Chapter 2

PRINCIPLES OF INSURANCE

CONTRACT OF INSURANCE

Any contract is entered between at least two persons/parties to do or abstain to do an act.

Contract of Insurance is between the Insurer & owner of subject matter of insurance/proposer, which concludes when the premium is paid and insurer accepts the risk. Policy is then issued and the same is an evidence of contract. The proposer on acceptance of risk and issuance of policy becomes insured. Condition necessary for a contract: - Consideration: Premium is consideration for insurer and promise to indemnify is consideration for insured. In any contract common Intention is Must.

Like mind: it is a basic element of a contract. Party desired a Mediclaim policy but the insurer issued a policy for Cancer Insurance: There is no legal Contract.

Competence: Another basic condition to the contract is that the party who desires to enter in to a contract should be major, of a sound mind and has legal capacity.

Object to be legal: Stolen goods, Public property or party who has no Insurable Interest cannot insure the property. Insurance contracts are subject to special principles evolved under common law.

Basic principles of insurance are:

- UTMOST GOOD FAITH
- INSURABLE INTEREST
- INDEMNITY
- SUBROGATION
- CONTRIBUTION
- PROXIMATE CAUSE

1. UTMOST GOOD FAITH

Common contracts/commercial contracts are of good faith (Caveat Emptor) "Let the buyer beware". Although good faith in insurance is to be observed, it is absolutely essential for the proposer to disclose all information that is material to the contract so that the insurer can decide (1) about acceptance (2) rate of premium to be charged subject to term and conditions. Insured is required not only to inform the details/information he knows but also the material facts, which he ought to know. This condition is known as Utmost Good Faith. Utmost good faith may be defined as:

A positive duty, voluntarily to disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not.

Material Facts:

Every circumstance is material, which would influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk.

The categories of facts, which must be disclosed:

Facts that show that particular risk represents a greater exposure than would be expected from its nature and class.

- External factors, which make the risk greater than the risk normally, be expected.

Previous losses and claims under other policies. Any declinature or special terms imposed on previous proposals by other insurers. The existence of other non-indemnity policies such as life and accidents.

Full facts relating to the description of the subject matter of insurance.

Example of material facts:

Fire:

1. Construction of building
2. Occupancy i.e. nature of use
3. Fire detection and fire- fighting equipment

Marine:

1. Nature of packing: single or double gunny bag, old or new drums.
2. Nature of goods: machinery new or old
3. Vessel carrying: age, condition of the vessel
4. Port of shipment: loading, security arrangement
5. Destination: unloading, security & clearance arrangement
6. Terms of sale

Motor

1. Type of vehicle
2. Cubic capacity
3. Carrying Capacity
4. Age of the owner/ driver
5. Model
6. Geographical Area

Personal Accident:

1. Nature of job of the person
2. Age, height & weight
3. Disability if any

Theft Insurance:

- Nature of goods stored: non-hazardous, hazardous, extra hazardous
- Value of stocks and security arrangement
- Facts, which need not to be disclosed, example:

Need not to be disclosed:

- Facts of law
- Facts of common knowledge example: riot, flood/earthquake prone areas.
- Facts, which lessen the risk
- Facts, which could reasonably discovered
- Facts which survey report will revealed
- Facts covered by policy conditions.

  General: Previous insurance and claim history has a bearing on deciding rates to be charged, whether to accept on normal rates or to reject or load the premium.

  Duty of disclosure ceases no sooner than policy/cover note is issued but at the time of renewal, again all material facts are to be disclosed. It is very important to note if some material change takes place during currency of policy that must be also disclosed.

  The breach of utmost good faith may be defined of two types: the two types are intentional and unintentional. Unenforceable contracts is another topic altogether.

- **Unintentional:**

  If through an oversight or as per insured certain details/information were not material to disclose, in such case the contract is voidable.

- **Intentional:**
  If non-disclosure or misrepresentation with fraudulent intention, in such case the contract becomes void. Void contract is which is not legal and is not a contract at all.

- **Unenforceable:**
  Contracts, which cannot be enforced at law, are unenforceable. i.e. a policy not stamped as per Stamp Act, cannot be evidence in court of law.

- **Contractual Duty:**
  Every proposal has a declaration clause, which is required to be signed by the insured confirming that all material facts have been disclosed. In the legal terms, the insurer can avoid the contract if any answer is not correct and may not be even material to the contract. This is a contractual duty of utmost good faith, a stricter than common law duty of good faith.

2. INSURABLE INTEREST

The legal right to insure arising out of a financial relationship recognized under law, between the insured and subject matter of insurance. The rightful owner suffers loss if the property he possesses is destroyed or damaged. This is known as Insurable interest. He can get such property insured. Without insurable interest the contract of Insurance will be VOID.

