promotes something illegal or immoral is contrary to the public interest and cannot be enforced. For example, a street pusher of heroin and other illegal drugs cannot purchase a property insurance policy that would cover seizure of the drugs by the police. This type of contract obviously is not enforceable because it would promote illegal activities that are contrary to the public interest.

4.3. UNIQUE CHARACTERISTICS OF INSURANCE CONTRACTS

Insurance contracts have distinct legal characteristics that make them different from other legal contracts. Several distinctive legal characteristics have already been discussed. As we noted earlier, most property and liability insurance contracts are contracts of indemnity; all insurance contracts must be supported by an insurable interest; and insurance contracts are based on utmost good faith. Other distinct legal characteristics are as follows:

- ♥ Aleatory contract
- ♥ Unilateral contract
- ♥ Conditional contract
- ♥ Personal contract
- ♥ Contract of adhesion

♥ Aleatory contract

An insurance contract is aleatory rather than commutative. An aleatory contract is a contract where the values exchanged may not be equal but depend on an uncertain event. Depending on chance, one party may receive a value out of proportion to the value that is given. For example, assume that Mr **"z"** pays a premium of $500 for $100,000 of home owners insurance on his home. If the home were totally destroyed by fire shortly thereafter, he would collect an amount that greatly exceeds the premium paid. On the other hand, a homeowner may faith fully pay premiums for many years and never have a loss.

In contrast, other commercial contracts are *commutative*. A commutative contract is one in which the values exchanged by both parties are theoretically equal. For example, the purchaser of real estate normally pays a price that is viewed to be equal to the value of the property.

♥ Unilateral contract

An insurance contract is a unilateral contract. A unilateral contract means that only one party makes a legally enforceable promise. In this case, only the insurer makes a legally enforceable promise to pay a claim or provide other services to the insured. After the first premium is paid, and the insurance is in force, the insured cannot be legally forced to pay the premiums or to comply with the policy provisions. Although the insured must continue to pay the premiums to receive payment for a loss, he or she cannot be legally forced to do so. However, if the premiums are paid, the insurer must accept them and must continue to provide the protection promised under the contract.

In contrast, most commercial contracts are bilateral in nature. Each party makes a legally enforceable promise to the other party. If one party fails to perform, the other party can insist on performance or can sue for damages because of the breach of contract.

- **Conditional contract**

An insurance contract is a conditional contract. That is, the insurer's obligation to pay a claim depends on whether the insured or the beneficiary has complied with all policy conditions. Conditions are provisions inserted in the policy that qualify or place limitations on the insurer's promise to perform. The conditions section imposes certain duties on the insured if he or she wishes to collect for a loss. Although the insured is not compelled to abide by the policy conditions, he or she must do so to collect for an insured loss. The insurer is not obligated to pay a claim if the policy conditions are not met. For example, under a homeowner's policy, the insured must give immediate notice of a loss. If the insured delays for an unreasonable period in reporting the loss, the insurer can refuse to pay the claim on the grounds that a policy condition has been violated.

- **Personal contract**

In property insurance, insurance is a personal contract, which means the contract is between the insured and the insurer. Strictly speaking, a property insurance contract does not insure property, but insures the owner of property against loss. The owner of the insured property is indemnified if the property is damaged or destroyed. Because the contract is personal, the applicant for insurance must be acceptable to the insurer and must meet certain underwriting standards regarding character, morals, and credit.

A property insurance contract normally cannot be assigned to another party without the insurer's consent. If property is sold to another person, the new owner may not be acceptable to the insurer. In contrast, a life insurance policy can be freely assigned to anyone without the insurer's consent because the assignment does not usually alter the risk or increase the probability of death.

- **Contract of adhesion**

A contract of adhesion means the insured must accept the entire contract, with all of its terms and conditions. The insurer drafts and prints the policy, and the insured generally must accept the entire document and cannot insist that certain provisions be added or deleted or the contract rewritten to suit the insured. Although the contract can be altered by the addition of endorsements or other forms, the endorsements and forms are drafted by the insurer. To redress the imbalance that exists in such a situation, the courts have ruled that any ambiguities or uncertainties in the contract are construed against the insurer. If the policy is ambiguous, the insured gets the benefit of the doubt.

End!!!