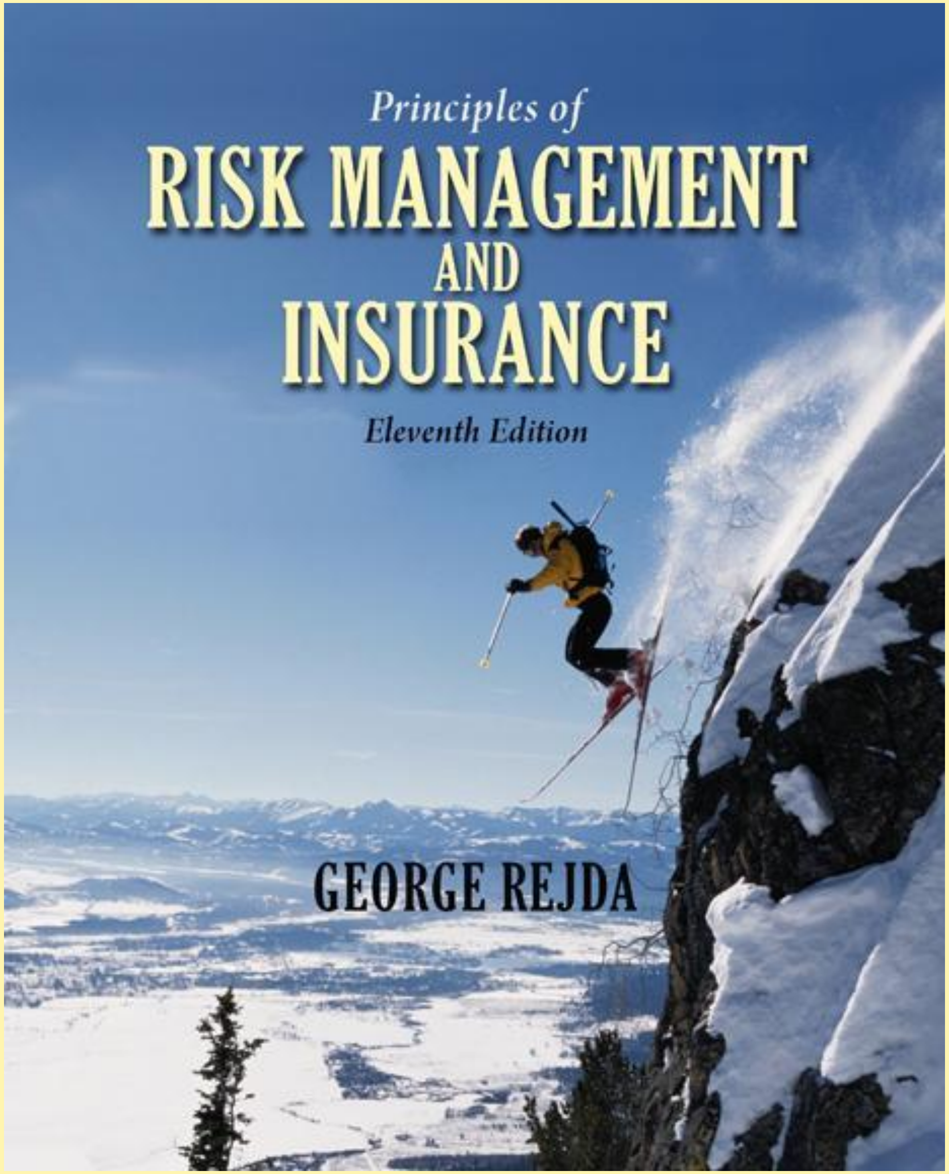
Chapter 9

Fundamental Legal Principles



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Agenda

- Principle of Indemnity
- Principle of Insurable Interest
- Principle of Subrogation
- Principle of Utmost Good Faith
- Requirements of an Insurance Contract
- Distinct Legal Characteristics of Insurance Contracts
- Law and the Insurance Agent

Principle of Indemnity

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

- 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:
  - Replacement cost less depreciation
  - Fair market value is the price a willing buyer would pay a willing seller in a free market
  - 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

- There are some exceptions to the principle of indemnity:
  - A valued policy pays the face amount of insurance if a total loss occurs
  - Some states have a valued policy law 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
  - 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

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

Principle of Utmost Good Faith

– A <u>concealment</u> is intentional failure of the applicant for insurance to reveal a material fact to the insurer

– A <u>warranty</u> 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

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
  - Consideration – the values that each party exchange
  - Legally competent parties, with legal capacity to enter into a binding contract
  - The contract must exist for a legal purpose

Distinct Legal Characteristics of Insurance Contracts

- Aleatory: values exchanged are not equal
- Unilateral: only the insurer makes a legally enforceable promise
- 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
  - There is no presumption of an agency relationship
  - An agent must be authorized to represent the principal
    - Authority is either express, implied, or apparent
  - 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 by adding a <u>nonwaiver clause</u> to the application or policy

Law and the Insurance Agent

- <u>Waiver</u> is defined as the voluntary relinquishment of a known legal right
- <u>Estoppel</u> occurs when a representation of fact made by one person to another person is reasonably relied on by that person to such an extent that it would be inequitable to allow the first person to deny the truth of the representation