Chapter 11
INSURANCE CONTRACTS

Legal Framework of Insurance
- Requirements of a valid contract
- Characteristics of contracts
- Legal principles underlying insurance contracts

Requirements of a Valid Contract
- Offer and acceptance
- Consideration
  - In most states contracts can be oral or written
- Capacity
- Legal Purpose
Valid Insurance Contract - Offer and Acceptance

- A meeting of the minds between the parties of the contract. Does this really exist in insurance?
- Who makes the offer?
  - Applicant always makes the offer
- Property insurance:
  - Agent solicits offer, applicant offers, agent accepts (binds)
  - If the company does not want the contract, it may cancel the contract according to the contract's cancellation clause

Valid Insurance Contract - Offer and Acceptance

- Life insurance:
  - Agent solicits offer
  - Applicant offers
  - Insurance company accepts, rejects, or counter offers
  - Counter offer may be accepted or rejected by the applicant

Valid Insurance Contract - Consideration

- Property: monetary payment and an agreement to abide by conditions and stipulations in the contract
- Life: monetary payment and making truthful statements in the application
  - Checks must be honored by bank before that part of the “consideration” is fulfilled
Valid Insurance Contract - Capacity

- The legal ability to enter into a contract
- Capacity is assumed except:
  - Minors
  - Insane
  - Intoxicated
  - Corporation acting outside the scope of its charter

Valid Insurance Contract – Legal Purpose

- From society's standpoint "insurance" needs to be for a legal purpose
  - It shares and redistributes the cost of losses
  - It must not encourage or protect illegal activities
- From an individual contract’s point of view
  - Individual insurance contracts cannot pay for certain losses. (e.g. individual buys a life insurance contract with the intent to murder) In this case the contract is perfectly legal but the use and intent is malicious so the contract cannot be enforced.

Insurance by Type of Contract

- Aleatory - dollar outcome is assumed unequal
- Conditional - performance is conditional upon the occurrence of an uncertain event
- Adhesion - ambiguities are construed against the writer of the contract
- Personal - requires privity of contract – cannot freely exchange parties to the contract
- Unilateral - only one party has to perform - the insurer
Legal Principles

- Principle of Indemnity
- Principle of Insurable Interest
- Principle of Subrogation
- Principle of Utmost Good Faith

Legal Principles - Principle of Indemnity

- Principle of insurable interest determines if a loss is suffered; the principle of indemnity places a limit on the amount of the loss.
- A person may not collect more than the actual loss sustained - cannot make a profit
- The best that one can hope for is to be placed in the same financial position after the loss compared to before
Legal Principles - Principle of Insurable Interest

- Must demonstrate a "loss" to collect
  - Would be gambling or intentional loss if an insured could collect with no personal loss
- Insurance is a "personal" contract
  - Follows the person - not the property

Legal Principles - Principle of Insurable Interest

- What constitutes insurable interest?
  - Ownership
  - Leases (in some cases)
  - Secured creditors (not general creditors)
  - Legal liability
  - Care, custody, and control
  - Life insurance - exists for person voluntarily insuring one's own life - others must have insurable interest

Legal Principles - Principle of Insurable Interest

- When must the insurable interest exist?
  - Property insurance - must exist at the time of the loss
  - Life insurance - must exist at the inception of the policy; continuing insurable interest is not necessary
Principle of Indemnity
Actual Cash Value

Actual Cash Value = Replacement Cost Less Depreciation

\[ ACV\ loss = [RC\ loss - DEP\ loss] \]

- \( RC \) = the cost to repair or replace with like kind and quality of material
- \( Loss \) = calculation is performed only on the part that was damaged
- \( DEP \) = A measure of “betterment”
  - Not an accounting concept

Principle of Indemnity Exceptions

- Valued policies
- Valued policy laws
- Replacement cost coverage
- Life insurance - not an indemnity contract

Legal Principles
Principle of Subrogation

If insurance did not exist

Injured → injury → Negligent party

suit
Legal Principles - Principle of Subrogation

One who indemnifies another’s loss is entitled to recovery from any liable third parties

Principle of Subrogation

- Reinforces the principle of indemnity - can only collect once
- Holds rates below what they would otherwise be - salvage
- Places burden of the loss on those responsible (i.e. negligence)

Principle of Subrogation

- Subrogation does not exist where the principle of indemnity does not apply - life insurance
- Subrogation is ALWAYS waived for AN INSURED
- If an insured violates or destroys insurer’s subrogation rights, insured may forfeit collection rights under the contract
- The insurer is entitled to subrogation dollars only after insured has collected fully for the loss
Principle of Subrogation

Example

Insured has $10,000 loss and recovers $7,000 from insurer

Negligent Party pays $5,000

Insurer pays $8,000 less $1,000 Deductible

Subrogates $3,000 to insured $2,000 to insurer

Principle of Utmost Good Faith

- Higher standard of honesty is imposed on insurance contracts as compared to other contracts
- Categories of abuse:
  - Material misrepresentation
  - Material Concealment
  - Breach of a warranty
  - Breach of utmost good faith

Principle of Utmost Good Faith

Representations

- Statements made before a contract starts to induce a party to enter the contract
- Oral or written statements
- Contract can be avoided if the representation is false and material
Material Misrepresentations

