

Basic Legal Principles and Contract Analysis

Learning Objectives

An understanding of the material in this chapter should enable you to

- 6-1. Describe the unique aspects of an insurance contract that differentiate it from other goods and services.
- 6-2. Explain the general legal requirements of an insurance contract.
- 6-3. Describe the special legal characteristics of an insurance contract.
- 6-4. Explain how to analyze the various provisions in an insurance contract.

This chapter begins by describing some fundamental attributes of insurance. Financial planners must understand these basics to make effective use of insurance as a financial planning tool. Some of these attributes are, in a sense, so obvious that they almost go without saying. But it is necessary to state them in order to understand the nature and importance of insurance.

Private insurance is usually provided through a written contract, known as an insurance policy. (Sometimes, insurance begins with a binding oral agreement between the insurer, or its agent, and the insurance applicant; the oral binder is later replaced by a written contract.) The most tangible product resulting from the insurance transaction is the insurance policy—a legally enforceable written contract. The effectiveness of insurance depends to a high degree on contract law, which governs the making and enforcement of contracts. Most financial planners are not attorneys, and they should not therefore deal in depth with legal issues. However, financial planners need to understand the basic principles described in this chapter that relate to contracts.

INSURANCE: AN INTANGIBLE CONTRACT

The insurance policy consists of tangible pieces of paper. However, insurance is more than mere pieces of paper; those pieces of paper contain the insurer's promise to pay money. Unlike tangible assets that have intrinsic value, an insurance contract is an intangible asset that represents value. Other intangible assets include stock certificates and savings bonds.

Unlike most physical goods, which are purchased for immediate use, consumers usually view insurance as a product that provides future benefits

when loss payments are made. A hurricane, an auto accident, a premature death, or a retirement are all *future* possibilities for the insurance purchaser. A policyowner who focuses on the future benefits, however, is likely to overlook the significant immediate benefit of insurance: freedom from worry about financial losses.

Many people who buy insurance are convinced they will never have a loss. They buy insurance "just in case," but at the same time they think, "It will never happen to me." It's true that most families carry insurance for many years without having serious illness and/or without experiencing serious damage to their homes. Only the unfortunate minority who suffer losses come to realize the substantial benefits of insurance. Insurance is activated by contingencies that might or might not occur, contingencies that normally do not happen very often.

Insurance transfers the financial risk of losses to the insurer, an organization that is in the business of bearing risks. Insurance is affordable because it involves an exchange of unequal values. The insurance buyer pays a relatively small premium, or a series of premiums, in exchange for the insurer's promise to pay for a potentially large loss.

GENERAL LEGAL REQUIREMENTS

The rights and obligations of the parties to an insurance agreement are determined largely by the general laws that govern contracts. The agreement by which insurance is effected is a contract in which the insurer, in consideration of the policyowner's payment of a specified sum, agrees to make good the losses suffered through the occurrence of a designated unfavorable contingency.

A contract has been defined as "an agreement enforceable by law." A more complete definition would include the following essentials required by law:

- offer and acceptance
- legal purpose
- competent parties
- consideration

Absence of any of the essential elements prevents enforcement of any contract. To be valid and enforceable, insurance contracts must meet these four general legal requirements.

Offer and Acceptance

The first requirement of a legally enforceable contract involves offer and acceptance. A contract requires both an offer by one party to the contract and acceptance of that offer by another party. In insurance, the offer is usually made in a request for coverage by the prospect, or applicant. The simplest method, used for many types of property and liability insurance, is an oral request to an

agent either in person or by telephone. In life insurance and in many forms of health insurance, the offer must be made in a written application.

Before a contract is effective, acceptance of the offer is necessary. As noted earlier, with property and liability insurance, the agent often has authority to bind coverage, or accept the offer, even before receiving any payment from the applicant. The protection may commence immediately, if desired, based entirely on the oral request of the applicant and the oral acceptance by the agent.

