CHAPTER 5

LEGAL PRINCIPLES OF AN INSURANCE CONTRACT

Chapter Introduction

In this chapter, we discuss the elements that govern the working of an insurance contract. The chapter also deals with the special features of an insurance contract.

Learning Outcomes

A. Insurance contracts – Legal aspects and special features

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1. Insurance contracts – Legal aspects

a) The insurance contract

Insurance involves a contractual agreement in which the insurer agrees to provide financial protection against certain specified risks for a price or consideration known as the premium. The contractual agreement takes the form of an insurance policy.

b) Legal aspects of an insurance contract

We will now look at some features of an insurance contract and then consider the legal principles that govern insurance contracts in general.

Important

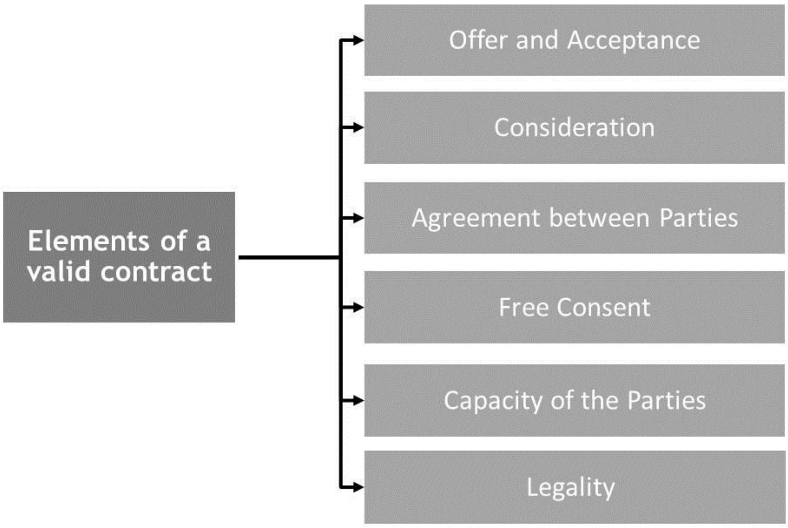
A contract is an agreement between parties, enforceable at law. The provisions of the Indian Contract Act, 1872 govern all contracts in India, including insurance contracts.

An insurance policy is a contract entered into between two parties, viz., the company, called the **insurer**, and the policy holder, called the **insured** and fulfils the requirements enshrined in the Indian Contract Act, 1872.

Diagram 1: Insurance contract

c) Elements of a valid contract

Diagram 2: Elements of a valid contract



The elements of a valid contract are:

i. Offer and acceptance

When one person signifies to another his willingness to do or to abstain from doing anything with a view to obtaining the assent of the other to such act, he is said to make an offer or proposal. Usually, the offer is made by the proposer, and acceptance made by the insurer.

When a person to whom the offer is made signifies his assent thereto, this is deemed to be an acceptance. Hence, when a proposal is accepted, it becomes a promise.

The acceptance needs to be communicated to the proposer which results in the formation of a contract.

When a proposer accepts the terms of the insurance plan and signifies his assent by paying the deposit amount, which, on acceptance of the proposal, gets converted to the first premium, the proposal becomes a policy.

If any condition is put, it becomes a counter offer.

The policy bond becomes the evidence of the contract.

ii. Consideration

This means that the contract must contain some mutual benefit for the parties. The premium is the consideration from the insured, and the promise to indemnify, is the consideration from the insurers.

iii. Agreement between the parties

Both the parties should agree to the same thing in the same sense. In other words, there should be "**consensus ad-idem**" between both parties. Both the insurance company and the policyholder must agree on the same thing in the same sense.

iv. Free consent

There should be free consent while entering into a contract.

Consent is said to be free when it is not caused by

- ✓ Coercion
- ✓ Undue influence
- ✓ Fraud
- ✓ Misrepresentation
- ✓ Mistake

When consent to an agreement is caused by coercion, fraud or misrepresentation, the agreement is voidable.

v. Capacity of the parties

Both the parties to the contract must be legally competent to enter into the contract. The policyholder must have attained the age of majority at the time of signing the proposal and should be of sound mind and not disqualified under law. For example, minors cannot enter into insurance contracts.

vi. Legality

The object of the contract must be legal, for example, no insurance can be had for illegal acts. Every agreement of which the object or consideration is unlawful is void. The object of an insurance contract is a lawful object.

