Chapter Four

Legal Principle of Insurance Contract

Introduction

As we know insurance contracts are complex legal documents because by its nature it reflects both general rules of law and insurance laws. Insurance is based on the following general principles.

1. The principles of cooperation: Insurance is a cooperative device. If one person is financing his own losses, it cannot be strictly insured. Because in insurance the loss is shared by a group of persons who are willing to cooperate.
2. The principle of probability: the loss in the shape of premium can be distributed only on the base of theory of probability. The chance of loss is estimated in advance to affix the amount of premium. Since the degree of loss depends up on the various factors, the affecting factors are analyzed before determining the amount of loss.

4.1. Legal principles of insurance contracts

Insurance is affected by legal agreements called contracts or policies. A contract cannot be complete in effect, but must be interpreted in light of the social environment of the society in which it is made. The legal principles of insurance that are generally applicable are discussed as follows.

4.1.1. Principle of indemnity

The principle of indemnity is one of the most important principles insurance. *The principle of indemnity states that the insurer agrees to pay no more than the actual amount of the loss; stated indifferently, the insured should not profit from the loss.*

Most property and causality insurance contracts are contracts of indemnity. If covered loss occurs, the insurer should not pay more than the actual amount of loss.

A contract of indemnity does not mean that all covered losses are always paid in full. Because of deductibles, dollar limits on the amount paid, and other contractual provisions, the amount paid may be less than the actual loss.

Indemnity implies that:

- There must be an actual loss
- The loss should have occurred through the risk insured
- The loss must be capable of calculation in terms of money

- The payment made by another person (third party) should not exceed the actual loss suffered.

The principle of indemnity has two fundamental purposes.

- ♠ The first purpose is to prevent the insured from profiting from a loss.
- ♠ The second purpose is to reduce moral hazard.

If the dishonest insured could profit from a loss, they might deliberately cause losses with the intention of collecting the insurance.

If the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced.

Actual Cash Value: - the concept of actual cash value supports the principle of indemnity. In property insurance, the standard method of indemnifying the insured is based on the actual cash value of the damaged property at the time of loss. The Courts have used three major methods to determine actual cash value;

(i) Replacement cost less depreciation

(ii) Fair market value

(iii) Broad Evidence rule

1. **Replacement cost less depreciation:**

Under this rule, actual cash value is defined as replacement cost less depreciation. This rule has been traditionally used to determine the actual cash value of property in property insurance.

- ♠ It takes into consideration both inflation and depreciation of property values over time.
- ♠ Replacement cost is current cost of restoring the damaged property with new materials of some kind and quality. Depreciation is a deduction for physical wear and tear, age and economic obsolescence.

Example

For example, machinery has been insured against fire. It burnt out of a fire. Assume that the machinery was bought 5 years ago, and that machinery is 50% depreciated. The similar machinery would cost 10,000 birr. Under the actual cash value rule, the insured will collect only 5,000 birr for the loss of the machinery, because the replacement cost is 10,000 birr, but depreciation is 5,000 birr or 50%. If the insured were paid the full replacement value of 10,000 birr, the principle of indemnity would be violated, because the insured would be receiving the value of new brand machinery instead of one 5 years old. In short, 5,000-birr payment represents indemnification for the loss of 5-year-old machinery.

This can be summarized as follows;

Replacement Cost	= 10,000 birr
Depreciation	= 5,000 birr (Machinery is 50% depreciated)
Actual Cash Value	= Replacement Cost – Depreciation
∴ Actual cash value	= 10,000 birr – 5,000 birr
	= 5,000 birr.

2. Fair Market Value

Fair market value is the price a willing buyer would pay a willing seller in a free market. The fair market value of a building may be below its actual cash value based on replacement cost less depreciation. This may be due to poor location, bad neighborhood or economic obsolescence of the building.

For example, in a big city, large homes in older residential areas often have a market value well below the replacement cost less depreciation. If a loss occurs, the fair market value may be used to determine the value of the loss. In one case, a building valued at $ 170,000 based on the actual cash value rule had a market value of only $ 65,000 when a loss occurred. The court ruled that the actual cash value of the property should be based on the fair market value of $ 65,000 rather than $ 170,000

3. Broad Evidence Rule

The broad evidence rule means that the determination of actual cash value should include all relevant factors an expert would use to determine the value of the property. Relevant factors include replacement cost less depreciation, fair market value, and present value of expected income from the property, comparison sales of similar property, opinions of appraisers and other factors.