- Material Misrepresentation Tests
  - False - not true at the time of the statement
  - Material - would the insurer have declined the contract, changed the wording, or priced it differently if the truth were known
  - Statement of opinions are not sufficient to avoid the contract

Principle of Utmost Good Faith Concealments

- Silence when there is an obligation to speak
- Utmost good faith imposes a duty to voluntarily divulge material information
- When a material fact is concealed the insurer can avoid the contract
- Generally involves an element of deception

Tests for Concealment

- Did the insured know of a certain fact?
- Was the fact material?
- Was the insurer ignorant of the fact?
Principle of Utmost Good Faith

Warranties

- A warranty creates a condition in a contract
- Any breach of warranty, even if not material, will allow the insurer to avoid the contract (*strict interpretation*)

Types of Warranties

- Express - written
- Implied - not written, understood by all
- Promissory - condition to continue throughout contract period
- Affirmative - exists at contract’s inception; promises nothing about the future

Warranties - Examples

- Implied affirmative
- Implied promissory
- Express affirmative
- Express promissory
Principle of Utmost Good Faith - Breach of Utmost Good Faith

- Commonly referred to as a "bad faith claim"
- Used when the insured feels the insurer is not acting in "good faith"
- Used to force insurance companies to perform according to the contract

Basic Parts of an Insurance Policy

- Declarations: Establish "named insured" and provides rating information
- Insuring Agreements: Create binding agreement between insurer and insured
- Deductibles: Subagreements provide specific coverage
- Definitions: Cause insured to bear first dollars of covered losses
- Exclusions: Control insurance costs and moral hazard
- Conditions: Establish meaning of important words found in the policy, thereby reducing room for ambiguity
- Endorsements and Riders: Limit insurance coverage by specifically identifying pets, people, property, or time period not covered
- Amend contracts to create more coverage

Standardized Insurance Policies - Why?

- More economical to print and maintain
- Eases the development of rates - given a standard coverage set
- Loss and claim data of different companies can be combined to provide more credible data
- Meaning of standardized policies becomes known to attorneys, courts, insurer's employees, and consumers
Standardization of Contracts

- Not all US policies are “standard”
  - Personal and Commercial policies are generally standardized – variations are found
  - The larger commercial policies can be “manuscript” but based on standard clauses
- Many international policies are standardized too
  - Several Spanish-language (South American) policies are translations of US policies
  - Austrians use standardized HO and Auto policies

A NON-Exhaustive List of Questions to Ask

- Is the property / event / liability covered?
- Is the person sustaining the loss covered?
- Is the loss caused by a covered peril?
- Do any exclusions apply?
- Are there any special / sufficient limits or penalties?
- Do any deductibles apply?
- Are there any territorial restrictions?
- Did the loss occur during the policy period?

Basic Parts of an Insurance Contract - Declarations

- Personalizes the insurance contract to the insured
- Usually first page of an insurance contract contains such things as:
  - Identifies the insurance company
  - Identifies the named insured
  - Policy period
  - Policy limits
  - Deductibles
  - Premium
  - Identifies forms and / or endorsements
Basic Parts of an Insurance Contract - Insuring Agreements

- Broadly describes what is covered and the insurer’s and the insured’s rights, obligations, and duties
- Examples from:
  - Homeowners (HO)
  - Auto (PAP)

Basic Parts of an Insurance Contract - Deductibles

- Straight deductible - amount paid by insured before the insurer pays any money
  - Example: from the loss v. from the claim
    - $25,000 loss
    - $20,000 coverage
    - $1,000 deductible
- Deductible from the loss
  - $25,000 - $1,000 = $24,000; $20,000 paid because hits policy limit
- Deductible from claim
  - $20,000 - $1,000 = $19,000; deductible taken from claim

Basic Parts of an Insurance Contract - Deductibles

- Reasons for deductibles
  - Reduces moral hazard since insured pays a small portion of each loss
  - Eliminates the expenses involved in small, frequent claims and most losses are small
  - As a result premiums are lower
Basic Parts of an Insurance Contract - Definitions

- Clarify meaning of words and terms in contract - [remember the doctrine of adhesion]
- Found in definitions page, glossary, or throughout the contract
- Reduces the word count in insurance policies

Basic Parts of an Insurance Contract - Exclusions

- Identify losses that are not covered
- Designed to:
  - Eliminate catastrophic events - flood, war
  - Eliminate moral or morale hazards - intentional loss, failure to protect property
  - Require extra charge - unfair to charge all insureds for covering $100,000 gun collections
  - Eliminate coverage where another policy is specifically designed for the coverage
  - To truncate the doctrine of proximate cause

Basic Parts of an Insurance Contract - Conditions

- If you want the claim paid, you must meet the conditions stated in the contract. These include:
  - No Concealment or Fraud
  - No Suspension of coverage
  - Cancellation – policy must be in force
  - Other insurance does not apply or loss is shared
  - Meet your duties after a loss
  - Abide by the appraisal procedure
  - Agree to salvage
  - Agree to claims payment - time limits
Basic Parts of an Insurance Contract - Endorsements

- Modify standard insurance contracts in predetermined ways - examples
  - Expand coverage
  - Delete exclusions in contract
  - Change definitions
    - e.g.: "sporadic baby-sitting is not a "business"
  - Add locations / insureds / perils
  - Add additional insureds