3
Part 1: Insurance principles

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Learning objectives

After studying this chapter, you should be able to:

- explain the essential features of a valid contract;
- explain the concept of insurable interest and state when insurable interest needs to exist;
- explain the importance of utmost good faith;
- outline the insurer's and insured's duty of disclosure;
- explain the importance of material facts;
- describe the facts which need not be disclosed;
- explain the concept of indemnity and its relevance to life insurance.

Introduction

An insurance policy is a legal contract between the insurance company and the insured person and it must satisfy certain conditions to ensure that it is a valid contract.

In this chapter we will learn what the essential features of a valid contract are, including some unique principles that apply only to contracts of insurance.

Key terms

This chapter features explanations of the following terms and concepts:

Offer and acceptance	Consideration	*Consensus ad idem*	Insurable interest
Key person insurance	Utmost good faith	Duty of disclosure	Material facts
Ab initio	Indisputability clause	Indemnity	Capacity to contract
Contract of indemnity	Value contracts		

A Essentials of a valid contract of insurance

An insurance contract is an agreement, enforceable by law, between the insurance company and the insured person; the insured person agrees to pay a premium to the insurance company and the insurance company agrees to pay a sum of money, on the happening of a specified event, to the insured person.

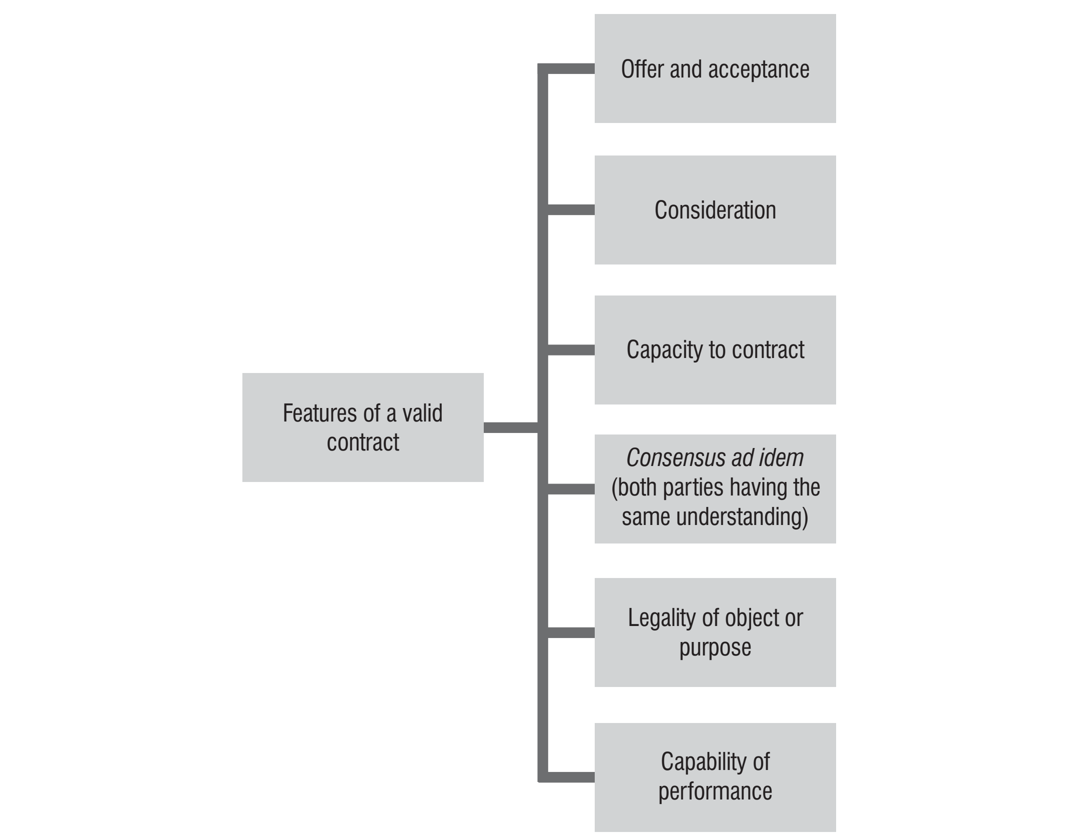
How do both parties enter into this legally binding agreement and what conditions must be satisfied by both parties to ensure that the contract is a valid one?

To answer these questions, we will first look at the essential features of a valid contract, and then we will move on to see how an insurance contract differs from other contracts.

