

Class 3 Outline
Business Finance 640 - Insurance and Risk
Autumn Quarter, 2007

This class focuses on several important legal principles that are reflected in insurance contracts. We review the principles of indemnity, insurable interest, subrogation, and utmost good faith. These principles are important in understanding individual insurance contracts discussed later in the course.

We will start by looking at the costs of insurance to society, which is a subject introduced in chapter 2.

I. Costs of Insurance to Society

- A. Costs of doing business
 - B. An expense loading is added to the pure premium to:
 - 1. Cover expenses, including commissions, general administrative expenses, state premium taxes and acquisition expenses
 - 2. Allow for contingencies and profit.
 - C. Insurance Fraud – Examples:
 - Staged auto accidents
 - Fake slip and fall accidents
 - False health claims
 - Life Insurance purchased on already deceased people
 - Loss Exposure value and amount of property stolen from a home or business
 - D. Inflated Claims - Examples
 - Suits for high liability judgments that exceed the economic loss of the victim
 - Inflated auto collision claims to cover the collision deductible
 - Exaggerated claims regarding the value of property stolen
 - Disabled persons malingering beyond true duration of disability to collect disability benefits
 - E. Cost of Fraudulent and Inflated Claims: \$80 Billion per year*
 - Equivalent to:
 - ✓ Annual tuition to four-year public university for 15.6 million students
 - ✓ Salaries of 2.2 million workers for a year
- *Source: Coalition Against Insurance Fraud

II. Fundamental Legal Principles

- A. Principle of Indemnity
 - 1. Insurer agrees to pay no more than the actual amount of loss; the insured should not profit if a loss occurs
 - 2. Actual cash value rule
 - a. Replacement cost less depreciation
 - b. Fair market value
 - c. Broad evidence rule
 - 3. Exceptions to the principle of indemnity
 - a. Valued policy
 - b. Valued policy laws
 - c. Replacement cost insurance

- d. Life insurance
- B. Principle of Insurable Interest
 1. Insured stands to lose financially if a loss occurs.
 2. Purposes of an insurable interest
 - To prevent gambling
 - To reduce moral hazard
 - To measure the amount of the insured's loss in property insurance
 3. Examples of an insurable interest
 4. Time that an insurable interest must be met
- C. Principle of Subrogation
 1. Insurer is entitled to recover from a negligent third party any loss payments made to the insured.
 2. Purposes of subrogation
 - To avoid collecting twice
 - To hold the negligent person responsible
 - To hold down rates
- D. Principle of Utmost Good Faith
 1. Higher degree of honesty is imposed on both parties to an insurance contract.
 2. Areas of application—legal doctrines of misrepresentation, concealment, and breach of warranty

III. Basic Requirements of an Insurance Contract

- A. Offer and Acceptance
 1. The applicant usually makes the offer.
 2. The insurer accepts or rejects the offer.
 3. Agent's authority to bind the insurer varies by type of insurance.
 - a. Property and liability insurance
 - b. Life insurance
- B. Consideration
 1. Insured's consideration generally is payment of the first premium.
 2. Insurer's consideration is the promise to perform the contract.
- C. Competent Parties
- D. Legal Purpose

IV. Special Characteristics of an Insurance Contract

- A. Insurance Is an Aleatory Contract.
- B. Insurance Is a Unilateral Contract.
- C. Insurance Is a Conditional Contract.
 1. Conditions are provisions that qualify or place limitations on the insurer's promise to perform.
 2. The insurer does not have to pay the claim if the policy conditions are violated. For example, in property insurance, the insured must give immediate written notice of a loss in order to collect.
- D. Insurance Is a Personal Contract.

1. Consent of the insurer is required to assign a property or liability insurance policy to another person.
2. Since loss payments are money, they can be freely assigned without the insurer's consent.

E. Contract of Adhesion

1. Policy is offered on a "take-it-or-leave-it" basis with no bargaining over its terms.
2. The result is that any ambiguity is strictly construed against the insurer.

V. Law and the Insurance Agent

A. General Rules of Agency

1. There is no presumption of an agency relationship.
2. Agents may bind the principal by express authority, by implied authority, or by apparent authority.
3. Principal is responsible for an agent's torts and is charged with agent's knowledge of notice.

B. Doctrines of Waiver and Estoppel

1. Waiver—voluntary relinquishment of a known legal right
2. Estoppel—representation of fact made by one person to another person that is reasonably relied on by that person to such an extent that it would be inequitable to allow the first person to deny the truth of the representation
3. Practical significance of these legal doctrines—insurer legally may be required to pay a claim that it ordinarily would not have to pay.