

Chapter 3

PRINCIPLES OF INSURANCE

In this module we will learn about basic principles of Insurance contracts.

Learning Outcomes:

1. Offer (Proposal) and Acceptance
2. Consideration (Premium)
3. Insurable Interest
4. Material Facts
5. Utmost good faith and duty of disclosure
6. Indemnity
7. Subrogation & Contribution
8. Proximate Cause
9. Sec 64VB in the Insurance Act 1938
10. Policy Terms & Conditions

Insurance contracts (Policy) is an agreement between Insurer and Insured enforceable by law. The Indian Contract Act 1872 governs all contracts in India, including insurance contracts.

UTMOST GOOD FAITH	
CONCEPTS AND PRINCIPLES OF INSURANCE	<p>Both parties: the insurer and the insured should have a good faith towards each other.</p> <p>The insured must provide the insurer complete, correct and clear information of subject matter.</p> <p>The insurer must provide the insured complete, correct and clear information regarding terms and conditions of the contract</p> <p>This principle is applicable to all contracts of insurance i.e. life & non-life contracts of insurance.</p>

1. OFFER (PROPOSAL) AND ACCEPTANCE

1.1 Proposal (Offer) is an application for taking insurance. Generally a person who needs insurance makes the proposal.

1.2 When an insured approaches insurance company to insure his life or his property he is required to fill up a form called Proposal form. In proposals from the questions are asked, depending on the type of insurance sought for.



Examples:

- a) In case of Insurance of life, generally questions about age, gender, health condition, occupation, income etc. are asked.
- b) In case of property insurance-say for insurance for a house-questions related to type of construction, age of the building, distance from river etc. are asked.

1.3 Depending upon the details given in the proposal insurers decided about acceptance or rejection of the proposal. If they accept the proposal as it is, it is called “accepted as proposed”.

1.4 In many cases insurers may be willing to accept the proposal but for lesser covers or modified terms.

Examples:

If Shyam approaches an insurance company to insure his life against death and disability, the insurer may not be willing to grant disability cover but may be prepared to grant only death cover. In this case the proposal is not accepted but what is done by the insurance company is called the issue of a “Counter Offer”.

1.5 When a counter offer is made, the proposer has to decide whether he will accept the counter offer or not. If he accepts, then it amounts to acceptance.

1.6 Many a times an insurance company also may approach a prospective client and make an offer to insure his property in that case the offer is made by the insurer and the client has to decide whether he will accept it or not.

Examples:

ABD insurers approach a big farmer and offer to insure the crop in his 25 acre field. Here insurers are making an offer and acceptance lies on the farmer.

2. CONSIDERATION (PREMIUM)

2.1 Once an offer is accepted it becomes an agreement. But only agreement is not sufficient to make an insurance contract valid. Other conditions are also to be fulfilled.

An important condition is about payment of premium. After acceptance if the agreed premium is paid then only the insurance contract will come to existence.

Premium is the consideration, which is to be paid by the proposer to the insurer, at the beginning of the period for which the Insurance is being provided.

2.2 Under the provisions of the Contract Act the provision is 'No consideration no contract'. If premium is not paid it amounts to absence of consideration and the insurance contract will not come into existence. The right to insurance cover depends on payment of subsequent instalments of premium (if any) at the beginning of each period.

Please note life insurance policy has a cooling off period of 15 days after the date of intimation of underwriter's acceptance. The proposer has the right to decide to reject the insurer's offer, within 15 days of receipt of the policy.

Example: A proposal for insurance was accepted by the insurer on 15th April 2011.

Confirmation about the acceptance was received by the proposer on 15th May 2011.

The latter sent a letter intimating that he wanted to cancel the policy. The letter was sent on 17th of May and reached the insurer on 20th May. Can the proposer cancel the policy contract?

3. INSURABLE INTEREST

3.1 Insurable interest is said to exist when the insured stands in such a relationship to the subject matter of insurance that he or she stands benefit from its existence and suffers financial loss in the event of its damage or destruction.

3.2 The relationship of insured with the subject matter should be direct and not indirect. In life insurance one can insure one's own life, lives of dependent children, spouse, etc. but one cannot insure brothers, sisters or distant relatives.

Example: Shyam stays in a house which was purchased by his father ten years ago, with his wife and brother. He can take a life policy on his life and also on the life of his wife but he cannot insure his brother's life. House is owned by his father so Shyam cannot insure it.

3.3 Life policies: For policies covering life insurance, personal accident and sickness insurance, disability insurance etc. insurable interest is required when the proposal to insure is made.

