CHAPTER ELEVEN

PRINCIPLES OF INSURANCE: PART THREE

11.1 Principle of Indemnity

Indemnity according to the Cambridge International Dictionary is “Protection against possible damage or loss” and the Collins Thesaurus suggests the words “Guarantee”, “Protection”, “Security”, “Compensation”, “Restitution” and “Reimbursement” amongst others as suitable substitute for the word “Indemnity”. The words protection, security, compensation etc. are all suited to the subject of Insurance but the dictionary meaning or the alternate words suggested do not convey the exact meaning of Indemnity as applicable in Insurance Contracts.

In Insurance the word indemnity is defined as “financial compensation sufficient to place the insured in the same financial position after a loss as he enjoyed immediately before the loss occurred.”

Indemnity thus prevents the insured from recovering more than the amount of his pecuniary loss. It is undesirable that an insured should make a profit out of an event like a fire or a motor accident because if he was able to make a profit there might well be more fires and more vehicle accidents.

As in the case of Insurable Interest, the principle of indemnity also relies heavily on the financial evaluation of the loss but in the case of life and disablement it is not possible to be precise in terms of money.

An Insurance may be for less than a complete indemnity but it may not be for more than it. To illustrate let us take the example of a person who insures his car for Rs.4 lacs and it meets with an accident and is a total loss. It is not certain that he will get Rs.4 lacs. He may have over valued the car or may be the prices of cars have fallen since the policy was taken. The Insurer will only pay an amount equal to the value of the car at the time of loss. If he finds that a car of the same make and model is available in the market for Rs.3 lac then he is not liable to pay more than this sum and payment of Rs.3 lacs will indemnify the Insured.

Similarly, in the case of partial loss if some part of the car needs to be replaced the Insurer will not pay the full value of the new part. He shall assess how much the old part had run and after deduction of a proportionate sum he shall pay the balance amount. An insured is not entitled to new for old as otherwise he would be making a profit from the accident.

However, there are two modern types of policy where there is a deviation from the application of this principle. One is the agreed value policy where the insurer agrees at the outset that they will accept the value of the insured property stated in the policy (sum insured) as the true value and will indemnify the insured to this extent in case of total loss. Such policies are obtained on valuable pieces of Art, Curious, Jewellery, Antiques, Vintage cars etc.

The other type of policy where the principle of strict indemnity is not applied is the Reinstatement policy issued in Fire Insurance. Here the Insured is required to insure the property for its current replacement value and the Insurer agrees that in the event of a total loss he shall replace the damaged property with a new one or shall pay for the replacement in full.

Other than these there are Life and Personal Accident policies where no financial evaluation can be made. All other Insurance policies are subjected to the principle of strict Indemnity. In most policy documents the word indemnity may not be used but the courts will follow this principle in case of any dispute coming before them.

11.2 How Is Indemnity Provided?

The Insurers normally provide indemnity in the following manner and the choice is entirely of the insurer

1) Cash Payment
2) Repairs
3) Replacement
4) Reinstatement

1. Cash Payment

In majority of the cases the claims will be settled by cash payment (through cheques) to the assured. In liability claims the cheques are made directly in the name of the third party thus avoiding the cumbersome process of the Insurer first paying the Insured and he in turn paying to the third party.

2. Repair

This is a method of Indemnity used frequently by insurer to settle claims. Motor Insurance is the best example of this where garages are authorized to carry out the repairs of damaged vehicles. In some countries Insurance companies even, own garages and Insurance companies spend a lot on Research on motor repair to arrive at better methods of repair to bring down the costs.

3. Replacement

This method of Indemnity is normally not preferred by Insurance companies and is mostly used in glass Insurance where the insurers get the glass replaced by firms with whom they have arrangements and because of the volume of business they get considerable discounts. In some cases of Jewellery loss, this system is used specially when there is no agreement on the true value of the lost item.

4. Reinstatement

This method of Indemnity applies to Property Insurance where an insurer undertakes to restore the building or the machinery damaged substantially to the same condition as before the loss. Sometimes the policy specifically gives the right to the insurer to pay money instead of restoration of building or machinery.

Reinstatement as a method of Indemnity is rarely used because of its inherent difficulties e.g., if the property after restoration fails to meet the specifications of the original in any material way or performance level then the Insurer will be liable to pay damages. Secondly, the expenditure involved in restoration may be much more than the sum Insured as once they have agreed to reinstate they have to do so irrespective of the cost.

11.3 Limitations on Insurers Liability

1. The maximum amount recoverable under any policy is the sum insured, which is mentioned on the policy. The amount is not the agreed value of the property (except in Valued policies) nor is it the amount, which will be paid automatically on occurrence of loss. What will be paid is the actual loss or sum insured whichever is less.

