

C11 Principles and Practice of Insurance

Addendum December 2011

(To be used with 2009 edition of the textbook.)

Contents, Page iii, Contents for Study 9 has been changed to the following:

- Introduction
- Policies of indemnity
 - Insurable interest
 - The principle of indemnity
 - Actual cash value contracts
 - Replacement cost contracts
 - Valued contracts
- Policies of compensation
- Utmost good faith
 - Insurance brokers/agents and non-disclosure
 - Practical application

Study 1, Page 8, Third bullet point under the heading **Liability** has been changed to the following:

If children cause injury to others or damage to someone else's property, their parents may be all or partly responsible for it. There are many factors to consider, such as, but not limited to, the age of the child and the parents' supervision of the child. Some examples of potential liability are a seven-year old lofting a ball or a stone through the neighbour's window; a three-year-old loving a rare pedigree kitten to death by squeezing it too hard; or young teenagers horse-playing, resulting in the need for expensive dental work for one individual.

Study 2, Page, 5 Third paragraph from the top of the page has been changed to the following:

Other associations were later formed in New Brunswick, Quebec, Ontario, and Western Canada. Many of these associations later consolidated under a federal banner.

Study 2, Page 6, Second paragraph from the top of the page has been changed to the following:

Because of their activities in loss prevention, as well as protection, insurance organizations played a significant role in the community.

Study 2, Page 14, Last paragraph under the heading **Capital** has been changed to the following:

In 2007, the property and casualty insurance industry in Canada had annual premiums of more than \$36 billion. Much of this was invested in Canada. The industry also provides a substantial portion of the Canadian tax base. In 2007, more than \$5.7 billion was paid in taxes.

Study 2, Page 14, First sentence, of first paragraph under the heading **Employment** has been changed to the following:

In 2007, it was estimated that over 110,000 people were directly employed in the private sector of the insurance industry.

Study 4, Page 17, The date in the first sentence beside the marginal heading “Lloyd’s coffee house venue” has been changed to 1688, as follows:

The history of Lloyd’s dates back to 1688, when Edward Lloyd opened a coffee house in London.

Study 4, Page 17, The date in the first sentence beside the marginal heading “Professional underwriters” has been changed to 1774, as follows:

In 1774, Lloyd’s underwriters moved out of the coffee house to premises at the Royal Exchange.

Study 9 has been replaced—the revised Study 9 is included at the end of this document.

Study 12, Page 20, The following organizations have been deleted from the list of industry organizations in the Summary at the bottom of the page:

Insurer’s Advisory Organization (1989) Inc. (IAO)

The Vehicle Information Centre of Canada (VICC)

Investigative Service

Study 9

The Insurance Contract

Learning Objectives

When you finish this study, you should be able to meet the following objectives:

- Discuss the following concepts as they relate to insurance contracts:
 - Insurable interest
 - Indemnity
 - Utmost good faith
- Identify the elements of an insurance contract in a practical application.

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Introduction

Additional requirements for legally binding insurance contract

An insurance policy is the evidence of a contract between an insured and an insurer. When a client submits an application and an insurer accepts it, the five basic requirements for a legal contract must be fulfilled.

Insurance policies are also distinguished from other types of contract by the additional principles of

- insurable interest; and
- utmost good faith.

Insurance policies are sub divided into **policies of indemnity** and **policies of compensation**.

The characteristics and requirements of each type of policy are discussed below.

Policies of Indemnity

Insurable Interest

In England, in the early 18th Century, it was common practice to take out a life insurance policy on the life of a prominent person or insure a public building against fire as a form of gambling. Laws were passed to put an end to such contracts, and the validity of a contract became dependent upon the insured's financial interest in the subject matter of the contract (for example, the life that was insured). This became known as insurable interest.

Insurable interest: life and health

The nature of the insurable interest necessary to support a life insurance contract or accident and sickness insurance policy is found in the personal relationship between the party who contracts for the insurance and the party whose life or health is insured. There must be a legitimate insurable interest in the continuance of the life insured

Legislation

The Civil Code of Québec and the provincial Insurance Acts of the common law provinces specify those persons who have an insurable interest in life and accident and sickness policies. For example, British Columbia's *Insurance Act* states that a person has an insurable interest in his or her own life and the life of

- a) his or her child or grandchild;
- b) his or her spouse;
- c) any person on whom he or she is wholly or in part dependent for, or from whom he or she is receiving, support or education;

- d) his or her employee; and
- e) any person in the duration of whose life he or she has a pecuniary interest.

Although they may have slight variations in wording, Insurance Acts for other provinces are similar.