3.4 Property insurance; insurable interest is required at both the time-when policy is taken and when the loss occurs.

3.5 Absence of insurable interest make the contract Void or an unenforceable. It is treated as a gambling transaction and payment of any claim under is illegal.

Three essential of insurable interest:	Insurable Interest
<ol style="list-style-type: none"> 1. There must be property, right, interest, life or potential liability capable of being insured. 2. Such property, right, interest, life or potential liability must be the subject matter of insurance. 3. The insured must bear a legal relationship to the subject matter such that he stands to benefit by the safety of the property, right, interest, life or freedom of liability. By the same token, he must stand to loss financially by any loss, damage, injury or creation of liability. 	<ul style="list-style-type: none"> • The insured must have insurable interest in the subject matter of insurance. • In life insurance it refers to the life insured. • In marine insurance it is enough if the insurable interest exists only at the time of taking policy and also at the time of the occurrence of loss. • In fire and general insurance it must be present at the time of the occurrence of loss. • The owner of the party is said to have insurable interest as long as he is the owner of it. • It is applicable to all contracts of insurance.

4. MATERIAL FACTS

4.1 'Material Facts' is fact which influence a prudent underwriter's decision to accept the risk or not. If he decides to accept the risk, at what rates, terms and conditions.

4.2 In other words, material facts help an underwriter to decide about the acceptance of an insurance proposal and its terms.

4.3 Examples of material facts:-

- **Life insurance:** age, health conditions, income, occupation, details of previous policies etc.
- **Fire insurance:** construction of building, occupation, age of the building etc.
- **Crop insurance:** type of crop being grown, average of the field, data about yield etc.
- **Motor Insurance:** year of manufacture, purpose for which vehicle is being used etc.

5. UTMOST GOOD FAITH AND DUTY OF DISCLOSURE

5.1 The principal of Utmost Good Faith is a concept which is a unique to insurance contracts. This relates to the duty of disclosure of material facts by the proposer. If material facts are not disclosed or incompletely disclosed, the insurance company can cancel the policy and/or reject the claim on this ground. This duty of disclosure of material fact lies on the proposer.

5.2 In insurance policies the duty of disclosure is at the time of making a proposal, and continues till the proposal is completed. The duties of disclosure once again arise, (if a policy lapses for non-payment of premium) at the time of revival/ reinstatement in long term policies.

However, in many non-life policies, it is mentioned whether changes in the conditions of assets insured are required to be intimidated or not.

5.3 An insurance policy becomes void when there is concealment with intent to deceive or when there is fraudulent non-disclosure or misrepresentation.

5.4 Example

- **5.4.1** Ram replies, in his proposal for life insurance, to a question that he does not suffer from cancer but in fact he is being treated for lung cancer. On his death when the insurer comes to know about this sickness they can refuse to pay the claim.
- **5.4.2** For insurance of his tractor, Gautam replies to a question about year of manufacture of tractor, that it is only two years old. In fact it was assembled by a local manufacturer and is ten years old. When the tractor becomes “total loss” due to an accident this comes to light and the insurance company rejects the claim because of non-disclosure of material fact.

5.5 However, these duties of proposer/policyholder cannot be taken advantage of by insurers for avoiding claims. To balance the principle of “Utmost Good Faith” and principles of policyholder’s rights, certain rules have been framed.

- **5.5.1** The question of materiality is a question of facts; no straightforward answer can be given. In real life, many times this question is a matter of interpretation.
- **5.5.2** In life insurance policies, Section 45 of Insurance Act 1938 puts a limit on the insurer’s privilege. In simple words, after two years of commencement of the policy the insurer can cancel the policy/reject the claim for breach of “Utmost Good Faith”, only if it can establish
 1. The statement made for obtaining the policy was false or inaccurate. And
 2. Such statement was a “Material Fact”, and
 3. The policyholder knew at the time of making the statement that the statement was false.

6. INDEMNITY

6.1 In insurance, to indemnify, means to make good the loss suffered by the insured.

6.2 If the insured suffers loss, due to a loss event, he can recover only the amount of loss suffered by him and not more. He is not allowed to make any profit out of loss.

Example: Ramphal has insured his buffalo for Rs. 50,000/- and the buffalo dies in an accident. The market value of the buffalo is Rs. 30,000/-. Insurance company will pay him Rs. 30,000 and not Rs. 50,000 though he may have paid an insurance premium for Rs. 50,000.