In life insurance, the method and timing of legal acceptance are different. The applicant usually submits the written application and the first premium payment as the offer to the insurer through the agent, who issues a conditional receipt. Acceptance is held by most courts to occur if the applicant meets the normal underwriting standards of the insurer, including a medical examination if required. Then coverage becomes effective as of the time of the application and premium payment. If the applicant does not meet the underwriting standards of the insurer, the insurer may make a counteroffer with a different contract, which the prospect may accept or reject upon delivery by the agent. If the premium is not paid with the application, the offer to insure is made by the insurer after reviewing the application. The insurance is accepted and becomes effective when the contract is delivered to the applicant while the applicant is in good health and the premium is paid.

Example 1 :

Shelley completed an application for \$25,000 of nonmedical (no examination required) life insurance on her own life and gave it to the insurer's agent with a check for the first premium. Shelley died in an auto accident 2 days later. Three weeks later, the insurer reviewed the application and found that Shelley, at the time of the application, met the insurer's normal underwriting standards. The insurer is obligated to pay \$25,000 to Shelley's beneficiary.

Example 2 :

Same facts as above, except that Shelley did not pay the premium. In this case, the insurer is not obligated to pay anything.

Legal Purpose

To be legally binding, any contract must meet the second requirement—a legal purpose or object. The courts will not enforce an insurance contract if it has an illegal purpose or is contrary to public policy. For example, a thief might purchase a property insurance policy listing stolen property. The courts will not require the insurer to pay a claim brought by the thief if that property is then lost or destroyed. Likewise, the courts will not enforce a life insurance

contract if it is proven that the applicant who purchased the insurance did so intending to murder the insured and collect the insurance proceeds.

Punitive damages claims provide a good example of the public policy issue. Courts award punitive damages, in some cases, to punish the defendant in a liability claim who has committed some particularly egregious act. Some states do not permit insurance to pay punitive damages claims on behalf of an insured on the basis that the insured is not really punished unless the insured pays punitive damages with his or her own funds. Some liability insurance policies exclude coverage for punitive damages, but even a policy without an exclusion cannot be enforced in states where insurers are not permitted to pay punitive damages claims on behalf of their policyowners.

Competent Parties

Valid contracts require that the party making the offer and the one accepting the offer be legally competent to make the agreement. In insurance, the most common problem arises in connection with applicants who are under the age of legal majority, which differs by state. Minority age applicants may have the option of repudiating contracts up to the time they reach legal adulthood, unless the contracts are for necessities, such as food, shelter, or clothing. Some insurance contracts are thus voidable by applicants who are minors, and these applicants will receive a full return of the premiums paid if they later decide to make them void. Some states have made exceptions for life, health, and auto insurance contracts by establishing special age limits of 14 or 16; beyond this age, minors are considered to have the legal capacity to insure themselves, and a contract is binding on them.

A similar problem may occur when insurance is purchased by legally insane or intoxicated persons. They cannot make legal contracts, because they fail to understand the agreement.

Insurers, too, must be competent to enter into a legal contract by meeting state charter and license requirements. In cases where legal capacity is lacking, many courts have nevertheless held the contracts binding on the insurer, or on its corporate officers personally, rather than penalizing a good-faith purchaser of the coverage.

Consideration

The final requirement for a valid contract is some "consideration" exchanged by both parties to the agreement—a right or something of value given up or an obligation assumed. In insurance, the applicant typically makes a premium payment, or the contract may become effective on the basis of the applicant's promise to pay and to meet other conditions of the contract. The insurer's consideration is its promise to pay for specified losses or to provide other services to the policyowner.

SPECIAL LEGAL CHARACTERISTICS

The next section of this chapter concerns special legal characteristics of the insurance contract. These are not necessarily unique to insurance contracts, but they help describe the fundamental ideas on which insurance contracts are based. A good understanding of these characteristics should help the financial planner, insurance advisor, and consumer to read insurance contracts and comprehend the underlying legal concepts that are essential to most insurance contracts. Figure 6–1 summarizes the characteristics.