2. Property Insurance is subjected to the Condition of Average. The underlying principle behind this condition is that Insurers are the trustees of a pool of premiums from which they meet the losses of the few who suffer damage, so it is reasonable to conclude that every Insured should bring a proper contribution to the pool by way of premium. Therefore, if an insured deliberately or otherwise underinsures his property thus making a lower contribution to the pool, he is not entitled to receive the full benefits.

The application of this principle makes the insured his own Insurer to the extent of under-insurance i.e. the pro-rata difference between the Actual Value and the sum insured. The amount of loss will be shared between the Insurer and the insured in the proportion of sum insured and the amount underinsured. The formula applicable for arriving at the amount to be paid by the Insurance Co. is

Claim = Loss X (Sum Insured / Market Value) Example

Mr. Sudhir Kumar has insured his house for Rs.5 lacs and suffers a loss of Rs.1 lac due to fire. At the time of loss, the surveyor finds that the actual market value of the house is Rs.10 lacs. In this case applying the above formula the claim will be as under:

Loss = 1 lac sum insured = 5 lacs Market Value = 10 lacs Therefore, 1 lac X 5 lacs / 10 lacs = 50,000/Claim = Rs 50,000/

11.4 Corollaries of Indemnity

There are two corollaries to the principle of Indemnity and these are Subrogation and Contribution.

11.4.1 Subrogation Principle

It has already been established that the purpose of Indemnity is to ensure that the Insured does not make a profit or gain in any way as a consequence of an accident. He is placed in the same financial position, which he had occupied immediately before the loss occurred.

As an off shoot of the above it is also fair that the insurer having indemnified the insured for damage caused by another (A Third Party) should have the right to recover from that party the amount of damages or part of the amount he has paid as indemnity.

This right to recover damages usually lies with the bereaved or injured party but the law recognises that if another has already paid the bereaved or injured party then the person who has paid the compensation has the right to recover damages.

In case the insured after having received indemnity also recovers losses from another then he shall be in a position of gain which is not correct and this amount recovered from another shall be held in trust for the insurer who have already given indemnity. Subrogation may be defined as the transfer of legal rights of the insured to recover, to the Insurer.

Case Study

Why Subrogation is called a corollary of Indemnity and not treated as a separate basic Principle of Insurance can be traced to the judgement given in the case of Casletlan V Preston (1883) in U.K.

"That doctrine (Subrogation) does not arise upon any terms of the contract of Insurance, it is only the other proposition, which has been adopted for the purpose of carrying out the fundamental rule i.e. indemnity. Which I (Judge) have mentioned "it is a doctrine in favour of the underwriters or insurers, in order to prevent the insured from recovering more than a full indemnity; it has been adopted solely for that reason."

Subrogation does not apply to life and personal accidents as these are not contracts of Indemnity. In case death of a person is caused by the negligence of another than the legal heirs of the deceased can initiate proceedings to recover from the guilty party in addition to the policy proceeds.

If the insured is not allowed to make profit the insurer is also not allowed to make a profit and he can only recover to the extent he has indemnified the Insured.

11.4.2 How Subrogation Principle can arise

(i) Tort

(ii) Contract

(iii) Statute

(iv) Subject matter of Insurance

(i) Tort: When an insured has suffered a loss due to a negligent act of another then the Insurer having indemnified the loss is entitled to recover the amount of indemnity paid from the wrongdoer.

The Insured has a right in Tort to recover the damages from the individuals involved. The Insurers assume these rights and act in the name of the insured and take his permission before starting legal proceedings.

Another reason for seeking permission of the insured is that the Insured may be having another claim which was not insured arising from the same incident which he may wish to include because the law allows one to sue a person only once for any single event.

Contract: This can arise when a person has a contractual right to compensation regardless of a fault then the Insurer will assume the benefits of this right.

(ii) Statute: Where the Act or Law permits, the insurer can recover the damages from Government agencies like the Risk (Damage) Act 1886 (UK) gives the right to insurers to recover damages from the District Police Authorities in respect of the property damaged in Riots which has been indemnified by them.

(iii) Subject Matter of Insurance: When the Insured has been indemnified and the property treated as lost he cannot claim salvage as this would give him more than indemnity. Therefore, when Insurers sell the salvage as in the case of damaged cars it can be said that they are exercising their right of subrogation.

Subrogation - When?

According to common law the right of subrogation arises once the Insurers have admitted the claim and paid it. This can create problems for the Insurers as delay in acting could at times hamper their chance of recovering the damages from the wrongdoer or it could be adversely affected due to any action taken by the Insured. To safeguard their rights and to ensure that they are in control of the situation from the beginning Insurers place a condition in the policy giving themselves subrogation rights before the claim is paid. The limitation is that they cannot recover from the third party unless they have indemnified the insured but this express condition allows the insurer to hold the third party liable pending indemnity being granted.