6.3 The principal of indemnity is applicable only when there is a possibility of finding out any definite value of subject matter insured. It is not applicable where there is no such possibility like in life insurance policy. What is the value of a life? Nobody can say any definite amount. So the principle of indemnity does not apply to life insurance policies.

7. PRINCIPAL OF INDEMNITY

- Indemnity means a guarantee or assurance to put the insured in the same position in which he was immediately prior to the happening of the uncertain event. The insurer undertakes to make good the loss.
- It is applicable to fire, marine and other general insurance.
- Under this the insurer agrees to compensate the insured for the actual loss suffered.

7.1 The principal of Contribution arises when the insured has taken many policies for the same property.

Example: If Supriya has insured her farm house worth Rs. 1,00,000 with ABC insurance company for Rs. 1,00,000 and with XYZ insurance company for Rs. 1,00,000 in the event of loss Rs. 50,000/- both insurers will pay Rs. 25,000/- each and not more. This is done to ensure that the insured does not make any profit out of the loss.

7.2 As stated earlier these principles support the principle of indemnity so they are not applicable to insurances where the principles of indemnity is not applicable. They do not apply to life Insurance policies.

8. PROXIMATE CAUSE

Many Insurance contracts provide indemnity only if losses are caused, by perils, mentioned in the policy. The concept of proximate cause is used to determine, whether the cause of loss is an insured peril or an excluded peril. If there are two or more causes for the loss, whether operating simultaneously or in sequence, the cause which is most effectual in contribution to the loss is the Proximate Cause. Note that the proximate cause need not always be the immediate cause of the loss.

To understand the principle of proximate cause, consider the following situation:-

Example:-Mr Pinto , while riding a horse, fell on the ground and had his leg broken. He was lying on the wet ground for a long time before he was taken to hospital. Because of lying on the wet ground, he had a fever that developed into pneumonia, finally dying of this cause. Though Pneumonia might seem to be the immediate cause, in fact it was the accidental fall that emerged as the proximate cause and the claim was admitted under Personal Accident Insurance.

Principle of 'Causa Proxima'

- The loss of insured property can be caused by more than one cause in succession to another.
- The property may be insured against some causes and not against all causes.
- In such an instance, the proximate cause or nearest cause of loss is to be found out.
- If the proximate cause is the one which is insured against the insurance company is bound to pay the compensation and vice versa.

There are certain losses which are suffered by the insured but cannot be said to be approximately caused by fire. In practice, some of these losses are customarily paid under fire insurance policies. Examples of such losses are-

1. Damage to property caused by water used to extinguish fire.
2. Damage to property caused by fire brigade in execution of its duty.
3. Damage to property during its removal from a burning building to a safe place.

9. SECTION 64VB IN THE INSURANCE ACT 1938

The section in the Insurance Act 1938 states that, No risk to be assumed unless premium is received in advance:

- No insurer shall assume any risk in India in respect of any insurance business on which premium is not ordinarily payable outside India unless and until the premium payable is received by him or is guaranteed to be paid by such person in such manner and within such time as may be prescribed or unless and until deposit of such amount as may be prescribed, is made in advance in the prescribed manner
- For the purposes of this section, in the case of risks for which premium can be ascertained in advance, the risk may be assumed not earlier than the date on which the premium has been paid in cash or by cheque to the insurer. Explanation.—Where the premium is tendered by postal money order or cheque sent by post, the risk may be assumed on the date on which the money order is booked or the cheque is posted, as the case may be.
- Any refund of premium which may become due to an insured on account of the cancellation of a policy or alteration in its terms and conditions or otherwise shall be paid by the insurer directly to the insured by a crossed or order cheque or by postal money order and a proper receipt shall be obtained by the insurer from the insured, and such refund shall in no case be credited to the account of the agent
- Where an insurance agent collects a premium on a policy of insurance on behalf of an insurer, he shall deposit with, or despatch by post to, the insurer, the premium so collected in full without deduction of his commission within twenty-four hours of the collection excluding bank and postal holidays

10. POLICY TERMS & CONDITIONS

There are several terms and conditions mentioned in the product brochure which the POS-Person should read carefully before selling it to any customers. Some of the parameters on which the Terms & Conditions applied are:

- Non Payment of Due Premiums during the first few years of the policy
- Non Payment of due premiums after the first few years
- Conditions on Policy Revivals
- Conditions on Surrender Value
- Nominations & Assignments
- Exclusions in the policy
- Prohibition in Rebates (Sec 41 of the Insurance Act, 1938)
- Fraud, Misrepresentation or Non-Disclosure