Important

i. **Coercion** - Involves pressure applied through criminal means.

ii. **Undue influence** - When a person who is able to dominate the will of another, uses her position to obtain an undue advantage over the other.

iii. **Fraud** - When a person induces another to act on a false belief that is caused by a representation he or she does not believe to be true. It can arise either from deliberate concealment of facts or through misrepresenting them.

iv. **Mistake** - Error in one's knowledge or belief or interpretation of a thing or event. This can lead to an error in understanding and agreement about the subject matter of contract.

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2. Insurance contracts – Special features

a) Uberrima Fides or Utmost Good Faith

This is one of the fundamental principles of an insurance contract. Also called uberrima fides, it means that every party to the contract must disclose all material facts relating to the subject matter of insurance.

A distinction may be made between Good Faith and Utmost Good Faith. All commercial contracts in general require that good faith shall be observed in their transaction and there shall be no fraud or deceit when giving information. Apart from this legal duty to observe good faith, the seller is not bound to disclose any information about the subject matter of the contract to the buyer.

The rule observed here is that of **"Caveat Emptor" which means Buyer Beware**. The parties to the contract are expected to examine the subject matter of the contract and so long as one party does not mislead the other and the answers are given truthfully, there is no question of the other party avoiding the contract

Utmost Good Faith: Insurance contracts stand on a different footing. Firstly, the subject matter of the contract is intangible and cannot be easily known through direct observation or experience by the insurer. Again there are many facts, which by their very nature, may be known only to the proposer. The insurer has to often rely entirely on the latter for information.

Hence the proposer has a legal duty to disclose all material information about the subject matter of insurance to the insurers who do not have this information.

Example

David made a proposal for an insurance policy. At the time of applying for the policy, David was suffering from and under treatment for Diabetes. But David did not disclose this fact to the insurance company. David was in his thirties, so the insurance company issued the policy without asking David to undergo a medical test. Few years down the line, David's health deteriorated and he had to be hospitalised. David could not recover and died in the next few days. A claim was raised on the insurance company.

To the surprise of David's nominee, the insurance company rejected the claim. In its investigation, the insurance company found out that David was already suffering from diabetes at the time of applying for the policy and this fact was deliberately hidden by David. Hence the insurance contract was declared null and void and the claim was rejected.

Material information is that information which enables the insurers to decide:

- ✓ Whether they will accept the risk?
- ✓ If so, at what rate of premium and subject to what terms and conditions?

This legal duty of utmost good faith arises under common law. The duty applies not only to material facts which the proposer knows, but also extends to material facts which he ought to know.

Example

Following are some examples of material information that the proposer should disclose while making a proposal:

i. **Life Insurance:** own medical history, family history of hereditary illnesses, habits like smoking and drinking, absence from work, age, hobbies, financial information like income details of proposer, pre-existing life insurance policies, occupation etc.
ii. **Fire Insurance:** construction and usage of building, age of the building, nature of goods in premises etc.
iii. **Marine Insurance:** description of goods, method of packing etc.
iv. **Motor Insurance:** description of vehicle, date of purchase, details of driver etc.
v. **Health Insurance:**

Insurance contracts are thus subject to a higher obligation. When it comes to insurance, good faith contracts become utmost good faith contracts.

Definition

The concept of "Uberrima fides" is defined as involving “a positive duty to voluntarily disclose, accurately and fully, all facts material to the risk being proposed, whether requested or not".

If utmost good faith is not observed by either party, the contract may be avoided by the other. This essentially means that no one should be allowed to take advantage of his own wrong especially while entering into a contract of insurance.