Unilateral Nature

unilateral contract

A *unilateral contract* is one in which only one party to the contract makes a binding promise that, if broken, gives rise to an action against that party for breach of contract. An insurance contract is a unilateral contract because only

one party, the insurer, makes a legally enforceable promise. If the insurer fails to fulfill the promises it makes, such as to pay the specified benefits at the death of the insured, it may be held legally liable for breach of contract. After the premium is paid and the insurance is in force, the policyowner has no further promises to keep, although, of course, failure by the policyowner to live up to policy conditions may release the insurer from the contract.

Unlike an insurance contract, most contracts are bilateral. If Able agrees to sell a car to Baker for \$7,000 and Baker agrees to buy it for that amount, they have formed a bilateral contract. If Able later decides not to sell the car, Baker can sue him to enforce the contract or, if the contract is breached, to pay damages. Likewise, if Baker changes his mind and decides not to buy the car, Able can insist that Baker honor his contract.

Personal Nature

An insurance contract is personal and covers the person rather than the property concerned. We may speak of insuring property, but this is not technically accurate. An insurer cannot guarantee that possessions will not be lost, or even guarantee replacement with items of like quality and kind. The insurer can, however, indemnify the person who has incurred the loss. We, therefore, speak of the personal nature of insurance. Consider an individual who pays for a property insurance contract and later sells the property without canceling the insurance. In the event of subsequent loss to the property, the insurer will make no payment, because the insured has suffered no loss. Insurance payment is contingent on loss to an insured party, not merely on loss of the property described in the policy.

One result of the personal nature of insurance is that many insurance contracts are not freely assignable, or transferable, by the policyowner to other parties. Most insurance contracts, with the exception of life insurance, represent a personal agreement between the insurer and the policyowner. To permit a property or liability insurance contract to be assignable without the insurer's approval would be unfair to the insurer. Only by knowing and investigating each policyowner can the insurance company accurately calculate the potential losses it is insuring.

A life insurance policy can be assigned to another party, such as a charity. Assigning ownership of a life insurance policy does not generally change the insured's life expectancy.

Conditional Nature

conditional contract

A *conditional contract* is an agreement in which one party has an obligation to perform only if the other party meets certain conditions specified in the agreement. Insurance is a conditional contract, because the insurer is obligated to pay claims, defend the insured against liability claims, or perform other services only if the insured (or the life insurance policyowner) has complied with policy conditions. Insurance policy conditions place some

limitations on the insurer's obligations to perform by paying claims. Any failure by the insured to comply with policy conditions may relieve the insurer of its obligation.

An insurance contract condition is usually regarded as either precedent (before) or subsequent (after) the time at which a promise becomes binding on the promisor. An illustration of a common condition precedent, which must take place before a promise becomes binding, is the requirement in many insurance contracts that an insurer must have proper notice and proof of loss before the claim is payable. Note that the policyowner who has a loss has no contractual obligation to file an insurance claim, but the insurer is not obligated to pay unless the policyowner makes a claim in the proper manner. An example of a condition subsequent is an insured's obligation to cooperate with the insurer in defending a liability claim. If the insured does not cooperate, that failure subsequently relieves the insurer of its earlier obligation to pay.

Contract of Adhesion

contract of adhesion

A *contract of adhesion* is prepared in all its details by one party, in contrast to a bargaining contract, in which the terms are negotiated between the parties to the contract. An insurance contract is usually characterized as a contract of adhesion because the insurer ordinarily prepares all its details. The policyowner has no part in drafting its clauses or determining its wording. When applying for insurance, the applicant either accepts the policy as prepared by the insurer (adheres to it) or does not purchase the insurance.

The insurer does not always create the wording for the contract. Sometimes legislation requires that specific wording be used. State regulators often approve policy wording.

Sometimes the policyowner is a large corporation that asks for and obtains special contract provisions. In these cases, the intent of the entire contract, and of both the insurer and the policyowner, will probably be considered in court interpretations of any contract ambiguities.

Benefit of Doubt to Policyowner

The insurer that drafts an insurance contract has an opportunity to represent its intentions clearly. If the terms of an insurance policy are ambiguous, obscure, or susceptible to more than one reasonable interpretation, the construction most favorable to the policyowner generally prevails. It is nearly impossible for insurers to draft contracts that clearly describe every possible situation that might develop. Therefore, in cases of ambiguity in insurance contracts, this principle often helps policyowners.