Many individuals having received indemnity from the Insurer lose interest in pursuing the recovery rights they may have. Subrogation ensures that the negligent do not get away scot free because there is Insurance. The rights which subrogation gives to the Insurers are the rights of the Insured and it places certain obligations on the Insured to assist the Insurers in enforcing their claims and not to do anything which would harm the Insurers chances to recover losses.

11.5 Contribution Principle

Contribution is the second corollary of Indemnity.

An individual may have more than one policy on the same property and in case there was a loss and he were to claim from all the Insurers then he would be obviously making a profit out of the loss which is against the principle of Indemnity. To prevent such a situation the principle of contribution has been evolved under common law.

Contribution may be defined as the "right of Insurers who have paid a loss to recover a proportionate amount from other Insurers who are also liable for the same loss". The common law allows the insured to recover his full loss within the sum insured from any of the insurers.

11.5.1 Conditions for Contribution Principle to Exist

Condition of Contribution will only arise if all the following conditions are met:

- **i.** Two or more policies of Indemnity should exist
- **ii.** The policies must cover a common interest
- **iii.** The policies must cover a common peril which is the cause of loss
- **iv.** The policies must cover a common subject matter
- **v.** The policies must be in operation at the time of loss

It is not necessary that the policies be identical to one another. What is important is that there should be an overlap between policies, i.e. the subject matter should be common and the peril causing loss should be common & covered by both.

As said earlier common law gives the right to the insured to recover the loss from any one insurer who will then have to effect proportionate recoveries from other insurers, who were also liable to pay the loss. To avoid this the Insurers, modify the common law condition of contribution by inserting a clause in the policy that in the event of a loss they shall be liable to pay only their "Rate-able proportion" of the loss. It means that they will pay only their share and if the Insured wants full indemnity he should lodge a claim with the other Insurers also.

Rateable Proportion

The accepted way to interpret the term Rate-able Proportion is exhibited. First being that the Insurers should pay in the proportion to the sum insured for example

Sum Insured Policy A	=10,000/Sum Insured Policy B	=	20,000/Sum
Insured Policy C	= 30,000/Total	=	60,000/-

In case of a claim of Rs.6000/- the three insurers would be liable to pay in the proportion 1:2:3 i.e. 'A' pays Rs.1000/- 'B' pays Rs.2000/- and 'C' pays Rs.3000/-.

However, the drawback of this simplistic method is that the terms and conditions of the policies may be different and it would not be prudent to ignore these terms and conditions. For example, the condition of average may apply to one or more policies or there may be an excess clause in one policy which may affect their share of contribution to the loss. It would therefore be correct to assess the loss as per the terms and conditions of the individual policy and pay the claims accordingly. If by following this method the total sum of the liability of the Insurers is more than the claim amount then the Insurers shall pay in proportion to the amount of liability of each.

11.6 Proximate Cause

There are three types of perils related to a claim under an Insurance policy

(1) Insured Perils: These are the perils mentioned in the policy as being insured e.g. Fire, lightening, storm etc. in the case of a fire policy

(2) Excepted Perils: These are the perils mentioned in the policy as being excepted perils or excluded perils e.g. Riot strike, flood etc. which may have been excluded and discount in premium availed.

(3) Uninsured Perils: Those not mentioned in the policy at all either in Insured or excepted perils e.g. snow, smoke or water as perils may not be mentioned in the policy.

Insurers are liable to pay claims arising out of losses caused by Insured Perils and not those losses caused by excepted or Uninsured perils.

Example: If stocks are burnt then the cause of loss is fire which is an Insured Peril under a fire policy and claim is payable. If the stocks are stolen the loss would not be payable as Burglary is not an Insured peril covered in fire policy Burglary policy is needed to take care of 'theft'.

It is therefore important to identify the cause of loss and to see if it is an Insured peril or not before admitting a claim.

Need to Identify Proximate Cause

If the loss is brought about by only one event then there is no problem in settlement of liability but more often than not the loss is a result of two or more causes acting together or in tandem i.e. one after another. In such cases it is necessary to choose the most important, most effective and the most powerful cause which has brought about the loss. This cause is termed the Proximate

Cause and all other causes being considered as “remote”. The proximate cause has to be an insured peril for the claim to be payable.

The following illustration may help in distinguishing between the proximate cause and the remote cause.

I. “A person was injured in an accident and was unable to walk and while lying on the ground he contracted a cold which developed into pneumonia and died as result of this. The court ruled that the proximate cause of death was the accident and Pneumonia (which was not covered) was a remote cause and hence claim was payable under the Personal Accident Policy.”

II. “A person injured in an accident was taken to a hospital where he contracted an infection and died as a result of this infection. Here the court ruled that infection was the proximate cause of death and the accident was a remote cause and hence no claim was payable under the Personal Accident Policy.

