Chapter Five

Legal Principles in Insurance

Principle of Indemnity

The insurer agrees to pay no more than the actual amount of the loss

- *Most property and casualty insurance are contracts of indemnity.*

- ***Purpose***:
  - To prevent the insured from profiting from a loss
  - To reduce moral hazard

Principle of Indemnity

- In property insurance, indemnification is based on the actual cash value of the property at the time of loss
- **There are *three main methods* to determine actual cash value:**
  1. Replacement cost less depreciation
  2. Fair market value is the price a willing buyer would pay a willing seller in a free market
  3. Broad evidence rule means that the determination of ACV should include all relevant factors an expert would use to determine the value of the property

Principle of Indemnity

- Relevant factors include replacement cost less depreciation, fair market value, present value of expected income from the property, comparisons sales of similar property, opinions of appraisers and numerous other factors.
- Although the ACV rule is used in property insurance, different methods are employed in other types of insurance, such as:

a) **In liability insurance**, the insurer pays up to the policy limit the amount of damages that the insured is legally obligated to pay because of bodily injury or property damage to another.

Principle of Indemnity

b) **In life insurance**, the amount paid when the insured dies is the face value of the policy.

c) **In business income insurance**, the amount paid is usually based on the loss of profits plus continuing expenses when the business is shut down because of a loss from a covered peril.

Principle of Indemnity

- There are some ***exceptions*** to the principle of indemnity:
  - A **valued policy** pays the face amount of insurance if a total loss occurs, Because of the difficulty of determining the actual value of the property at the time of the loss, the insured and the insurer both agrees on the value of property when the policy is first issued.

Principle of Indemnity

- Some states have a <u>valued policy law</u> that requires 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

-The original purpose of a valued policy laws was to protect the insured from an argument with the insurer if an agent has deliberately over insured property so as to receive a higher commission. After a total loss, the insurer might offer less than the face amount for which the policy owner had paid premiums on the grounds that the building was over insured.

Principle of Indemnity

- Replacement cost insurance means there is no deduction for depreciation in determining the amount paid for a loss
- A life insurance contract is a valued policy that pays a stated sum to the beneficiary upon the insured's death
- The principle of indemnity is difficult to apply to life insurance because of the actual cash value rule (replacement cost less depreciation) is meaning less in determining the value of a human life. Moreover, to plan for personal and business purposes such as the need to provide a specific amount of monthly income for the dependents, a certain amount of life insurance must be purchased before death occurs.

Principle of Insurable Interest

The insured must stand to lose financially if a loss occurs.

- ***Purpose:***
  - To prevent gambling
  - To reduce moral hazard
  - To measure the amount of loss
- When must insurable interest exist?
  - Property insurance: at the time of the loss
  - Life insurance: only at inception of the policy

Principle of Subrogation

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.

- ***Purpose:***
  - To prevent the insured from collecting twice for the same loss
  - To hold the negligent person responsible for the loss
  - To hold down insurance rates

Principle of Subrogation

- **The importance of subrogation**
- The insurer is entitled only to the amount it has paid under the policy
- The insured cannot impair the insurer's subrogation rights
- Subrogation does not apply to life insurance and to most individual health insurance contracts
- The insurer cannot subrogate against its own insureds

Principle of Utmost Good Faith

A higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts.

- Supported by three legal doctrines:
  - **Representations** are statements made by the applicant for insurance
    - A contract is voidable if the representation is material, false, and relied on by the insurer

Principle of Utmost Good Faith

- ***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.

- An innocent misrepresentation of a material fact, if relied on by the insurer, makes the contract voidable

Principle of Utmost Good Faith

- A **concealment** is intentional failure of the applicant for insurance to reveal a material fact to the insurer.

- This doctrine is applied in a harsher manner in ocean marine insurance. Therefore, to deny a claim based on concealment, the insurer must prove 2 things:

1) The concealed fact was known by the insured to be material.
2) The insured intended to defraud the insurer.

Principle of Utmost Good Faith

- A **warranty** is a statement that becomes part of the insurance contract and is guaranteed by the maker to be true in all respects
  - Statements made by applicants are considered representations, not warranties

- Because strict application of the warranty doctrine harmed many insureds, there were some modifications made to the warranty doctrine.

Principle of Utmost Good Faith

- Statements made by applicants are considered representations, not warranties. Thus the insurer can’t deny liability for a claim if the misrepresentation is not material.

Requirements of an Insurance Contract

- To be legally enforceable, an insurance contract must meet four requirements:
  - **Offer and acceptance** of the terms of the contract. In most cases, the applicant for insurance makes the offer and the company accepts or rejects the offer.

  - The applicant fills out the application and the agent accepts the offer on behalf of the insurance company, then the applicant pays the first premium.

Requirements of an Insurance Contract

- **Consideration** – the values that each party exchange. The insured consideration is the payment of the first premium (or promise to pay) also an agreement to abide by the conditions specified in the policy.
- The insurer's consideration is the promise to do certain things specified in the contract. This promise include paying for an insured peril, and also providing certain services.
    - Legally competent parties, with legal capacity to enter into a binding contract

The contract must exist for a legal purpose. An insurance contract that encourages or promotes something illegal or immoral is contrary to the public interest and can't be enforced.

Distinct Legal Characteristics of Insurance Contracts

- **Aleatory:** values exchanged are not equal. Depending on chance, one party may receive a value out of proportion to the value has given.

Although the essence of an aleatory contract is chance or the occurrence of some fortuitous event, an insurance contract is not a gambling contract although both are aleatory in nature

Distinct Legal Characteristics of Insurance Contracts

- **Unilateral**: only the insurer makes a legally enforceable promise. After the first premium is paid and the insurance is in force , the insured can't be legally forced to pay premiums or to comply with the policy provisions. Although the insured must continue to pay the premiums to receive the payment for a loss, he can't be forced to do so. On the contrary, the commercial contracts bilateral in nature in which each party makes a legally enforceable promise to the other.

Distinct Legal Characteristics of Insurance Contracts

- **Conditional**: policyowner must comply with all policy provisions to collect for a covered loss
- **Personal**: property insurance policy cannot be validly assigned to another party without the insurer's consent
- **Contract of adhesion**: since the insured must accept the entire contract as it is written, any ambiguities are construed against the insurer

Law and the Insurance Agent

- An agent is someone who has the authority to act on behalf of a principal (the insurer)
- Several laws govern the actions of agents and their relationship to insureds
  - An agent must be authorized to represent the principal
  - Knowledge of the agent is presumed to be knowledge of the principal with respect to matters within the scope of the agency relationship
  - Insurers can place limitations on the power of agents.

Distinct Legal Characteristics of Insurance Contracts

- In property and casualty insurance, agents typically have the power to bind their companies through using a binder.
- In life insurance, the life insurance agent does not have the power to bind the insurer. Therefore, the applicant must be approved by the insurer before the life insurance is in force. The usual procedure is for the applicant to fill out the applications and pay the first premium.

Law and the Insurance Agent

- <u>Binder</u> is a temporary evidence of insurance until a formal insurance contract can be drafted.
- <u>Waiver</u> is defined as the voluntary relinquishment of a known legal right.