Exceptions to the principle of indemnity: The important exceptions to the principle of indemnity are as follows;

(i) Valued policy
(ii) Valued policy laws
(iii) Replacement cost of insurance
(iv) Life Insurance

I. **A valued policy** is one that pays the face amount of insurance regardless of actual cash value if total loss occurs. They are used to insure fine arts & rare paintings. Because of difficulty in determining the actual cash value of the property at the time of loss, the insured and insurer both agree on the value of the property when the policy is first issued. (E.g. Old clock)

II. **Valued policy laws** are another exception to the principle of indemnity. The specified perils to which a valued policy law applies vary among the states. Some states cover only fire and others cover fire, lightning, wind storm and tornado. In addition, the laws generally apply only to real property and the loss must be total. For example, a building insured for 200,000 birr may have the actual cash value of 175,000 birr. If a total loss from a fire occurs, the face amount of 200,000 would be paid. Thus, the principle of indemnity would be violated.

III. **Replacement cost of insuranc**e means no deduction is taken for depreciation in determining the amount paid for a loss. For example, assume the roof on your home is 5 years old and has a useful life of 20 years. The roof is damaged by a tornado, and the current cost of replacement is 10,000 birr. Under the actual cash value rule, you would receive only 7,500 birr (10,000 – 2,500 = 7,500 birr). Under a replacement cost policy, you would receive the full 10,000 birr. Since you receive the value of a brand new roof instead of one that is 5 years old, the principle of indemnity is technically violated.

Life insurance is another exception to the principle of indemnity. A life insurance contract is not a contract of indemnity but it is a valued policy that pays a stated sum to the beneficiary upon the insured's death. The indemnity principle is difficult to apply, because the historical actual cash value rule is meaningless in determining the value of a human life.

4.1.2. Principle of Insurable Interest

For an insurance contract to be valid, the insured must possess an insurable interest in the subject matter of insurance. Insurable interest refers to the existence of financial relationship to the subject matter insured. The subject matter of insurance may be a property, life or legal liability.

The principle of insurable interest is another important legal principle. The principle of insurable interest's states that the insured must be in a position to lose financially if a covered loss occurs. For example, you have an insurable interest in your car because you may lose financially if the car is damaged or stolen. You have an insurable interest in your personal property, such as a television set or computer, because you may lose financially if the property is damaged or destroyed.

Purpose of an insurable interest

To be legally enforceable all insurance contracts must be supported by an insurable interest for the following reasons.

- ♥ To prevent gambling
- ♥ To reduce moral hazard
- ♥ To measure the amount of the insured's loss in property insurance.

`First, an insurable interest is necessary to prevent gambling. If an insurable interest were not required, the contract would be a gambling contract and would be against the public interest.

- ♦ For example, one could insure the property of another and hope for an early loss. In the same way, one could insure the life of another and hope for an early death.

Second, an insurable interest reduces moral hazard. If an insurable interest is not required, a dishonest person could purchase a property insurance contract on some one's property and then deliberately cause a loss to receive the insurance claims.

- ♦ But, if the insured person stands to lose financially, nothing is gained by causing the loss. Thus, moral hazard is reduced.

Finally, an insurable interest measures the amount of the insured's loss. In property insurance, most contracts are contracts of indemnity.

- ♦ Thus, the measure of recovery is the insurable interest of the insured. The amount of indemnification is measured by calculating the insurable interest in monetary terms.
- ♦ For example, if a person's property worth 1million Birr is insured and it was destroyed totally after some time, his insurable interest on that property depends on the financial loss met by him.
- ♦ Here, as the entire property is destroyed, his insurable interest tends to be 1 million Birr on that property. Thus, he will be indemnified the 1 million Birr.

Activity

4.1.3. Principle of subrogation

The principle of subrogation strongly supports the principle of indemnity. Subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from third person for a loss covered by insurance, in other words the insurer is entitled to recover from negligent third party any loss payments made to the insured.

Principle of subrogation is a supplement to the principle of indemnity. The reason behind this principle is to eliminate the profit motive of the insured. That means, the insured cannot claim both from the insurer and the wrong doer for single accident, which would enable him/her collect more than what was actually lost.