A1 Features of a valid contract

The following features are essential if a legal contract is to be valid:

Figure 3.1



The most important features are **offer and acceptance** and **consideration**.

A1A Offer and acceptance

A contract comes into existence when one party makes an offer which the other party accepts unconditionally. It is easier to see how unconditional acceptance works by looking at an example. Let's consider the following conversation:

Example

ABC insurance company: 'On the basis of your proposal form we can offer you cover, with a sum insured of Rs. XXXXX.'

Ganesh, the proposer (the person who wants to take out the insurance): 'I accept.'

In this example, Ganesh's acceptance does not alter any of the terms of ABC's offer and the acceptance is said to be unconditional. A contract is formed, subject to the other essential elements being present.

Now, consider an alternative response by Ganesh:

Example

ABC insurance company: 'On the basis of your proposal form we can offer you cover, with a sum insured of Rs. XXXXX.'

Ganesh, the proposer (the person who wants to take out the insurance): 'I accept, but I would like to increase the sum insured to Rs. YYYYY.'

In this case, a contract has not been formed as Ganesh has not unconditionally accepted the offer. Not until ABC accepts Ganesh's counter-offer, without further conditions, is a contract formed.

A1B Consideration

A contract must be supported by consideration in order to be valid. Consideration may be described as each person's side of the bargain which supports the contract. Consideration in contract law is merely something of value that is provided and which acts as the inducement to enter into the agreement. The payment of money is a common form of consideration, although not the only form. In terms of insurance policies, we refer to the premium as the insured's consideration.

A1C Capacity to contract

Persons entering into contracts should be competent to do so. An individual is said to be competent to enter into a contract if they are:

- of the age of majority (age 18);
- of sound mind; and
- not disqualified, by law, from entering into contracts

According to this provision therefore, minors (those under the age of 18) cannot enter into insurance agreements. In addition, people who are legally considered to be of unsound mind and any person who has been barred by law cannot enter into an insurance contract. Any contracts entered into by the above people will be null and void.

A1D *Consensus ad idem*

In simple terms this means both the parties to the contract must understand and agree upon the same thing, in the same sense. The proposer should have understood the features of the insurance policy in the same sense (manner) in which it was explained to them by the agent.

A1E Legality of object or purpose

The objective of both the parties to the contract should be to create a legal relationship. The purpose of the contract should also be legal.

Example

It is illegal for a husband to insure his wife's life, and then to kill her and present it as a case of accidental death in order to benefit from the claim amount that he will receive as the legal beneficiary. Insurance cannot be used for illegal purposes or to derive monetary benefits from it.

Another example of an illegal act is a person who is heavily in debt, taking out life insurance for a large amount and then committing suicide so that their family can benefit from the claim money. Claims for death due to suicide in the first year are excluded by most life insurance companies.

A1F Capability of performance

The contract must be capable of being performed by both the parties. For example, a person requesting life insurance for a very high amount should be capable of paying the premium required.

The agreement and its term must be certain and capable of performance and in a form that complies with the requirements of the laws of the land.

Consider this…

Jigar makes a proposal to an insurance company for life insurance cover of Rs. 75 lakhs with a premium payment of Rs.12,000. During the medical check-up the company finds out that Jigar is suffering from a disease and considers that he presents a higher than normal risk. The insurance company therefore tells him that the premium chargeable will be Rs.15,000 instead of Rs.12,000.

How will you treat the above scenario in terms of offer and acceptance?

Question 3.1

What are the essential features of a valid contract?

A2 The policy document

In order that both the insured person and the insurance company are clear as to the terms that have been agreed between them, a policy is issued. The policy contains all the details of cover, period of cover, exceptions, conditions, the premium and other relevant information. The policy is not the contract of insurance in itself; rather, it is evidence of the contract.

The contract of insurance comes into effect once the insurance company has accepted the insurance proposal, terms have been agreed and the premium has been paid or agreed to be paid. Thus, the contract exists irrespective of the existence of an actual policy document. The absence or loss of the policy does not invalidate the contract, but the policy is useful as proof in the event of a dispute over the terms agreed. We will examine the structure and contents of the policy in detail in Part 2 of this chapter.

A3 The role of insurance agents in insurance contracts

In the eyes of the law, anyone who acts on behalf of another person is an ‘agent’. If we allow someone to act for us, we probably have to accept responsibility for whatever is done by them on our behalf within the terms of the arrangement. This is true in insurance, and whenever there is the involvement of an intermediary, legal relationships are set up.