Insurable interest: property

You have an insurable interest in property when you stand in such a legal relationship to it that you will be financially prejudiced by its loss or damage and financially benefited by its continued existence. This insurable interest is further subject to the principle of indemnity (discussed below). Many different individuals could have an insurable interest in property.

Examples

Owners, lessees, tenants, custodians, lienholders, mortgagees

Insurable interest: liability

You also have an insurable interest in your potential capability to pay damages in the event that you are found responsible (legally liable) for having caused injuries to others or damage to their property.

Examples

As a contractor, you have an insurable interest in insuring your capability to pay in case you or your employees are found liable for injuring passers-by or doing damage to adjoining buildings while operating a crane at a construction site.

As the owner or driver of an automobile, you have an insurable interest in insuring your capability to pay in case the operation of the automobile causes injury to people or damage to other people's property.

The Principle of Indemnity

You purchase insurance to protect yourself against loss. Should a loss occur, you expect to be put back into the same financial position that you were in before the loss. This is the principle of **indemnity** upon which most insurance contracts are based.

Definition

To **indemnify** is to place someone back in the same financial position that they were in immediately prior to the loss. The principle of indemnity provides that insureds are to collect the amount of their financial loss—no more and no less.

The individual policy will impose other provisions such as deductibles and policy limits. These will vary as agreed between the insurer and the insured.

The method used to calculate the indemnity owed under insurance contracts varies with the policy language. **Actual cash value** and **replacement cost** of property at the time of the loss represent the typical types of calculation in use.

Actual Cash Value Contracts

Actual cash value can be defined as the value of an equivalent piece of property of the same age and condition and subject to the same wear and tear as the property that was lost or destroyed.

Replacement Cost Contracts

No depreciation deducted

Many residential property policies are issued on a replacement cost basis. This means the damaged or destroyed property will be valued on the basis of the cost to repair or replace (whichever costs less) it with property of like kind and quality, without any deduction for depreciation.

Example

Your roof is 10 years old when it is severely damaged by wind and hail. It will be replaced with a new roof; no depreciation will be charged even though it has been subject to ten years of normal wear and tear.

Valued Contracts

Value is determined at time item insured

Valued contracts offer an alternative method of loss calculation.

A valued contract is one that, in the event of a total loss, pays a predetermined amount agreed upon by the insurer and the insured at the time the contract was made. When the policy is issued, professional valuations are usually required for items over a certain value and the amount of insurance is based on them. Valued contracts are generally used when insuring items where it would be difficult to determine the true value after a loss has occurred.

Examples

Jewelry, paintings, works of historic value, antiques, stamp and coin collections

Valued contracts and replacement cost contracts provide less occasion for disagreements on values so claim settlements are made easier. This

may foster a better relationship between insureds and insurers. However, it has also been said that replacement cost contracts are an invitation to fraud.

The amount of indemnity paid to the insured is usually the subject of some negotiation between the parties to the contract. The amount payable is the amount necessary to reimburse the insured for financial loss but is subject to other conditions in the contract which might apply, for example, deductibles, and of course, the amount of the policy (policy limit). Indemnity is reinforced by three associated principles: salvage, subrogation, and contribution. They will be discussed in detail in the study about claims.

Policies of Compensation

Although indemnity is essential to most contracts of insurance, it does not apply to all of them. For example, **policies of compensation** are not contracts of indemnity.

-Specified amount payable-

A policy (contract) of compensation specifies that a stated amount is payable on the occurrence of the event insured against. This amount is not directly dependent on the monetary value of the insured's loss (although insurable interest is still required).

Examples

Life insurance contracts are contracts of compensation as are accident and sickness policies. Accident and sickness policies may contain some indemnifying features which will be subject to the principle of indemnity.

Utmost Good Faith

With respect to insurance contracts, one party (the insured) is in a superior position of knowledge; only an applicant or insured has knowledge of all material facts relating to the risk. The law imposes a duty to disclose any information that is basic to the acceptance of the risk or the terms of the policy. It requires that an insured act with a high standard of honesty or **utmost good faith** (sometimes referred to by its Latin name *uberrima fides*). The Civil Code of Québec requires insureds to act with a similar high standard of honesty—the Code designates this as the standard of **good faith**.

Definition

A **material fact** is a fact which would influence a prudent underwriter in setting the premium or determining whether to accept or reject the risk.