The Meaning of Proximate Cause

The doctrine of proximate cause is based on the principle of cause and effect, which states that having proved the effect and traced the cause it is not necessary to go any further i.e. cause of cause. The law provided the rule “Cause Proxmia non-Remote spectator”. The immediate cause and not the remote one should be taken into consideration.

Therefore, the proximate cause should be the immediate cause. Immediate does not mean the nearest to the loss in point of time but the one most effective or efficient. Thus, if there are a number of causes and the proximate cause has to be chosen the choice should be of the most predominant and efficient cause i.e. the cause which effectively caused the result.

Proximate cause has been defined as “The active efficient cause that sets in motion a train of events which bring about a result without the intervention of any force started and working actively from a new and independent source”.

(This definition comes from the ruling given in the case Pawsey v/s Scottish Union and National Insurance Co. (1907).

It is important to note that in Insurance Proximate has got nothing to do with time even though the Dictionary defines Proximity as ‘The state of being near in time or space’ (period or physical) and the Thesaurus given the alternate words as “adjacency of” “closeness”, “nearness” “vicinity” etc. But in Insurance Proximate cause is that which is Proximate in efficiency. It is not the latest but the direct, dominant, operative and efficient cause.

Losses can occur in the following manners:

i. Loss due to a single cause.

ii. A series or chain of events one following and resulting from the other causing the loss

iii. A series or chain of events which is broken by a new event independently from a different source causing the loss - Broken sequence and

iv. A contribution of two or more events occurring simultaneously and resulting in loss

1) In the case of a single cause being the cause of loss then if that peril is covered the claim is payable and if not covered claim is not payable.

2) Loss due to a series or chain of events. This can be illustrated by the following example event.

a) A driver of a car meets with an accident

b) As a result of the accident he suffers from concussion(shock)

c) Because of the concussion he strayed around not aware where he was going

d) While straying he fell into a stream

e) He died of drowning in the stream

It is clear that the above is a chain of events one leading to the other. The proximate cause would be accident (covered under PA Policy) which resulted in concussion (Disease - not covered) and hence the claim would be payable.

Irrespective of the fact that subsequent causes are covered or not if it is established that the event starting the chain is a covered peril then claim is payable.

However, if reverse were the case and the chain was started by an excepted or excluded peril then the claim would not be payable.

For e.g. A person suffers a stroke and falls down the steps resulting in his death. He will not be entitled to any claim under his personal accident policy as the chain was started by a stroke which is an excepted peril.

1. In case of the Broken sequence or Interrupted chain of events if the chain of events is started by an Insured peril but interrupted by an excepted or excluded peril then the claim is paid after deducting the damage caused by the excluded peril. For example, the burglars enter the house and leave the gas stove on leading to a fire and the house is damaged in the fire. The “burglary

Insurance" will only pay for the loss due to theft but exclude loss due to fire, which is accepted peril under the burglary policy.

In case the sequence of events started by an excluded peril is broken by an Insured peril, as a new and independent cause then there is a valid claim for even the damage caused by exempted peril. The burglars enter the house and after carrying out thefts put the house on fire. The fire policy will pay for the damages due to theft as well (which is an excluded peril).

2. In the case of loss due to concurrent causes or two or more causes occurring simultaneously then all the causes will have to be Insured perils only then the claim would be payable but even if one of the causes is an excluded peril the claim will not be payable.

Example: A house collapses due to an earthquake, which results in fire. Under the fire policy earthquake is not a covered risk, hence the claim will not be payable.

To really understand the complexities of Proximate cause and its proper identification one must go through the case studies and a few are being given hereunder.

Case Studies:

Example I

An army officer insured under a personal accident policy, which excluded accident directly or indirectly due to war during war time went to the railway line to inspect the sentries. While on the visit he was hit by a train and he died as a result of the accident. It was ruled that the policy did not cover as he was there on the line because of the war and the policy did not cover accident due to war.

Example II

A surveyor on surveying a factory damaged in a fire concluded after detailed investigation that the fire was caused by negligence as well as defective design and both these causes worked together to cause the damage. While the Insurance policy covered negligence, it did not cover Defective Design and hence claim was denied.

Example III

In an incident where stocks of potatoes kept in a cold storage got damaged due to leakage of ammonia gas. The stock was insured against contamination / Deterioration / putrefaction due to rise in temperature in the refrigeration chamber caused by any loss or damage due to an accident. The Insurance company did not pay the claim saying that the leakage of gas was not accidental and hence the risk was not covered. The aggrieved approached the consumer forum which held that the leakage of gas was not foreseen or premeditated or anticipated and loosening of the nuts and bolts of the flanges. The consequential escape of gas was within the meaning of the word accident and hence ordered the Insurance Co. to pay the claim.