We saw in chapter 1 that there are different types of intermediaries involved in the insurance industry and that the term ‘agent’ is applied to a licensed intermediary hired by an insurance company to sell that company’s products on its behalf. In doing so the intermediary becomes the legal ‘agent’ and is deemed to be acting on behalf of the ‘principal’ (in this case, the insurance company). They are authorised by the principal to bring the principal into a contractual relationship with a third party (in this case the proposer/person wanting to take out insurance).

Be aware

You will also remember from chapter 1 that certain intermediaries called composite brokers are independant advisers. Their legal status is complicated because they do some things on behalf of their client and some on behalf of the insurer, and so they can be deemed to be both the agent of the insured and the agent of the insurer (depending upon the nature of the function they are performing).

Be aware

Insurance contracts are specialised contracts and are subject to additional principles as well as the essentials of a valid contract described above.

We will now look at these additional principles in the following section.

B Insurable interest

Insurable interest is one of the elements necessary to create a valid insurance contract.

B1 What is insurable interest?

The following case study will help you to understand the meaning of insurable interest:

Case study

Ganesh is a 30-year-old man working for a multinational company (MNC). Ganesh's wife works for a domestic firm and she is a co-applicant in the loan on their home together with Ganesh. Whilst Ganesh has a well-paid job, as well as managing the monthly living expenses he has a running home loan and a car loan to take care of. Ganesh has worked hard to build these assets. So far everything has been going as Ganesh has planned. Imagine, however, the following scenarios:

Scenario 1: Ganesh meets with an accident and is hospitalised for a month.

Scenario 2: Ganesh's wife dies unexpectedly.

Let us have a closer look at the above scenarios and the possible solutions.

Scenario 1: Ganesh will not be able to work for at least a month. He will not receive a salary for that time and will also have to pay his hospital bills which could be very costly. To avoid this situation Ganesh should ensure that he has adequate health insurance to cover him against unexpected medical emergencies and to cover him against loss of pay if he is absent from work due to medical reasons.

Scenario 2: Ganesh's wife, apart from contributing to the family income, also takes care of the family. Following her unexpected death, Ganesh will face financial difficulties in repaying the home loan and meeting other financial commitments. To protect against the above scenario Ganesh can take out life insurance on his wife's life which will pay out in the event of her unexpected death, thus ensuring that the family's finances are not put in jeopardy. Ganesh's wife can also take out life insurance on Ganesh's life which would pay out on his unexpected death.

You will see from these scenarios that if either of the events happen, Ganesh and his family's **financial position will be adversely affected unless he has taken out insurance**.

Consider this…

How do these scenarios help us to understand insurable interest?

Insurable interest is said to exist when an individual stands to gain or benefit from the continued existence or well-being of another individual(s) or property, and at the same time the individual would suffer a financial loss or inconvenience if there is damage to the other individual(s) or property.

We can see from the case study that Ganesh has insurable interest in his own good health and the life of his wife because he benefits from the well-being of them, and he would be **financially adversely affected** should there be damage to either or both of them.

B2 Relevance of insurable interest

Now that you know the meaning of insurable interest, you must be wondering what is the relevance or importance of insurable interest in insurance? **Insurable interest is a very important principle of insurance**. In order to take out any kind of insurance, an individual has to have insurable interest in the subject matter they wish to insure. The subject matter is the item or event insured and can be a person's own life, the life of others or property. Insurable interest forms the legal basis for deciding whether insurance can be taken out or not.

To summarise: Insurable interest is the legal right of the person to insure the subject matter with which they have a legal relationship recognised by law.

B3 Circumstances in which insurable interest exists

Court judgements have established the circumstances in which insurable interest is deemed to exist.

By common law, insurance interest is deemed to exist in the following circumstances:

- **Own life:** a person has unlimited insurable interest in their own life.

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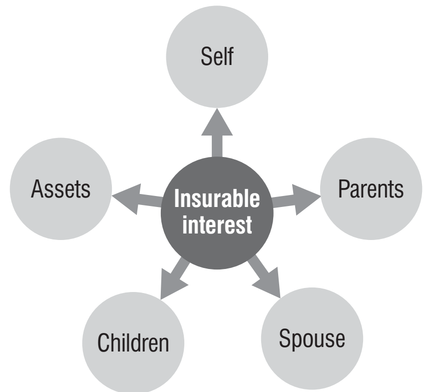
Example

Ganesh can take out life insurance for an amount equal to the present value of his future earnings. Alternatively, he might assess how much would be needed to take care of all his liabilities in his absence – such as the home loan, car loan, his family's living expenses etc.

