Chapter 5
Legal Principles in Insurance

Overview

Insurance contracts are complex documents embodying years of industry tradition, case law, and general practices. This chapter examines the legal environment of insurance contracts, including: fundamental legal principles, requirements to form an insurance contract, legal characteristics of insurance contracts, and insurance law as it applies to agency. Although you may have been introduced to some of these concepts in a business law course, there are unique aspects of insurance contracts that you should know.

Learning Objectives

After studying this chapter, you should be able to:

- Explain the fundamental legal principles reflected in insurance contracts, including: principle of indemnity, principle of insurable interest, principle of subrogation, and principle of utmost good faith.
- Explain how the legal concepts of representations, concealment, and warranty support the principle of utmost good faith.
- Describe the basic requirements for the formation of a valid insurance contract.
- Show how the nature of insurance contracts differs from that of other contracts.
- Explain the law of agency and how it affects the actions and duties of insurance agents.
- Define the following:

  - Actual cash value
  - Agency agreement
  - Aleatory contract
  - Apparent authority
  - Binder
  - Broad evidence rule
  - Commutative contract
  - Concealment
  - Conditional contract
  - Conditional premium receipt
  - Consideration
  - Contract of adhesion
  - Estoppel
  - Express authority
  - Fair market value
  - Implied authority
  - Innocent misrepresentation
  - Legal purpose
  - Legally competent parties
  - Material fact
  - Offer and acceptance
  - Pecuniary (financial) interest
  - Personal contract
  - Principle of indemnity
  - Principle of insurable interest
  - Principle of reasonable expectations
  - Principle of utmost good faith
  - Replacement cost insurance
  - Representations
  - Subrogation
  - Unilateral contract
  - Valued policy
  - Valued policy law
  - Waiver
  - Warranty
Outline

I. Fundamental Legal Principles
   A. Principle of Indemnity
   B. Principle of Insurable Interest
   C. Principle of Subrogation
   D. Principle of Utmost Good Faith

II. Requirements of an Insurance Contract
   A. Offer and Acceptance
   B. Consideration
   C. Competent Parties
   D. Legal Purpose

III. Distinct Legal Characteristics of Insurance Contracts
   A. Aleatory Contract
   B. Unilateral Contract
   C. Conditional Contract
   D. Personal Contract
   E. Contract of Adhesion

IV. Law and the Insurance Agent
   A. General Rules of Agency
   B. Waiver and Estoppel

Short Answer Questions

1. How do actual cash value settlements support the principle of indemnity? What are the exceptions to the principle of indemnity?
2. How does the principle of insurable interest help to reduce moral hazard?

3. How does the principle of subrogation support the principle of indemnity?

4. Distinguish between concealment and misrepresentation.
5. What four requirements must be met to form a binding insurance contract?

6. For each pair of terms, circle the characteristic that applies to insurance contracts.

<table>
<thead>
<tr>
<th>Bilateral</th>
<th>or</th>
<th>Unilateral</th>
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<tbody>
<tr>
<td>Aleatory</td>
<td>or</td>
<td>Commutative</td>
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<tr>
<td>Conditional</td>
<td>or</td>
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<tr>
<td>Personal</td>
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7. Differentiate between waiver and warranty.
8. What are the three sources of an agent’s authority to bind the principal? What powers are derived from each source of authority?

9. What are the three general rules of agency that govern the actions of agents and their relationships with insureds?

10. What elements are necessary to invoke the doctrine of estoppel?
Multiple Choice Questions

Circle the letter that corresponds to the BEST answer.

