PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

CLASS NOTES

Chapter 5 Fundamental Legal Principles of Insurance

1-Principle of Indemnity;
2-Principle of Insurable Interest;
3-Principle of Subrogation;
4-Principle of Utmost Good Faith.

- Principle of Indemnity: Insurer pays no more than the actual loss.

-The insured shouldn't profit from a loss.
-Most of property & liability ins. are contracts of indemnity.
-Often, the amount paid would be less than the actual loss because of deductible & other provisions.

- Purposes of Principle of Indemnity:

-Prevent the insured from profiting from a loss.
-Reduce moral hazard.

Actual Cash Value (ACV): means value of damage @ time of loss. The courts use 3 methods to determine ACV: replacement cost less depreciation, fair market price & broad evidence rule.
a) Replacement Cost Less Depreciation
(RCLD) = Original Cost + Inflation – Depreciation
or: Today's Price – Depreciation.
b) Fair Market Price (FMP): price of a similar product. Sometimes ACV based on FMP < ACV based on RCLD.
Ex: Home's value @ time of building $100,000.
Expected life 40 yrs.
ACV based on RCLD after 10 years = $75,000.
ACV based on FMP = $60,000 because of recession & bad location. Then: FMP < RCLD.
c) Broad Evidence Rule (BER): takes into account all factors that affect the value including: RCLD, FMP, Location, PV of Income, Opinions of Appraisers, …etc.
Remark:
In property ins.: insurer applies ACV.
In liability ins.: insurer pays up to the limit of the policy.
In life ins.: insurer pays the face value of the policy.
In business income ins.: insurer pays the loss of profits + continuing expenses.

- Exceptions to Principle of Indemnity:

a) Valued Policy: pays the face amount if a total loss occurs (used to insure antiques, fine arts, …etc).
The amount is determined @ time of ins. because it is difficult to determine it @ time of loss.
The principle of indemnity is violated because the amount paid may exceeds the ACV.
b)valued Policy Laws (VPL): applied to real property & pays the face amount if total loss occurs from specified perils.

Ex: ACV of a house at time of ins. $100,000.
ACV of a house at time of loss $75,000.
Insurer pays $100,000.
The cause behind VPL is to protect the insured from argument with insurer if the agent overinsured to get high commission (inflation reduces the importance of this policy).
The problem now is underinsurance because it results in: less prem. for the insurer & less protection for the insured.
c)Replacement Cost Ins. (RCI): means no deduction for depreciation.
Ex: a house 5 yrs old & useful life of 20 years with RC $200,000 damaged by fire.
-Under the ACV the insured receives $150,000
-Under the RC the insured receives $200,000.
Then, the principle of indemnity is violated.
d)Life Ins.: it is difficult to apply to human being because the ACV rule is meaningless & impossible to determine it's value.

Also, you buy ins. because you need a specific amount for your dependents in case of death.

- Principle of Insurable Interest: insured must lose financially if a loss occurs (car accident, home fire.)

Purposes of Insurable interest:
a)To prevent gambling: if you can buy ins. to other's car or life, then you hope for a loss (death) to occur, this against public interest.
b)To reduce moral hazard: w/out insurable interest, you could buy ins. on other's property & cause the loss to gain. If you lose from the loss, you try to prevent it from happening.
Then, insurable interest reduces moral hazard.

c)To measure the loss: insurer pay your loss (it is your insurable interest). Insurable interest supports principle of indemnity.

- Types of Insurable Interest in Property Ins.:

1-Ownership: (your car), potential liability (dry cleaning firm).
2-Creditors (mortgage: property serves as collateral for loan).
3-Contractual rights: (purchasing goods that you doesn't receive, you can ins. it because you lose your profit in case of accident).

- Types of Insurable Interest in Life Ins.:

1-You own your life; so, choose any one as a beneficiary w/out insurable interest. But, You can't purchase ins. on the life of others w/out insurable interest.
2-Close family ties (wife, husband, son, father, grandfather, grandson but not cousin) meets insurable interest.
3-Pecuniary interest satisfies insurable interest (key person, sales persons, partner in a Co.).

- When must Insurable Interest exist?

1)In Property Ins.: @ time of loss for 2 reasons:
a)If financial interest doesn't exist @ time of loss then, financial loss wouldn't occurs.
Ex: if you sell your car, in case of loss before you cancel or transfer ins. to the buyer, none of you get indemnity.

b)Future insurable interest.
Ex: you may buy cargo ins. for return trip. Later, goods shipped & loss occurred, you collect indemnity because insurable interest existed @ time of loss in spite of you didn't have it when you bought ins.

2)In life Ins.: @ time of buying ins.: because life ins. is a valued contract (not an indemnity).
If the wife has ins. on her husband's life & divorced, she collects the proceeds if he died.

- Priciple of Subrogation: insurer has the right to substitute the insured toward negligent party to claim indemnity for the covered loss.

Ex: red traffic for A & green for B. A hit B so, B can get his loss from his insurer & his insurer collect from A (or his insurer) up to what he paid to B. Also, B can collect directly from A only.
The insurer can't subrogate if he didn't pay to B.

- Purposes of Subrogation:

1-Prevent insured to benefit from his loss (can't collect twice from the insurer & the responsible).
2-Hold the guilty responsible for loss.
3-Reduce ins. cost (insurer collects part of loss).