Another method that can be used to calculate the amount of life insurance needed is to use a multiple of annual income, say, 15 times annual income or even 20 times annual income.

- **Spouse:** a husband has insurable interest in the life of his wife and, similarly, a wife has insurable interest in the life of her husband. Both benefit from the well-being of each other and each would be adversely affected if something were to happen to the other. So a husband can take out life insurance cover for his wife and vice versa.
- **Children:** parents can take insurance for their children when the children are dependants. Children can also take out insurance for their parents when the parents are dependent upon them. Ganesh can, therefore, take out life insurance for his children. Similarly Ganesh's children can take out health insurance for Ganesh in his old age when he may be dependent on his children.
- **Assets:** a person has insurable interest in the assets they own because they benefit from their use and they would be adversely affected if the assets were to be damaged.

Figure 3.2



Other circumstances where insurable interest is deemed to exist include:

- **Creditor:** a creditor has insurable interest in the life of the debtor to the extent they have lent money to the debtor.

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Example

If Ganesh has borrowed Rs.10,000 from Kailash, Kailash will then have insurable interest in the life of Ganesh to the extent of the loan amount lent, i.e. Rs.10,000.

This is because if something happens to Ganesh then Kailash will not be able to recover his Rs.10,000 and he will have incurred a loss. So in this case Kailash can take out life insurance on Ganesh's life for up to the loan amount of Rs.10,000.

- **Surety:** a surety has insurable interest in the life of the principal debtor and also in the life of the co-surety to the extent of the debt.
- **Employee – employer:** an employee has insurable interest in the life of their employer to the extent of their monthly salary.
- **Employer – employee:** employers have insurable interest in the well-being of all their employees to the extent of the value of their services, for example if an employee falls sick and remains absent from duty for a long time then it can hamper the delivery of the projects that they are working on.
- **Keyman insurance:** a company has insurable interest in the lives of certain important people. The company can take out **keyman insurance** on the lives of such people.
- **Partners:** partners in a business have insurable interests in the lives of each other.

Be aware

In **life insurance**, insurable interest needs to exist (be proven) at the time of taking out the policy, i.e. at the inception of the policy. In the event of a claim, insurable interest may or may not exist and is not required to be proved.

In the case of **general insurance**, insurable interest must exist at the time of inception of the policy **and also** at the time of making a claim.

Different rules apply to marine insurance where insurable interest need only exist at the time of the claim.

C Utmost good faith

Utmost good faith must also exist for a contract of insurance to be valid.

C1 Importance of utmost good faith

The following scenario will help you to understand the principle of utmost good faith:

Scenario

Rajesh had taken out a term insurance policy of Rs. 50 lakhs for 20 years.

While returning home from the office one day, Rajesh had a road accident and sadly died.

Rajesh's wife Komal (as the policy nominee) made a claim with the insurance company. To Komal's surprise the insurance company rejected the insurance claim. Komal was obviously very distressed and asked for an explanation for the rejection of the claim. The insurance company had found out in its investigation that Rajesh had manipulated his proof of age documents and, in order to benefit from a lower premium, declared his age to be five years younger than he actually was. Rajesh had deliberately misled the insurance company to obtain the insurance policy at better terms. Due to this the insurance company declared the policy null and void and rejected the claim made by Rajesh's wife.

The proposer knows all the facts about themselves and has the moral responsibility to disclose all true information at the time of completing the insurance proposal form and submitting proper documents.

The age of a person is a vital criterion in deciding the premium pricing of a life insurance policy which is what Rajesh manipulated.

In many contracts for the purchase of a tangible product, each party can examine the item. Provided that one party does not mislead the other party and answers questions truthfully, there is no question of the other party avoiding the contract. In the case of buying a refrigerator, its features can be examined and switched on to check that it works properly. The rule governing the sale and purchase of goods and services is *caveat emptor*, or 'let the buyer beware'.

But insurance cannot work like this. We can read the policy but the only point at which we will find out how it works is when a claim is made. There is nothing to touch or see. Equally the insurance company is relying entirely upon the proposer for much of the information that it will use to decide whether it wants to accept the risk, and if it does, on what terms.

The above scenario shows that the intentional suppression of a material fact is not permissible. That is why a different set of rules apply to insurance contracts and a higher duty is required called utmost good faith.

C2 Definition of utmost good faith

We can define 'utmost good faith' as:

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

This means that the parties to a contract must volunteer material information before the contract is concluded. The principle applies equally to both the proposer and the insurer throughout the contract negotiations, but the law sees the proposer as the main supplier of material facts to the contract. We shall be explaining what material facts are in section D.