Subrogation implies that:

- The insurer makes payment to the insured for his actual loss
- The insurer after making good the loss, places himself in the position of the insured and has all the rights and remedies of the insured
- The insurer cannot recover anything more than he has paid to the insured
- Like principle of indemnity, principle of subrogation is not applicable to life insurances.

Example

For example, assume that a negligent motorist smashes into Mr.X's car, causing damages of 5,000 Birr. If Mr.X has the collision insurance on his car, his insurance company will pay 5,000 Birr and then attempt to collect from the negligent motorist who caused the accident. Alternatively, if Mr..X directly collect from the negligent motorist, the principle of subrogation does not apply. Because, the loss payment is not made by the insurance company. However, to the extent that a loss payment is made, the insured gives to the insurer legal rights to collect damages from the negligent third party.

Why subrogation? Subrogation has three basic purposes.

- ☞ First, subrogation prevents the insured from collecting twice for the same loss. In the absence of subrogation, the insured could collect from the insurer and from the person who caused the loss. The principle of indemnity would be violated because the insured would be profiting from a loss.

- ☞ Second, subrogation is used to hold the negligent person responsible for the loss. By exercising its subrogation rights, the insurers can collect from the negligent person who caused the loss.
- ☞ Finally, subrogation helps to hold down insurance rates. Subrogation recoveries can be reflected in the rate making process, which tends to hold rates below where they would be in the absence of subrogation.

4.1.4. Principle of utmost good faith

Utmost good faith means that a higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts. This principle has its historical roots in ocean marine insurance. An ocean marine underwriter had to place great faith in statements made by the applicant for insurance concerning the cargo to be shipped.

Insurance contracts are based upon mutual trust and confidence between the insurer and the insured. This principle requires each party to tell the other "the truth, the whole truth and nothing but the truth". It means that both the insured and insurer must make full disclosure of material facts and information relating to the contract or facts that have a bearing on the assessment of the risk. Material facts are of the following types:

1. those which affect the nature or incidence of risk; and
2. those which affect the character of insured.

Insurance is said to be a contract of utmost good faith. In effect, this principle imposes a higher standard of honesty on parties of insurance agreement than is imposed on ordinary commercial contracts.

- Insurance contracts are based on mutual trust. This means that both the insured and the insurer must make full disclosure of material facts that have a bearing on the assessment of the risk.
- Intentional concealment, misrepresentations and fraud may lead to the avoidance of the insurance contract.
- The insured is bound to give all the facts having material effect on the assessment of risk. The application of this principle can be expressed in representation, concealment and warranties.

The principle of utmost good faith is supported by three important legal principles;

(i) Representations
(ii) Concealment
(iii) Warranty

(I) Representations:

Representations are statements made by the applicant for insurance. For example, if a person wants to apply for life insurance, he may be asked questions concerning his age, weight, height, occupation, state of health and other relevant questions. The answers given by that person are called representations.

The legal importance of a representation is that the insurance contract is voidable at the insurer's option if the representation is (a) material, (b) false, and (c) relied on by the insurer. **Material** means that if the insurer knew the true facts, the policy would not have been issued, or would have been issued on different terms. **False** means that the statement given by the insured is not true or it is misleading. **Reliance** means that the insurer relies on the misrepresentation in issuing the policy at the specified premium.

For example, Mr. X may apply for life insurance and state in the application form that he has not visited a doctor within the last 5 years. But, he may have undergone surgery six months earlier. In this case, he has made a statement that is both false & material and the policy is voidable at the insurer's option.

Finally, an innocent or unintentional misrepresentation of a material fact, if relied on by the insurer also makes the contract voidable.

(ii) Concealment:

Concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer. Here, the applicant for insurance deliberately withholds material information from the insurer. The legal effect of a material concealment is also voidable at the insurer's option.

To deny a claim based on concealment, an insurer must prove two things; (a) the concealed fact was known by the insured and (b) the insured intended to defraud the insurer.

Example

For example, Mr. Josep applied for a life insurance policy on his life. 6 months after the policy was issued, he was murdered. The death certificate named the deceased as Joseph De Luca, his true name. Thus, the insurer denied payment on the ground that Joseph had concealed a material fact by not revealing his true identity, and he had also an extensive criminal record. Thus, the court held that intentional concealment of his true identity was material and the insurer need not pay the claim.

(iii) Warranty:

The doctrine of warranty also reflects the principle of utmost good faith. A warranty is a statement of fact or promise made by the insured, which is part of the insurance contract and which must be true if the insurer is to be liable under the contract.