1. If there is ambiguity in an insurance contract, it is construed in favor of the insured because of which legal characteristics of insurance contracts?
   (a) principle of indemnity
   (b) contract of adhesion
   (c) aleatory contracts
   (d) doctrine of concealment

2. To collect for a covered loss under a property insurance contract, when must an insurable interest exist?
   I. At the inception of the contract
   II. At the time of the loss
   (a) I only
   (b) II only
   (c) both I and II
   (d) neither I nor II

3. Sandy purchased renter’s insurance that covered personal property on an actual cash value basis. She paid $2000 for a living room set three years ago. When the living room set was destroyed by fire, it was 20 percent depreciated. A comparable new living room set will cost $2400. How much will Sandy collect from her insurer?
   (a) $2000
   (b) $2400
   (c) $1600
   (d) $1920

4. Brad’s homeowners insurance excludes losses if there is a “material increase in hazard.” After buying the policy, Brad started to make fireworks in the basement. A spark from a wood stove ignited some gunpowder, and the home burned to the ground. Which legal characteristic of insurance contracts may prevent Brad from collecting under his policy?
   (a) conditional contracts
   (b) personal contracts
   (c) contracts of adhesion
   (d) aleatory contracts

5. Insurable interest is required for all of the following reasons EXCEPT:
   (a) to prevent gambling
   (b) to measure the extent of loss
   (c) to reduce premiums
   (d) to reduce moral hazard
6. Which statement(s) is/are true about subrogation?
   I. Subrogation supports the principle of indemnity.
   II. Subrogation helps to keep insurance premiums lower.
   (a) I only
   (b) II only
   (c) both I and II
   (d) neither I nor II

7. When Ellen completed her life insurance application, she answered “No” to the question, “Have you ever had hepatitis?” She had hepatitis two years ago. If Ellen dies shortly after the policy is issued, the insurer may be able to deny the claim because of the doctrine of:
   (a) concealment
   (b) insurable interest
   (c) warranty
   (d) misrepresentation

8. All of the following are exceptions to the principle of indemnity EXCEPT:
   (a) actual cash value insurance
   (b) replacement cost insurance
   (c) life insurance
   (d) valued policies

9. All of the following conditions must be met to form a binding property insurance contract EXCEPT:
   (a) contract must be in writing
   (b) exchange of consideration
   (c) competent parties
   (d) offer and acceptance

10. Insurance contracts have which of the following legal characteristics:
    I. They are bilateral contracts.
    II. They are aleatory contracts.
    (a) I only
    (b) II only
    (c) both I and II
    (d) neither I nor II

11. Kate completed a life insurance application. Her agent forwarded the application to the insurer. The insurer issued the policy. The agent delivered the policy to Kate. When Kate received the policy, she paid the premium. When was the offer accepted in this case?
    (a) when Kate completed the application
    (b) when the agent forwarded the application to the insurer
    (c) when the insurer issued the policy
    (d) when Kate received the policy and paid the first premium
12. Which statement about the principle of indemnity is correct?
   I. The principle of indemnity reduces moral hazard.
   II. Replacement cost insurance supports the principle of indemnity.
   (a) I only
   (b) II only
   (c) both I and II
   (d) neither I nor II

13. Bill called his insurance agent to check whether his auto insurance would apply to a rental car. The agent said, “No sweat, you’re covered.” Bill was involved in an accident while driving the rental car. The claim submitted to his insurer was denied. Bill may be able to collect because of the doctrine of:
   (a) reasonable expectations
   (b) estoppel
   (c) waiver
   (d) conditional contracts

14. Ted owns an auto parts store. In exchange for a premium discount from his insurer, he promised that no cash would be kept on the premises overnight and that two guard dogs would patrol the grounds at night. Ted’s promises were incorporated into the insurance contract. His promises are:
   (a) representations
   (b) warranties
   (c) waivers
   (d) expressed powers

■ True/False

Circle the T if the statement is true, the F if the statement is false. Explain to yourself why a statement is false.

T F 1. Actual cash value coverage on your personal property costs more than replacement cost coverage.

T F 2. If you knowingly withhold information that will affect the underwriting decision, you have committed misrepresentation.

T F 3. In property insurance, you can purchase insurance based on the expectation of an insurable interest.

T F 4. A principal is responsible for the acts of an agent when the agent is acting within the scope of his or her authority.

T F 5. It’s better for insurance applicants to have their statements construed as warranties rather than as representations.