Breach of the duty of utmost good faith
Breaches of the duty of utmost good faith can be categorised as:

- **Non-disclosure**, or the omission to disclose a material fact, either inadvertently or because the proposer thought it was immaterial.

For example, Ajay, while applying for life insurance with Company ABC, does not disclose that he had undergone surgery during his childhood. He feels it is immaterial to disclose this information to the insurance company as the surgery was done during his childhood, some 15 years ago, and he had completely recovered from the incident a long time ago.

- **Concealment** of a material fact.

For example, Ajay consumes alcohol regularly. However, before applying for life insurance he does not consume alcohol for a month, thinking that by doing so it will not be detected during the medical test and he will get insurance at better terms.

- **Fraudulent misrepresentation** or statements made with the intention of deceiving the insurer.

For example, Ajay declares his age to be five years less than he actually is. To support this he forges the proof of age documents and submits them to the insurance company to get insurance at better terms.

- **Innocent misrepresentation** or inaccurate statements which are believed to be true.

Question 3.2

List some practical circumstances in which insurable interest is deemed to exist for an individual.

C3 Duty of disclosure

As we have explained, there is a duty to disclose material facts implicit in all insurance negotiations; this is particularly important at the proposal stage, before the contract comes into existence. The duty of disclosure is revived at each renewal date.

Insured's duty of disclosure
It is important that the proposer makes full and complete disclosure of all the material facts relating to the contract since, in the vast majority of cases, the full circumstances of the subject matter are only known to the proposer. The insured should also act towards the insurer in good faith throughout the duration of the insurance contract.

Examples

- The proposer should mention all facts relating to their health. If they are suffering from any illness which may affect the insurer's decision, it must be disclosed at the time of the proposal itself.
- The proposer must declare their correct age and support it with proper proof of age documents.
- If the proposer smokes tobacco or consumes alcohol, then this should be mentioned on the proposal form.
- If the proposer has been denied insurance in the past by any company or a proposal has been accepted at a higher premium than normal, then this should be mentioned along with the reason for it, on the proposal form.

Insurer's duty of disclosure
The insurer also has a duty of disclosure to the insured. In order to fulfil this duty, the insurer must also behave with utmost good faith.

Examples

- The insurer should make sure that it discloses all information related to the insurance product in all its literature, such as pamphlets, brochures, website etc.
- Insurance companies, for example, charge a lower premium for non-smokers compared to those for smokers.
- In the case of health insurance, at the time of renewal some companies offer a discount on the premium or increase the cover by a certain percentage keeping the premium the same, if there has been no claim made by the insured in the entire year.

Suggested activity

We have mentioned above some instances where the insurer has a duty of disclosure to the proposer/insured person. Think about some other instances where there might be a duty of disclosure on the insurer towards the insured.

Or

Search the internet for some cases or examples where the insured has not followed the duty of disclosure and their claims have been rejected by the insurer on the grounds of non-disclosure. Study the reasons for such a rejection of claims.

D Material facts

D1 Importance of material facts

Material facts can be defined as those which:

> would influence the judgment of a prudent insurer in fixing the premium or determining whether it will take the risk.

From the above definition we can see that material facts are important because they help the insurance company's underwriter to decide two things:

- whether to accept the risk proposal or to reject it; and
- if the proposal is to be accepted, then at what price (premium) it should be accepted.

If the proposer is in any doubt about facts which may be considered material, they should disclose them, regardless of whether there is a specific question on the proposal form. This is because the proposer alone is in possession of the full facts and these must be presented to the insurer when the insurer is underwriting the business.

Any facts which render the risk greater than normal are clearly material, as are those that explain the exceptional nature of a risk, or suggest some special motive for insurance.

D2 Consequences of non-disclosure

If the insured is in material breach of the duty of disclosure, the insurer may avoid the contract entirely, *ab initio* (from the beginning). In other words, no claims are payable. If the non-disclosure is fraudulent (often termed 'concealment') the insurer may keep the premium. The legal rule is that non-disclosure arises and gives grounds for avoidance by the second party to the contract (the insurer) where a fact is:

- within the **knowledge** of the first party (the insured);
- **not known** to the second party (insurer); or
- **calculated**, if disclosed, **to induce** the second party to enter the contract at terms they consider to be better, or not to enter the contract at all.