**Onus to disclose is
heaviest on the insured**

Facts that affect acceptance or cost of insurance

Often materiality is not fully appreciated by insureds. They should be reminded of the importance of honest and full disclosure in completing applications for insurance; failure of doing so could be costly. The duty to disclose is confined to facts which the insured knows or ought to know. Whether a particular fact in a given situation is material is a question which must be decided in the individual circumstances, and if a dispute arises, it may have to be settled by the courts.

Not disclosing or hiding material facts

Failing to disclose material facts is a type of **misrepresentation** and is known as **non-disclosure** or **concealment**. Many court cases have been initiated to determine if misrepresentation actually existed in a particular case and what constitutes non-disclosure or concealment under certain circumstances. The circumstances surrounding a case are always important and any misrepresentation or non-disclosure must be material to the risk before any court will consider setting aside a policy.

Definition

Non-disclosure may be defined as silence where there exists an obligation to speak. An applicant for insurance is presumed to be a prudent and reasonable person who knows the material facts of the risk.

Insurers' responsibility

An insured is guilty of non-disclosure in the eyes of the law, even if he or she did not know certain facts that he or she should have known. However, the insurer also has an obligation to ask questions and be knowledgeable about the nature of the risks presented by an insured. If a dispute arises, it will be up to the insurer to satisfy the court that there was non-disclosure or concealment of material facts.

Contract voidable if obtained because of misrepresentation

If an insurer discovers that a contract has been obtained by non-disclosure or misrepresentation, the contract is voidable at the option of the insurer; the insurer may choose to continue the contract, and in effect, overlook the misrepresentation or non-disclosure or treat the contract as void with a full return of any premium paid.

For example, one of the main elements that enters into property insurance rates is the type of construction. Facts relating to construction of a property therefore are material facts. When an innocent misrepresentation occurs a policy will not necessarily be voided; it may merely be amended and the rate adjusted to reflect the true risk. On the other hand, if the fact is discovered after a loss that occurred because of the increased hazard associated with the fact being misrepresented, an insurer may move to have the policy declared void.

Example

Green applies for and obtains a homeowners policy on his dwelling, which he describes as a single-family brick dwelling. He neglects to mention that he runs a part-time welding business in his attached garage. A fire occurs when a spark from his welder ignites stored lumber and seriously damages the building. This is an obvious case of

failure to disclose a material fact. An insurer would very likely move to have such a policy declared void.

Legislation sets out good faith requirements

The Provincial Insurance Acts in the common law provinces detail the circumstances where misrepresentations and non-disclosures will affect the validity of contracts. Fire, Automobile, and Accident & Sickness policies are required by law to include certain conditions, stipulated in the Insurance Acts, as an integral part of each policy; they define the extent of utmost good faith required of an insured. These Statutory Conditions also ensure that insurers do not take a position more favourable to themselves than is in the public interest. Even if a policy contained a condition that would make any inaccurate statement sufficient grounds to void the policy, the condition would only be valid with reference to material facts. If there were no safeguards, it would be possible for a simple spelling mistake to be grounds for voiding a policy; this would be unreasonable as well as unfair to the insuring public

Quebec

In Quebec, policy conditions based on Civil Code of Québec provisions have the same effect.

Application for insurance

The duty to disclose material facts commences with the negotiations leading up to the submission of the proposal or application for insurance and continues throughout the negotiations until the risk has been accepted by the insurer. When new material facts arise during the term of the contract, the insured is required to disclose these to the insurer promptly. This gives the insurer the opportunity to evaluate the risk in light of the new information. An insurer then has the options of doing nothing, cancelling the policy and returning any unexpired premium, or agreeing to continue the policy upon payment of an increased premium. Utmost good faith must also be exercised when any claim situations arise.

New facts must be reported

Claims

Examples

A manufacturer of paper items turns her factory into one that makes firecrackers. She must advise her insurer of the change.

A manufacturer installs steam powered machinery. He must advise his insurer.

Insurance Brokers/Agents and Non-disclosure

Responsibilities—brokers with no binding authority

Where brokers/agents do not have binding authority, an insurer may regard any omission or non-disclosure by them as a failure to disclose by the insured and thus have the option to void the contract. If an insured informed a broker/agent of the particular facts in question, then the insured may have a right of action against that broker/agent arising out of his/her negligence in failing to pass on information.

Responsibilities—brokers with binding authority

Where brokers/agents have binding authority, their knowledge is considered the knowledge of the insurer. If an insured tells the

broker/agent a material fact which is not passed along to the insurer, the insurer is considered to have knowledge of that fact. The omission of the broker/agent to relay the fact will not prejudice the insured's right to recover under the policy. The insurer may, however, take legal action against the broker/agent because he or she may have violated the terms of his/her agreement or contract with the insurer.