T F 6. In general, property insurance agents have greater authority to bind the companies they represent than do life insurance agents.
T   F   7. While the applicant for insurance coverage gives consideration in the form of the premium, the insurance company does not give any consideration.
T  F  8. If an insurer voluntarily waives a legal right under the contract, it cannot later deny payment of a claim on the grounds that the legal right was violated.

T  F  9. If you interfere with your insurer’s subrogation rights against a third party, you jeopardize your right to collect from your insurer.

T  F  10. Insurance contracts are characterized by an equal exchange of value by the parties to the contract.

T  F  11. If an individual claims to represent an insurer but gives no proof of an agency relationship, you should not presume the individual is an agent for the insurer.

T  F  12. The cover page of an insurance contract is called a binder.

**Case Applications**

**Case 1**
Kate was trying to sell her home. In listing the many positive features of the home, Kate said, “...and I just paid for my homeowners insurance for another year. If you buy the house, I’ll throw in free homeowners insurance for a year!” What do you think of Kate’s offer?

**Case 2**
An employee considered terminating employment. When he asked his employer about health insurance coverage if he quit his job, he was told that his group health insurance plan (which included major medical insurance) could be converted to identical individual coverage. The coverage would also apply to his wife and children. The employee converted the coverage and quit his job. Shortly thereafter, his wife gave birth to a child who was born with a serious medical condition. When the former employee sought reimbursement of the child’s medical expenses, he learned that the conversion policy did not include major medical insurance. He brought suit against the former employer. Will his suit be successful?
Solutions to Chapter 5

Short Answer Questions

1. An actual cash value settlement supports the principle of indemnity because through such a settlement, an insured is restored to his/her pre-loss position. If a partially depreciated asset is destroyed, the depreciated value of a replacement asset is paid, rather than the full value of a replacement asset.

   There are four exceptions to the principle of indemnity: life insurance, replacement cost coverage, valued policies, and valued policy laws.

2. In the absence of insurable interest, there would be a severe moral hazard problem. Individuals could purchase life insurance on strangers or property insurance on property they did not own. Then they would have an incentive to bring about a loss in order to collect the insurance settlement. The insurable interest requirement prevents such losses.

3. Subrogation supports the principle of indemnity because through subrogation, an insured collects only once for a loss covered by insurance. When an insurer pays its insured, the insured surrenders his or her right of action against the negligent third party to the insurer. Thus the insured collects from the insurer only, not from the insurer and the third party.

4. Misrepresentation occurs when an applicant for insurance lies about something. If the lie involves something material, it is grounds for the insurer to void the contract. Concealment is silence when there is an obligation to disclose information. If the information that is not disclosed is material, it is grounds for the insurer to void the policy.

5. To form a binding insurance contract, there must be a valid offer and acceptance, the contract must be for a legal purpose, the parties to the contract must be competent, and there must be an exchange of consideration between the parties to the contract.

6. Insurance contracts have the following characteristics: they are unilateral, aleatory, conditional, and personal.

7. In the context of insurance contracts, waiver refers to the voluntary relinquishment of a legal right. Warranty refers to a promise made by an insured that must be satisfied for an insurer to be held liable under the contract.

8. The three sources of authority are express authority, implied authority, and apparent authority. Express authority is authority specifically conferred on the agent by the principal. Implied authority is the authority to perform all incidental activities to fulfill the agency agreement. An agent may also bind the principal through apparent authority.

9. There is no presumption of an agency relationship. An agent must have authority to bind the principal. A principal is responsible for the acts of an agent when the agent is acting within the scope of his or her authority.

10. For estoppel to be invoked, three conditions are necessary. First, there must be a representation of fact. Second, this representation of fact must be reasonably relied upon by another party. Finally, harm would occur to the party who relied upon the representation of fact if the representation was retracted; therefore the person who made the representation cannot take it back.
Multiple Choice Questions

1. (b) Insurance contracts are contracts of adhesion. The contract must be accepted in its entirety and any ambiguity in the contract is construed in favor of the insured.