- Importance of Subrogation:

1-Insurer is entitled to collect what he paid to the insured from the guilty or his insurer, the insured must be fully reimbursed (because underinsurance or deductible) & the insurer gets the rest up to what he paid.

2-The insured can't waive the right to sue the negligent party or he loses his right toward insurer.
Ex: if you admitted fault in an accident or attempted to settle it with negligent driver w/out the insurer consent, you lose your right.
3-The insurer can waives its subrogation's right if the landlord agrees to release tenant from fire liability at time of contract.
So, in case of fire insurer pays to landlord & couldn't recover from the tenant.
Also, insurer may decide not to exercise subrogation because legal expenses exceeds recovery.
4-Subrogation doesn't apply to life & health ins.
5-Insurer can't subrogate against its insured (this against purpose of purchasing ins.).

- Priciple of Utmost Good Faith (UGF): means higher degree of honesty is imposed on both parties specially the applicant than other contracts.

The principle of UGF is supported by 3 legal doctrines: representations, concealment & warranty.
a)Representations: statements made by applicant for ins. Your answer about your age, family's health history called representations.

- Importance of Representation: ins. contract is voidable at insurer's option if representation is: material, false & relied on by insurer.
- 1-Material: means if the insurer knew the true facts @ time of ins. , it wouldn't issue the policy or issued it in different terms.
- 2-False: mean statement isn't true or misleading.

- 3-Reliance: insurers rely on misrepresentation in issuing the policy @ specific premium.
- Ex: Ali stated in the application he hasn't visited a doctor within the last 5 yrs. But, he did & 2 month later he had a lung cancer surgery & died.
- Insurer didn't pay (misrepresentation).

If an applicant stated an opinion or belief that turns out to be wrong, insurer must prove that insured intended to deceive it
Ex: do you have high blood pressure?
Also, an innocent misrepresentation of a material fact if relied on by insurer makes the contract voidable.

b)Concealment: intentional failure to reveal material fact & make the contract voidable @ the insurer option (as misrepresentation) but he has to prove 2 things:
1-The concealed fact was known by the insured to be material.
2-The insured intended to defraud the insurer.
Ex: Ali Hasan applied for life ins., 6 months later he murdered.
His name in ID was Ali Hasanain. Insurer denied paying as he had concealed a material fact (because his true ID has a criminal record).
Then, he breached the principle of UGF.
c)Warranty: a statement of fact or a promise made by applicant & must be true if the insurer is to be liable under the contract.
Ex: Insured promised that burglary & rubbery alarm system will be working & on at all times.
Remark: insure can rely on warranty if breach of warranty contribute to loss.

Requirements of Ins. Contract:
1-Offer & acceptance.
2-Consideration.
3-Competent parties.
4-Legal purpose.

1-Offer & Acceptance: invitation from agent, offer from applicant & acceptance from insurer.
In Property & Liability Ins.: offer can be oral or written.
When applicant fill out the application & pays (or promise) 1st prem., this constitute offer & agent accept it by binder (temporary contract).

In Life Ins.: offer must be written & accompanied by 1st prem.
Insurer (not agent) accepts it & issue conditional receipt.
Ins. becomes valid from this time or time of medical exam which is later.

2-Consideration: value each party pays.
Insured consideration: pays (or promises) 1st prem. & abide by conditions.
Insurer consideration: pays loss (or ins. amount), loss control service & defends insured.

3-Competent Parties: parties must have legal capacity to inter into a binding contract:
Insured must not be: insane, minor or intoxicated.
Insurer must be licensed.

4-Legal Purpose: not to be illegal or immoral (seizure of drug or heroin).

Legal Characteristics of Ins. Contract:
1-Aleatory.
2-Unilateral.
3-Conditional.
4-Personal.
5-Adhesion.

1-Aleatory Contract: amount exchanged not equal. Insured pays prem. many yrs & get nothing & insurer gets one prem. & pays huge amount.

Other contacts are commutative (values exchanged are equal).

2-Unilateral Contract: one party makes a legally enforceable promise (insurer has to pay loss & deliver services).

After 1st prem., insured isn't legally forced to pay prem. or comply with policy's provisions.

Other contracts are bilateral (each party can enforce other party to perform his obligation).

3-Conditional Contract: insurer's obligations depend on fulfillment of insured obligations.
Ex: loss notice within 10 days or no payment.

4-Personal Contract: insurer insure property for specific person not the property itself, so, it has to meet underwriting standard.
In Property Ins.: insured can't assign ins. w/out insurer consent (if he sells it).
In life Ins.: insured can assign ins. w/out insurer consent but just notification is required.

5-Adhesion Contract: insured accepts all conditions or leave it (he can change some if insurer agrees through endorsement).

So, if the policy is ambiguous, insured gets the benefits of doubt under reasonable expectation principle.

- Law & Ins Agent:

1-No presumption of agency relationship: agent must have material evidence (business card, business ID, application) or insurer wouldn't hold responsible.
2-Agent must have authority to represent the principal.

3-Principal is responsible of agent's acts within the scope of their authority.

- Waiver: is exemption of legal right.

Ex: you didn't answer question in application & policy issued, so, insurer can't deny claims.

- Estoppel: if you didn't pay prem. on time & called your agent & he said: you have 10 days grace period. If loss occurs, insurer can't deny loss.

-END OF CHAPTER 5-