It is expected that the insured should not make any misrepresentation regarding any fact that is material for the insurance contract. The insured must disclose all relevant facts. If this obligation did not exist, a person taking insurance might suppress certain facts impacting the risk on the subject matter and receive an undue benefit.
The policyholder is expected to disclose the status of his health, family history, income, occupation etc. truthfully without concealing any material fact so as to

enable the underwriter to assess the risk properly. In case of non-disclosure or misrepresentation in the proposal form which may have impacted the underwriting decision of the underwriter, the insurer has a right to cancel the contract.

The law imposes an obligation to disclose all material facts.

Example

An executive is suffering from hypertension and had a mild heart attack recently following which he decides to take a medical policy but does not reveal the same. The insurer is thus duped into accepting the proposal due to misrepresentation of facts by insured.

An individual has a congenital hole in the heart and reveals it in the proposal form. The same is accepted by the insurer and proposer is not informed that pre-existing diseases are not covered for at least 4 years. This is misleading of facts by the insurer.

b) Material facts

Definition

Material fact has been defined as a fact that would affect the judgment of an insurance underwriter in deciding whether to accept the risk and if so, the rate of premium and the terms and conditions.

Whether an undisclosed fact was material or not would depend on the circumstances of the individual case and could be decided ultimately only in a court of law. The insured **has to disclose** facts that affect the risk.

Let us take a look at some of the types of material facts in insurance that one needs to disclose:

i. Facts indicating that the particular risk represents a greater exposure than normal.

Example

Hazardous nature of cargo being carried at sea, past history of illness

ii. Existence of past policies taken from all insurers and their present status

iii. All questions in the proposal form or application for insurance are considered to be material, as these relate to various aspects of the subject matter of insurance and its exposure to risk. They need to be answered truthfully and be full in all respects.

The following are some scenarios wherein material facts need not be disclosed

Information

Material Facts that need not be disclosed

It is also held that unless there is a specific enquiry by underwriters, the proposer has no obligation to disclose the following facts:

i. **Measures implemented to reduce the risk.**

Example: The presence of a fire extinguisher

ii. **Facts which the insured does not know or is unaware of**

Example: An individual, who suffers from high blood pressure but was unaware about the same at the time of taking the policy, cannot be charged with non-disclosure of this fact.

iii. **Which could be discovered, by reasonable diligence?**

It is not necessary to disclose every minute material fact. The underwriters must be conscious enough to ask for the same if they require further information.

iv. **Matters of law**

Everybody is supposed to know the law of the land.

Example: Municipal laws about storing of explosives

v. **About which insurer appears to be indifferent (or has waived the need for further information)**

The insurer cannot later disclaim responsibility on grounds that the answers were incomplete.

When is there a duty to disclose?

In the case of insurance contracts, the duty to disclose is present throughout the entire period of negotiation until the proposal is accepted and a policy is issued. Once the policy is accepted, there is no further need to disclose any material facts that may come up during the term of the policy.

Example

Mr. Rajan has taken a insurance policy for a term of fifteen years. Six years after taking the policy, Mr. Rajan has some heart problems and has to undergo some surgery. Mr. Rajan does not need to disclose this fact to the insurer.

However if the policy is in a lapsed condition because of failure to pay the premiums when due and the policy holder seeks to revive the policy contract and bring it back in force, he may, at the time of such revival, have the duty to disclose all facts that are material and relevant, as though it is a new policy.

Breach of Utmost Good Faith

We shall now consider situations which would involve a Breach of Utmost Good Faith. Such breach can arise either through Non-Disclosure or Misrepresentation.

Non-Disclosure: may arise when the insured is silent in general about material facts because the insurer has not raised any specific enquiry. It may also arise through evasive answers to queries raised by the insurer. Often disclosure may be inadvertent (meaning it may be made without one's knowledge or intention) or because the proposer thought that a fact was not material.

In such a case it is innocent. When a fact is intentionally suppressed it is treated as concealment. In the latter case there is intent to deceive.

Misrepresentation: Any statement made during negotiation of a contract of insurance is called representation. A representation may be a definite statement of fact or a statement of belief, intention or expectation. With regard to a fact it is expected that the statement must be substantially correct. When it comes to Representations that concern matters of belief or expectation, it is held that these must be made in good faith.