Need for Policyowners to Read Contract

Where there is no ambiguity, an insurance contract is to be enforced in accordance with its terms. If the contract is clear and understandable, few

interpretations are necessary. Readers must consider the generally understood meaning of the terms used and examine the entire context to determine the nature and extent of coverage.

The law holds persons to be bound by the terms of a written contract that they sign or accept, regardless of whether they have acquainted themselves with all of its terms and conditions.³⁷

Most people do not read their policies. Insurance contracts are complicated and difficult to understand. Policyowners assume that a policy meets their needs and let it go at that. However, when a loss occurs, claiming ignorance of the policy's terms because of failure to read the agreement is no defense. The policyowner's failure to read the contract does not change or extend the rights of the policyowner as stated in the written policy. A financial planner's advice to insurance buyers should be: "To avoid problems (and uncertainties), know what is in your insurance policy by reading it, having it explained, or both."

Oral Evidence

parol evidence rule

The *parol evidence rule* is a legal principle that specifies that oral contemporaneous evidence may not be used to contradict or vary the terms of a valid written contract. Thus, with the parol evidence rule, for example, a policyowner may not usually contradict the written contract by saying that the agent promised that the policy covered a specific type of loss.³⁸

Although the written contract is not ordinarily subject to modification by oral evidence, the language of the policy is nevertheless not binding in clear cases of mutual mistake of fact. In some cases, the injured party has a right in equity to ask that the contract be reformed to the true agreement. An example might be a contract that misspells the name of the insured.

Contract of Indemnity

contract of indemnity

A *contract of indemnity* is one in which the insurer agrees, if a covered loss occurs, to pay an amount directly related to the amount of the loss. Most property, liability, and health insurance contracts are contracts of indemnity. A policyowner is entitled to payment only to the extent of financial loss or legal liability. The policyowner might not be made completely whole because of policy limits and other policy provisions and limitations, such as deductibles.

principle of indemnity

Indemnity refers to financial compensation. According to the *principle of indemnity*, the purpose of insurance is to indemnify (financially compensate) people entitled to insurance benefits in an attempt to make them financially

37. This is the general rule—see *Grace v. Adams*, 100 Mass. 505. However, some cases seem to say that the policyowner does not have to read his or her policy. Special situations sometimes occur, such as those in which the policyowner has reasonably relied upon advice of a professional agent, but it is unwise for policyowners to assume that courts will be lenient in excusing policyowners from a contract's written terms.

38. *Northern Assurance Co. v. Grand View Building Assn.*, 182 U.S. 380 (1902).

whole; however, people should not profit from an insured loss. Insurance supports the principle of indemnity. However, insurance does not necessarily make people completely whole, as insurance benefits are subject to policy limits, deductibles, and other limitations.

Example:

Assume an insured has an individual major medical policy with a \$1 million lifetime limit. Also assume that the policy limits hospital room and board benefits to the cost of semiprivate accommodations. Furthermore, assume that the insured is hospitalized and incurs \$25,000 in hospital bills, \$1,200 of which is for the extra cost of a private room occupied at the insured's request. The policy will reimburse the insured for \$23,800 of the hospital expenses, minus policy deductibles and percentage participation. Therefore, the insured has been reimbursed to the extent of his or her financial loss, subject to policy limits and provisions.

valued contract

A *valued contract* specifies the amount the insurer will pay in the event of a specified loss—usually a total loss. This amount does not depend on the actual value of the loss. Although most insurance contracts are contracts of indemnity, some are valued contracts. Life insurance is the most common example. The insurer must pay the stated death benefit if the insured dies. The insurer cannot, for example, deny full payment under a \$1 million life insurance policy by arguing that the insured's life was worth only \$650,000.

Insurable Interest**insurable interest**

Most insurance contracts contain an element of *insurable interest*. An insurable interest is a right or relationship with regard to the subject matter of the insurance contract such that the policyowner would suffer financial loss from its damage, loss, or destruction.