2. (b) Property insurance contracts can be purchased based on an expectation of insurable interest. It is only necessary to demonstrate insurable interest when the loss occurs in order to collect under the policy.

3. (d) As the coverage is written on an actual cash value (ACV) basis, the insurer will make an adjustment to take depreciation into consideration. ACV is replacement cost less depreciation:

\[
ACV = 2400 - (2400 \times 0.20)
\]

\[
ACV = 1920
\]

4. (a) In an insurance contract, the insurer makes a conditional promise to indemnify. Here the conditions were not satisfied as Brad significantly increased the chance of loss.

5. (c) Insurable interest helps to prevent gambling, assists in determining extent of the loss, and helps to reduce moral hazard. Insurable interest does not reduce premiums.

6. (c) Subrogation supports the principle of indemnity because the insured is only permitted to collect once for a loss. When the insurer pays the insured, the insured surrenders his or her right to proceed against a negligent third party. As insurers are able to recoup part or all of the loss settlements paid to their policyowners, subrogation helps reduce premiums.

7. (d) Ellen’s lie about hepatitis is a material misrepresentation. If Ellen dies during the first or second year that the life insurance contract is in force, her insurer may be able to deny the claim because of the material misrepresentation.

8. (a) Actual cash value insurance supports the principle of indemnity by restoring the insured to his or her pre-loss position. The other choices are all exceptions to the principle of indemnity.

9. (a) It is not necessary for a property insurance contract to be in writing. As property agents have greater authority, it is not uncommon for coverage to be bound over the phone. The other element of valid insurance contracts missing from the list is the legal purpose requirement.

10. (b) Insurance contracts are unilateral, not bilateral. Only the insurer makes a legally enforceable promise. They are aleatory as the values exchanged by the parties to the contract are unequal due to chance.

11. (d) As Kate did not pay the premium when her application was submitted, the offer was made by the insurer when the contract was issued. Kate accepted this offer by paying the first premium and accepting delivery of the policy.

12. (a) The principle of indemnity reduces moral hazard as it prevents you from collecting more than the actual amount of the loss. Replacement cost insurance violates this principle, as you are “better off” after the settlement because no allowance for depreciation is made.
13. (b) The doctrine of estoppel may be invoked in this case. There was a representation of fact made by the agent. Bill reasonably relied upon the representation. Harm would clearly result if the agent were allowed to retract the statement, so the agent may not be permitted to do so.

14. (b) Ted’s promises are warranties. He is promising that certain conditions must be met (no cash on the premises over night and guard dogs on site) before the insurer will be liable for losses.

**True/False**
1. **F** As actual cash value coverage allows the insurer to reduce the loss settlement because of depreciation, it costs less than replacement cost coverage.

2. **F** Failure to divulge material information is concealment, not misrepresentation.

3. **T**

4. **T**

5. **F** Under common law, materiality is not considered with regard to a warranty. If a statement is false, regardless of whether the fact is material, it can be used to defeat a claim against the insurer. Misrepresentation considers whether the fact was material.

6. **T**

7. **F** The insurer’s consideration is in the form of a conditional promise. Should a loss occur, the insurer will provide indemnity if the conditions stated in the policy are satisfied.

8. **T**

9. **T**

10. **F** There is an unequal exchange of values because chance is involved. Because of this characteristic, insurance contracts are described as aleatory.

11. **T**

12. **F** A binder is temporary evidence of insurance until a formal insurance contract can be drafted.

**Case Applications**

**Case 1**

Although Kate’s offer sounds generous, insurance contracts are personal in nature. An insurance company will want to consider the insurability of the new homeowner. While underwriters consider the property that will be covered, they also consider the character of the property owner. The purchaser, for example, may have several arson convictions or may be close to declaring bankruptcy. The purchaser of Kate’s home should secure his or her own homeowners insurance.

**Case 2**

The suit filed by the former employee will be successful because of the doctrine of estoppel. The employer made a statement of fact. The employee reasonably relied upon this representation of fact. Clearly harm would result if the employer were allowed to retract the representation after it had been reasonably relied upon by the former employee.