➔ For example, in order to pay a reduced premium, the owner of a shop may warrant that an approved burglary and robbery alarm system will be operational at all times. The conditions describing the warranty become part of the contract.

4.1.5. The principle of contribution

Contribution is the right of the insurer who has paid under a policy, to call upon other insurers equally or otherwise liable for the same loss to contribute to the payment.

- This also supports the principle of indemnity. The doctrine of this principle preaches for an "equitable distribution" of any loss among insurers. It is applied to a situation where a person or firm, for some reasons, purchase insurance from two or more insurers to cover the same subject matter against loss or damage.
- Under such circumstance, the insured cannot collect compensation from each insurer. If this happen, insurance becomes a profit making mechanism.
- So, the insured is paid only to the extent of the loss he has suffered. But, each insurer will make contribution to settle the claim.
- The contribution may be a proportional amount based on the sum insured under the respective insurers. However, to know if an insured has more than one insurer for the same risk, especially in countries like ours could be difficult.

The principle of contribution is enforceable only under the following conditions:

1) The policies must cover the same period
2) The policies must have been inforce at the time of loss
3) They must protect the same peril
4) The subject matter of insurance must be the same, and
5) The insured must be the same person.

Note: The principle of contribution is not applicable to life insurances.

Example

Eg: Assume that Mr.X has insured his house, which is worth 80,000 Birr against fire with three insurers namely A, B & C for 60,000 Birr, 40,000 Birr, and 20,000 Birr respectively. Mr.X's house was completely destroyed by a fire caused by Mr.Y's negligence. The amount of indemnity that Mr.X will be entitled to receive would be 80,000 Birr, the value of the actual loss or the amount of insurance covered.

Solution

Insurers will pay proportionately to the cover they have provided, in accordance with the following formula

Contribution of each insurer $\frac{\text{Each amount of premium}}{\text{Total sums insured with all insurers}} X\ Loss$

A's share of loss $\frac{60,000}{120,000} X\ 80,000$ = Br.40, 000

B's share of loss $\frac{40,000}{120,000} X\ 80,000$ = Br.26, 667

C's share of loss $\frac{20,000}{120,000} X\ 80,000$ = Br.13, 333

4.1.6. Principle of proximate cause

The rule is that immediate and not the remote cause is to be regarded. i.e., see the proximate cause and not the distant cause. The insurer is liable to make the payment of loss under the policy, otherwise not. The insured may recover the loss from the insurer only when:

- The loss has been caused by the insured peril; and
- The cause has been proximate to the loss.

Therefore, the insurer is not liable for the loss due to a proximate cause, which is not an insured peril.

The real cause must be seen while payment of the loss.

☞ In many cases, a loss is caused by several reasons, not a single one. Thus, the principle of proximate cause is used in the insurance contract.

➢ It means among several causes, the insurer tries to examine whether the most effective and decisive cause is under the coverage of the insurance contract.

Example

Ato Abebe insured his car worth of Br. 500,000 in two insurance companies: Ethiopian Insurance Corporation and Awash Insurance Company for Br 300,000 and Br. 200,000 respectively. While the policy is in force the car was damaged due to collusion done intentionally by Kebede. The loss is estimated to be Br. 200,000.

Required:

a) How much each insurance company is going to pay to Ato Abebe? Why?
b) How much Ato Abebe is going to claim? Why?
c) Abebe has an intention to claim compensation from the two insurance companies and Kebede at the same time. Advise him. What he/she should does?

Answers

a) The insured has the right to claim compensation from the insurer as far as the policy is in force an amount equal to the loss or face value of the policy. (Indemnity principle). Due to contribution principle, Abebe can claim the amount of loss (Br. 200,000) from the two companies. They contribute to the loss based on the proportion insured. The proportion is calculated as:

For EIC $\frac{300{,}000}{500{,}000} = 0.6\%$

For Awash Insurance Co. $\frac{200{,}000}{500{,}000} = 0.4 = 40\%$

b) Ato Abebe can collect a total of Br. 200,000 an amount of the loss; and 120,000 Br (60% x 200,000) from EIC and 80,000 Br (40% 200,000) from Awash.

c) Ato Abebe cannot collect from the insurance companies and the wrong doer Ato Kebede because of the principle of indemnity and subrogation