Definition

Binding authority is the authority given to a broker/agent by an insurer to bind certain insurance coverages without first submitting an application to the insurer for approval.

Responsibilities—insurers

Although, it can be seen that the onus is heavy on the insured to deal with utmost good faith, the insurer also must act in good faith. Losses may occur years after a contract was made; insurers must be financially solvent to meet them when they occur. All claims must be dealt with fairly and expeditiously. In recent years a number of legal cases have arisen wherein insureds have claimed that settlement negotiations were not conducted in good faith by their insurers.

Practical Application

As mentioned earlier, insurance affects the lives of virtually every individual in a modern society from birth to death. Everywhere we turn there are potential risks. In our country, when a child is born medical and hospital insurance is available to the parents and the newborn child. As the child grows, dental coverage may be acquired. Many parents have various forms of life insurance to ensure that funds will be available to care for their family should the parent(s) die prematurely.

In this course we concern ourselves mainly with references to those types of insurance that relate to property and casualty. Now meet Marie and Paul Richard, a young, recently married couple who have purchased their first home.

Paul lived with his parents and attended university at Hometown. After graduation, he started working and continued living at home, until the time of his marriage. He had his own car which was insured along with his parents' cars.

Marie attended university in another city and shared a furnished apartment with a friend. She also had her own car which was insured under her parents' policy. Upon graduation, she started a job in Hometown and moved into her own apartment. She bought a tenant's policy to cover the contents consisting of clothing, furniture, and household items. She and Paul became engaged and started buying more furniture in anticipation of their marriage. They lived in the apartment for several years after the wedding. Now they are in the process of purchasing their first house. Before they can get final approval on their

mortgage they must show that they have insurance to protect their investment.

They submit an application to All Lines Insurance Brokers Ltd., who are agents of Fire Insurance Company Limited, the company of their choice; this constitutes an offer to purchase insurance from Fire Insurance Company Limited. In their application, they disclose all the material facts about the property so that the underwriters may properly assess the risk (utmost good faith).

On receipt of the application, the insurer (offeree) may either accept it or reject it, or accept it with certain conditions attached (make a counter offer). The insurer's underwriters review the application, find it to be a desirable risk and accept the offer. An agreement (offer and acceptance) is reached between the parties to the contract. The insureds, Marie and Paul Richard, will be required to pay a premium (consideration) for the insurance. In exchange for the premium, the insurer promises to indemnify the Richards for damage caused by the perils set out in the policy, and a policy is issued setting out all the terms of the agreement. Offer and acceptance, consideration, and utmost good faith are present in this contract. However, other elements must also be present in order to make it a legally binding contract of insurance.

If Fire Insurance Company Limited is a properly licensed and registered company, it has the legal capacity to enter into contracts of insurance. Likewise, if Marie and Paul are each of sound mind, not intoxicated or under the influence of drugs, and of legal age, they too have the legal capacity to contract.

It is quite obvious that both the insurer and the Richards intend to enter into a legally binding contract so there is a genuine intention to contract. The object of this contract is insurance against loss resulting from fire and other named perils; this is a legal object.

Marie and Paul are joint owners of the property and so both have an insurable interest in it. Secure Lenders Inc. has the mortgage on the property and so the mortgagee's interest is shown on the policy, as it also have an insurable interest.

If fire causes damage to the property, the Richards will be indemnified for their loss; put back in the same financial position that they were in before the loss, no more and no less.

Offer and acceptance, consideration, genuine intention, legal capacity, legal object, insurable interest, indemnity, and utmost good faith are all present in the contract. It is a legally binding contract of insurance.

Summary

In addition to the requisites for all contracts, insurance contracts are distinguished by the additional principles of **insurable interest** and **utmost good faith**.

The purpose of insurance is to shift the risk of a potential loss from an insured to an insurer. The insured must have an **insurable interest** so that no profit can be made from that risk.

Utmost good faith (**good faith** in Quebec) denotes a standard of honesty greater than that found in other contracts; it is required of the insured and the insurer. Insureds have the duty to disclose all **material facts** relating to a risk. **Misrepresentation** includes **non-disclosure** and **concealment**. If brokers or agents have binding authority their knowledge of a risk is considered knowledge of the insurer.

The **principle of indemnity**, which is essential to most (but not all) contracts of insurance, provides that insureds are to collect *only* the amount of their loss. However, in some contracts, such as **valued contracts** and **replacement cost contracts**, the policy language varies the manner in which indemnity is calculated.

Policies of compensation are not contracts of indemnity.