Misrepresentation is of two kinds:

i. **Innocent Misrepresentation** relates to inaccurate statements, which are made without any fraudulent intention.
ii. **Fraudulent Misrepresentation** on the other hand refers to false statements that are made with deliberate intent to deceive the insurer or are made recklessly without due regard for truth.

An insurance contract generally becomes void when there is a clear case of concealment with intent to deceive, or when there is fraudulent misrepresentation.

Recent amendments (March, 2015) to Insurance Act, 1938 have provided certain guidelines about the conditions under which a policy can be called into question for fraud. The new provisions are as follows

Fraud

A policy of insurance may be called in question at any time within three years from the date of issuance of the policy or the date of commencement of risk or the date of revival, of the policy or the date of the rider to the policy, whichever is later, on the ground of fraud:

The insurer shall have to communicate in writing to the insured or the legal representatives or nominees or assignees of the insured the grounds and materials on which such decision is based.

The term “Fraud” has been defined and specified as follows:

The expression "fraud" means any of the following acts committed by the insured or by his agent, with the intent to deceive the insurer or to induce the insurer to issue a insurance policy:

(a) the suggestion, as a fact of that which is not true and which the insured does not believe to be true;

(b) the active concealment of a fact by the insured having knowledge or belief of the fact;

(c) any other act fitted to deceive; and

(d) any such act or omission as the law specially declares to be fraudulent.

Mere silence as to facts likely to affect the assessment of the risk by the insurer is not fraud, unless the circumstances of the case are such that regard being had to them, it is the duty of the insured or his agent, keeping silence to speak, or unless his silence is, in itself, equivalent to speak.

No insurer shall repudiate a insurance policy on the ground of fraud if the insured can prove that the mis-statement of or suppression of a material fact was true to the best of his knowledge and belief or that there was no deliberate intention to suppress the fact or that such mis-statement of or suppression of a material fact are within the knowledge of the insurer:

It is also provided that in case of fraud, the onus of disproving lies upon the ben eficiaries, in case the policyholder is not alive.

A person who solicits and negotiates a contract of insurance shall be deemed for the purpose of the formation of the contract, to be the agent of the insurer.

c) Insurable interest

The existence of ‘insurable interest’ is an essential ingredient of every insurance contract and is considered as the legal pre-requisite for insurance. Let us see how insurance differs from a gambling or wager agreement.

i. Gambling and insurance

Consider a game of cards, where one either loses or wins. The loss or gain happens only because the person enters the bet. The person who plays the game has no further interest or relationship with the game other than that he might win the game. Betting or, wagering is not legally enforceable in a court of law and thus any contract in pursuance of it will be held to be illegal. In case someone pledges his house if he happens to lose a game of cards, the other party cannot approach the court to ensure its fulfillment.

Now consider a house and the event of it burning down. The individual who insures his house has a legal relationship with the subject matter of insurance – the house. He owns it and is likely to suffer financially, if it is destroyed or damaged. This relationship of ownership exists independent of whether the fire happens or does not happen, and it is the relationship that leads to the loss. The event (fire or theft) will lead to a loss regardless of whether one takes insurance or not.

Unlike a card game, where one could win or lose, a fire can have only one consequence – loss to the owner of the house.

The owner takes insurance to ensure that the loss suffered is compensated for in some way.

The interest that the insured has in his house or his money is termed as insurable interest. The presence of insurable interest makes an insurance contract valid and enforceable under the law.

Example

Mr. Chandrasekhar owns a house for which he has taken a mortgage loan of Rs. 15 lakhs from a bank. Ponder over the below questions:

- ✓ Does he have an insurable interest in the house?
- ✓ Does the bank have an insurable interest in the house?
- ✓ What about his neighbour?