ESSENTIALS OF INSURABLE INTEREST

Four essentials feature:

- There must be some property, right, interest, life, limb or potential liability capable of being insured.
- It is this property, right, interest, etc. which must be the subject matter of insurance.
- The insured must stand in a relationship with the subject matter of insurance whereby he benefits by its safety, well-being or freedom from liability and would be prejudiced by its loss, damage or the existence of liability.
- Law must recognize the relationship between the insured and the subject matter of insurance.

Example

- *Owner of the property can insure it.*
- *Banks/Financiers/Mortgagee and Mortgagor have insurable interest in vehicles or property for which they have given loan.*
- *Buyers, Sellers, Shippers all have an insurable interest in cargo.*
- *Everyone has an insurable interest in Self, wife & children.*
- *Owner of the vehicle has insurable interest in, third party, and occupants of the car as well as in the vehicle.*
- *Executors and Trustees have insurable interest in the property under their charge.*
- *Bailees have insurable interest in the property under their custody either for repair or cleaning. Example motor garage owners, dry cleaners or watch repairers, required to take reasonable care as if their own.*

INSURANCE CONTRACTS are not gambling transaction & insurable interest must be there. Subject matter of the insurance contract is related to the financial interest one has in the property to be insured. What is insured in a fire policy? Not the bricks and material used in the building of the house but the interest of the insured in the subject matter of insurance.

WHEN INSURABLE INTEREST SHOULD BE PRESENT

In case of Fire & Miscellaneous Insurance: At all the time i.e. at the time of effecting insurance as well as at the time of Loss/Claim.

In case of Marine Insurance: The insurable interests need not to exist at the time of effecting insurance but it must exist at the time of loss. Exporter, Importer, Shipper and Carrier can affect insurance.

In case of Life insurance: The insurable interest is required to exist at the time of entering in to a contract.
Lawful possession of property will normally support insurable interest provided that possession also includes responsibilities i.e. future challans, any accident, future liabilities while vehicle in use or not.

Assignment: Transfer of Right and liabilities to another person who has attained Insurable Interest in property insured. The person is known as Assignee. He can directly deal with the insurance company in his own name.0

Fire & Miscellaneous policy: Can be assigned with the consent of insurer.
Marine policy: Is freely assignable without knowledge and consent of insurer. Mere signing/ Endorsing at the back of policy documents is sufficient. But Marine Hull Policy cannot be assigned without consent of the insurer.

Insurer's insurable interest: having insured the subject matter insurers has assumed the liability. They can insure this property fully or partly by way of Reinsurance.

3. INDEMNITY

The principle of indemnity arises under common law and requires that an insurance contract is a contract of indemnity only and nothing more.
The object of this principle is to place the insured in the same financial position as far as possible he occupied immediately before the loss. The effect of this principle is to prevent the insured from making profit out of his loss or gaining benefit or advantage. If it is not there the insured himself will bring about the losses so as to make profit.

How Indemnity is provided:

The company may at its option indemnify the insured by payment of the amount of the loss or damage by cash, repair, reinstatement or replacement.

- **Cash Payment:** An insurance contract is a contract to pay money. In most of the cases Insurance Company pays claim by way of a cheque to indemnify the insured. In liability claims insurers pay by way of cheques the liability amount as established either by court or arrived at compromise.

- **Repair:** Insurers make extensive use of repair as a measure of providing indemnity. In most cases , especially motor insurance companies, authorized repairers carry out repair work on damaged vehicles.

- **Replacement:** This method is where insurance company provides replacement although this not quite commonly applied. The company may exercise this method where the market is low but insurance is quite high.\

- **Reinstatement:** In this method company undertakes to restore or rebuild the damaged property or machinery. The company would normally not exercise this right because of difficulties to face later on.

Liability of insurer: Major factors considered at the time of settlement of claims are:

- What is the extent of loss of the insured?
- To what extent will policy respond?

The measures, which are important, are as under:

- Sum Insured is the highest amount payable in case of loss.
- Average applicable in case of under insurance. In case property is not insured for actual value then it's applied. Insured is self-insurer for proportionate value. The average is applied based on formula **(Sum Insured/value) x Loss**

Other factors which applies to indemnify:

- Excess or franchise applied as the case may be.

- Deductible: is used where large excess is applicable
- Limits: restricting value to pay in event of claim say 5% of total sum insured.
- Salvage application.

Extension in the operation of Indemnity

Reinstatement

It normally applies to building and machinery. In this type of settlement the following is included:

1. Indemnity;
2. Wear, tear and depreciation;
3. The effect of inflation between the date of loss and eventually date of replacement. In case of reinstatement if machinery replaced were of better quality or performance then contribution would be equitable from the insured.

Additional Agreed Cost: This also is payable if the same is agreed and premium is paid for it.

Valued Policy: In case of fire policy where value is not ascertained the insurance is granted on agreed value. At the time of claim in case of total loss sum insured is paid but in case of partial loss principle of indemnity is applied.