D3 Indisputability clause (section 45)

As specified in section 45 of the Insurance Act, in the first two years of the policy, if the insurance company comes to know that some material fact has not been disclosed by the proposer, it can declare the policy to be null and void. The insurance company can also keep all the premiums paid. This right can be enforced by the insurance company only during the first two years of the policy. After two years, fraud must be established by the insurance company if it wishes to make the policy void. This clause is referred to as the 'indisputability' clause and applies to life insurance.

D4 Life insurance: duty of disclosure

In the case of life insurance, the duty of disclosure arises at the time of proposal up until the time the risk is accepted by the insurance company and the policy cover has commenced.

Be aware

In the event that a lapsed policy is revived, the insurance company may ask the insured to disclose all material facts along with proof of continued good health. More details about policy lapse and revival are discussed in Part 2 of this chapter.

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Example

Scenario 1: Arjun took out a whole of life policy from an insurance company at the age of 30. At the time of completing the proposal form Arjun declared all the material facts. Five years later Arjun is diagnosed with diabetes. Even if Arjun does not disclose this fact to the insurance company it will not affect his policy cover in any way as it happened five years after the policy cover had started. If Arjun's policy lapses and he revives the policy then, at the time of reviving it, the insurance company may ask him to disclose all material facts again.

Scenario 2: At the age of 35 Arjun wants to take out another policy (term insurance) but he is now a diabetic. This time while making the proposal, in accordance with the principle of utmost good faith, Arjun will have to disclose that he is suffering from diabetes.

Based on the disclosures made by Arjun, the insurance company will assess his proposal and may decide to accept or reject the risk. If the company decides to accept the risk it will advise Arjun of the premium it requires.

If Arjun does not disclose that he is suffering from diabetes and the insurance company finds out about this fact 6 months later, it may declare the policy to be null and void and keep all the premiums paid by Arjun to date.

E Indemnity

Indemnity can be defined as:

> financial compensation sufficient to place the insured in the same financial position after a loss as they enjoyed immediately before the loss occurred.

In short, this means that in the event of a loss the insurance company indemnifies (compensates) the insured for the loss they incur, under the terms and conditions of the policy.

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Example

Suresh has taken out an individual health insurance policy with a sum insured of Rs. 2,00,000. Suresh falls ill and has to be hospitalised, resulting in a hospital bill of Rs. 40,000. So in this case the insurance company will compensate (indemnify) Suresh with Rs. 40,000.

Insurance cannot be used to make a profit

The principle of indemnity makes sure that the insured is compensated only to the extent to which they have suffered a loss. Thus the insured cannot profit from insurance.

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Example

Rajesh has taken out an individual health insurance policy with a sum insured of Rs. 1,00,000. Rajesh also has health cover of Rs.1,00,000 from his employer. Rajesh falls ill and has to be hospitalised, resulting in a hospital bill of Rs. 25,000. So in this case Rajesh cannot make a claim of Rs. 25,000 from both insurers. Rajesh will get a total claim of only Rs. 25,000. So the principle of indemnity ensures that insurance cannot be used to make a profit.

To summarise: indemnity makes sure that the insured is neither better nor worse off after the claim is settled by the insurance company. It also makes sure that neither the insured benefits at the cost of the insurer, nor that the insurer benefits at the cost of the insured.

E1 Indemnity and life insurance

General insurance policies and health insurance policies are contracts of indemnity whereby the insured is compensated for the loss incurred in line with the principles explained above.

But the same **does not apply** to life insurance.

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Example

If Ajit has taken out an endowment policy of Rs.1,00,000 for 10 years with an annual premium payment of Rs. 10,000 and he dies in the fourth year of the policy, the beneficiary will get the full amount of Rs. 1,00,000 (plus the bonuses accumulated up to that point), even though Ajit has paid premiums for only four years.

Therefore life insurance contracts are also known as **value contracts** and the principle of indemnity does not apply to them. In the case of life insurance, even if a person takes out multiple policies, the insured's death will result in all the insurance companies paying the full sums insured.

So remember that where life insurance is concerned, the concept of sharing claims, as per the principle of indemnity, does not apply; we can see this in the following example:

Example

Manish has taken out a whole of life policy from insurance company ABC for Rs. 15,00,000 and an endowment policy for Rs. 10,00,000 from insurance company XYZ. In the event of his death, within the policy term, both insurance companies will pay Manish's nominee. So Manish's nominee will get a total insurance amount of Rs. 25,00,000 (Rs. 15,00,000 + Rs. 10,00,000) from the two insurance companies.