Mr. Srinivasan has a family consisting of spouse, two kids and old parents. Ponder over the below questions:

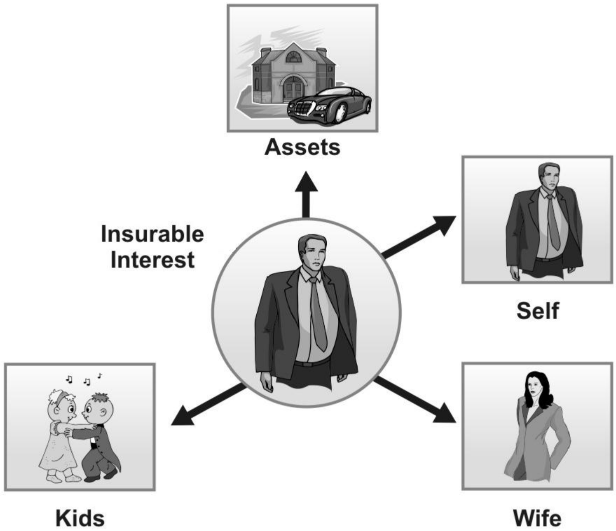
- ✓ Does he have an insurable interest in their well-being?
- ✓ Does he stand to financially lose if any of them are hospitalised?
- ✓ What about his neighbour's kids? Would he have an insurable interest in them?

It would be relevant here to make a distinction between the subject matter of insurance and the subject matter of an insurance contract.

Subject matter of insurance relates to property being insured against, which has an intrinsic value of its own.

Subject matter of an insurance contract on the other hand is the insured's financial interest in that property. It is only when the insured has such an interest in the property that he has the legal right to insure. The insurance policy in the strictest sense covers not the property per se, but the insured's financial interest in the property.

Diagram 3: Insurable interest according to common law



ii. Time when insurable interest should be present

In insurance, insurable interest should be present at the time of taking the policy. In general insurance, insurable interest should be present both at the time of taking the policy and at the time of claim with some exceptions like marine policies.

d) Proximate Cause

The last of the legal principles is the principle of proximate cause.
Proximate cause is a key principle of insurance and is concerned with how the loss or damage actually occurred and whether it is indeed as a result of an insured peril. If the loss has been caused by the insured peril, the insurer is liable. If the immediate cause is an insured peril, the insurer is bound to make good the loss, otherwise not.

Under this rule, the insurer looks for the predominant cause which sets into motion the chain of events producing the loss. This may not necessarily be the last event that immediately preceded the loss i.e. it is not necessarily an event which is closest to, or immediately responsible for causing the loss.

Other causes may be classified as remote causes, which are separate from proximate causes. Remote causes may be present but are not effectual in causing an event.

Definition

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

How does the principle of proximate cause apply to insurance contracts? In general, since insurance provides for payment of a death benefit, regardless of the cause of death, the principle of proximate cause would not apply. However many insurance contracts also have an accident benefit rider wherein an additional sum assured is payable in the event of accidental death. In such a situation, it becomes necessary to ascertain the cause - whether the death occurred as a result of an accident. The principle of proximate cause would become applicable in such instances.

Contract of Adhesion

Adhesion contracts are those that are drafted by the party having greater bargaining advantage, providing the other party with only the opportunity to adhere to i.e., to accept the contract or reject it. Here the insurance company has all the bargaining power regarding the terms and conditions of the contract.
To neutralise this, a free-look period has been introduced whereby a policyholder, after taking a policy, has the option of cancelling the it, in case of disagreement, within 15 days of receiving the policy document. The company has to be intimated in writing and premium is refunded less expenses and charges.

e) Indemnity

The principle of indemnity is applicable to Non-life insurance policies. **It means that the policyholder, who suffers a loss, is compensated so as to put him or her in the same financial position as he or she was before the occurrence of the loss event**. The insurance contract (evidenced through insurance policy) guarantees that the insured would be indemnified or compensated up to the amount of loss and no more.

The philosophy is that one should not make a profit through insuring one's assets and recovering more than the loss. The insurer would assess the economic value of the loss suffered and compensate accordingly.

Example

Ram has insured his house, worth Rs. 10 lakhs, for the full amount. He suffers loss on account of fire estimated at Rs. 70000. The insurance company would pay him an amount of Rs. 70000. The insured can claim no further amount.

Consider a situation now where the property has not been insured for its full value. One would then be entitled to indemnity for loss only in the same proportion as one's insurance.