4. SUBROGATION

Transfer of rights and remedies by the insured to the insurer who has indemnified the insured in respect of loss suffered by him.
The principle of subrogation arises from the principle of indemnity. After payment of claim the insurer steps into the shoes of insured and can claim recovery from a third party responsible for the loss and can sue in the name of the insured. The insured is entitled to indemnity – but no more than that. It avoids the situation where an insured might profit from an insured event. It also enables the insurer to pursue rights and remedies, which the insured may possess, always in the name of the insured, which may reduce the loss. In case he recovers the loss from another source the money received is held in trust and it belongs to the insurer.
The subrogation applies to all losses other than life and personal accident, in which case, the person can claim for money from the third party who negligently caused death. A person who holds a life policy also can recover compensation from him as well as from life/non-life insurance company payment in respect of his insurance.

Extent of Subrogation Rights

There is a strong link between indemnity and subrogation; an insurer is not entitled to recover more than he has paid out. The insured may succeed in recovering more claim amount than that he/she has received from a third party. There are circumstances in which the insured has been considered his own insurer for part of the risk. This would apply in a case where there is excess or where average applies. In this event he is entitled to retain an amount equal to that share of the risk out of any money recovered.

How subrogation Arises

- Tort
- Contract
- Statute
- Subject matter of insurance

Tort: Where insured has sustained some damages, lost rights or incurred liability due to tortuous acts of some other person then the insurer, having indemnified for the loss is entitled to take action to recover the outlay from the wrongdoer.

Contract: Subrogation relates to the rights, which arise out of certain contracts. This may arise where there is a custom of the trade to which the contract applies. The other situation where subrogation may arise from contract is where a person has a contractual right to compensation regardless of fault. Insurer will assume the benefits of these rights

Statute: In U.K. the insurance company has the right to recover from police for loss to the property for which claim has been paid for the damage sustained due to riot.

Subject Matter of Insurance: After payment of claim of lost property the insurance company procures the right of taking over the property if recovered.

When Subrogation right arises: The right of common law arises when insurance company has admitted the claim and paid it.

Modification of subrogation: The Company can exercise the right before payment or even may not exercise the right under Knock for Knock agreement. The right may also be waived in case the injury or damage to employee is due to negligence of another employee.

5. CONTRIBUTION

An insured may have insurance of the same subject matter with a different insurer. In the event of loss he can recover the loss from any one insurer to the extent of sum insured or from all insurers as per insurances with them. But in case he recovers from all insurers he will obviously make profit out of loss. The insurer who has paid the loss under the policy can recover a proportionate amount from the other insurers who are liable for the loss. The insured can recover the full amount within the sum insured from the insurer he likes. This is known as the principle of Contribution.

Contribution is the right of an insurer to call upon others similarly, but not necessarily equally liable to the same insured to share the cost of an indemnity payment. The crucial point is if an insured has paid a full indemnity, that insured can recoup an equitable portion from the other insurer of the risk. If the full indemnity has not been paid then insured will wish to claim from insurers also to receive an indemnity. The principle of contribution enables the total claim to be shared in a fair way.

How Contribution Arises

Requirement of common law needs following to be met:

- Two or more policies of indemnity must exist.
- The policies must cover common interest.
- The policies must cover the common peril which gives rise to the loss.
- The policies must cover a common subject matter.
- Each policy must be liable for loss rateable proportion.
- Each insurer pays in proportion to the sums insured on the policies.

Example

Policy A sum Insured	*Rs. 100,000*
Policy B sum Insured	*Rs. 200,000*
Policy C sum Insured	*Rs. 300,000*
Total	***Rs. 600,000***

In case the loss is Rs 60000 which works out to 10% of the total sum insured, the share of loss for the three insurers will be Rs.10000 for insurer A, Rs.20000 for insurer B and Rs.30000 for insurer C.

6. PROXIMATE CAUSE

Proximate cause means the active, efficient cause that sets in motion a train of events, which brings about a result, without the intervention of any force started and working actively from a new and independent source.

The object of insurance is to provide for such loss, which are covered under the insured perils. If the loss is brought about by one event there is no problem to clear the question of liability. If it is due to two or more events then it is important to see for the most effective, most powerful cause, which has brought about the loss. This cause is termed as proximate cause. All other causes are considered as remote causes.

The insurance company is liable for the injuries /damages caused by the event and looks into the proximate cause of the loss when fixing the liability. The question therefore arises as to how is a proximate cause to be determined in order to fix the liability?

Example

1

A person insured under a personal accident policy went on hunting and met with an accident. Due to shock and weakness he was unable to walk. While lying on wet ground he contracted cold which developed into pneumonia, which caused the death.

2

An insured suffered accidental injury and was taken to the hospital while undergoing treatment he contracted infectious disease, which caused death.

In case of example 1, the proximate cause of death is accident. Hence death claim is payable. Whereas in example 2, death is due to infectious disease contracted after the chain has broken. Hence only accidental loss is payable and not death claim.