Suppose the house, worth Rs. 10 lakhs has only been insured for a sum of Rs. 5 lakhs. If the loss on account of fire is Rs. 60000, one cannot claim this entire amount. It is deemed that the house owner has insured only to the tune of half its value and he is thus entitled to claim just 50% [Rs. 30000] of the amount of loss. This is also known as underinsurance.

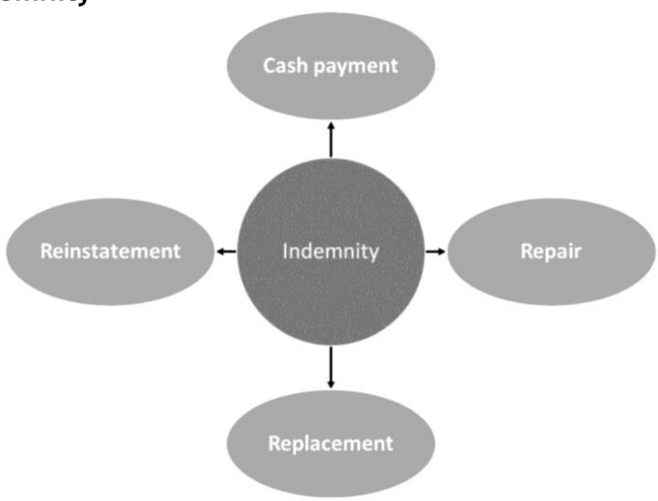
The measurement of indemnity to be paid would depend on the type of insurance one takes.

In most types of non-life insurance policies, which deal with insurance of property and liability, the insured is compensated to the extent of actual amount of loss i.e. the amount of money needed to replace lost or damaged property at current market prices less depreciation.

Indemnity might take one or more of the following modes of settlement:

- ✓ Cash payment
- ✓ Repair of a damaged item
- ✓ Replacement of the lost or damaged item
- ✓ Restoration, (Reinstatement) for example, rebuilding a house destroyed by fire

Diagram 1: Indemnity



But, there is some subject matter whose value cannot be easily estimated or ascertained at the time of loss. For instance, it may be difficult to put a price in the case of family heirlooms or rare artefacts. Similarly in marine insurance policies it may be difficult to estimate the extent of loss suffered in a ship accident half way around the world.

In such instances, a principle known as the Agreed Value is adopted. The insurer and insured agree on the value of the property to be insured, at the beginning of the insurance contract. In the event of total loss, the insurer agrees to pay the agreed amount of the policy. This type of policy is known as “**Agreed Value Policy**”.

f) Subrogation

Subrogation follows from the principle of indemnity.

Subrogation means the transfer of all rights and remedies, with respect to the subject matter of insurance, from the insured to the insurer.

It means that if the insured has suffered from loss of property caused due to negligence of a third party and has been paid indemnity by the insurer for that loss, the right to collect damages from the negligent party would lie with the insurer. Note that the amount of damage that can be collected is only to the extent of amount paid by the insurance company.

Important

Subrogation: It is the process an insurance company uses to recover claim amounts paid to a policy holder from a negligent third party.

Subrogation can also be defined as surrender of rights by the insured to an insurance company that has paid a claim against the third party.

Example

Mr. Kishore's household goods were being carried in Sylvain Transport service. They got damaged due to driver's negligence, to the extent of Rs 45000 and the insurer paid an amount of Rs 30000 to Mr. Kishore. The insurer stands subrogated to the extent of only Rs 30000 and can collect that amount from Sylvain Transports.

Suppose, the claim amount is for Rs 45,000/, insured is indemnified by the insurer for Rs 40,000, and the insurer is able to recover under subrogation Rs 45,000/ from Sylvain Transports, then the balance amount of Rs 5000 will have to be given to the insured.

This prevents the insured from collecting twice for the loss - once from the insurance company and then again from the third party. Subrogation arises only in case of contracts of indemnity.

Example

Mr. Suresh dies in an air crash. His family is entitled to collect the full sum assured of Rs 50 lakhs from the insurer who have issued a Personal Accident Policy plus the compensation paid by the airline, say, Rs 15 lakhs.