The purposes of requiring an insurable interest in insurance contracts are to prevent gambling and to decrease moral hazard. Without an insurable interest, an insurance contract might be a wager or gambling contract. The contract also could provide an undesirable incentive to cause losses or injuries purposely. When an insurable interest exists, no profit results from an insurance claim settlement, because policyowners merely receive repayment for the loss they have suffered.

A property owner has an insurable interest in that property, because the owner could suffer a financial loss if the property is destroyed by fire, windstorm, or some other peril. Mortgagees, bailees, and creditors may have insurable interests, and often several persons have an insurable interest in the

same property. A homeowner may insure his or her interest in property, for example, while at the same time the policy insures the mortgagee's interest up to the value of the mortgage loan.

The continuance of life and good health serves as the basis for many other examples of insurable interest. Death, injury, or sickness may result in financial losses to the persons insured or to their families, creditors, business partners, or employers. The right of persons to insure their own lives, as well as the right of close family members to insure blood relatives, is based on a presumed insurable interest. Other insurable interests for life or health insurance are based on potential losses, either increased expenses or reduced income potential, resulting from the relationship to the insured. For example, a creditor may insure the life of a debtor, normally up to the amount of the loan, or a business person may insure a partner's life for the potential loss that his or her death would cause for the partnership.

When must an insurable interest exist? The situation is different with life insurance than with property insurance. Life insurance requires an insurable interest only when the insurance contract is purchased. The insurer is obligated to pay a life insurance claim even if the current policyowner does not have an insurable interest in the insured's life at the time of the insured's death. This long-standing life insurance principle has raised recent questions and ethical concerns in light of the growing market for life insurance settlement agreements, in which a life insurance policy is sold for a portion of its face value to a third party who has no insurable interest in the life of the insured but acquires the policy as an investment that is expected to return a profit when the insured dies.

With property insurance, an insurable interest must exist at the time of the loss. It is not enough for an insurance policy to be in force that lists the property that was damaged. The policy must also provide coverage for a party who has an insurable interest in that property. Without an insurable interest, that party would have no loss. In practice, people do not usually buy property insurance unless they have an insurable interest, and insurers do not usually sell property insurance to people with no insurable interest in the property.

Insurable interest never becomes an issue in liability insurance. Unless a claim is made, there is no need to raise the issue. If a claim is made, the claim itself proves that the insured could have a liability claim that would result in financial loss.

Subrogation Rights

The common-law doctrine of *subrogation* provides that an insurer who has paid a claim under a contract of indemnity takes over any rights of recovery that the insured might have against another party responsible for the loss. In common law, a person who causes a loss to another is responsible for that loss.

subrogation

Example:

Jonathan's negligent burning of trash sets fire to his neighbor Laura's house. Therefore, Jonathan will be held responsible for paying for the damage to Laura's house. Laura will probably submit a claim to the insurance company that provided her homeowners policy. The insurer will pay Laura's claim, subject to any deductible, and then take over Laura's rights to recover from Jonathan. (Jonathan might be protected by liability insurance that ultimately pays the claim on Jonathan's behalf, but that is not the issue here.)

The right of the insurer against other negligent persons usually does not rest on any contractual relationship. As a general rule, an insurer has the right of subrogation even when there is no subrogation clause in the indemnity contract. For the most part, an insurance policy's subrogation clause merely makes the policyowner aware of this common-law doctrine. In some cases, however, the clause might also modify the insurer's subrogation rights.

The right of subrogation by the insurer is limited in amount to the loss payment made to the insured. The insurer may not make a profit by subrogating against the person who caused the loss and recovering a larger amount than the insurer has paid. In fact, subrogation rights are often of little value to the insurance company. There may be no doubt that someone else was responsible for the loss, but to recoup its loss payments (1) the insurer must prove the liability of the wrongdoer and (2) the negligent party must have the financial ability to pay for the loss he or she caused. In many cases, the expense or difficulty of legal proof may prevent the insurer from exercising its subrogation rights. If it might cost \$1,000 to collect a \$600 claim, the subrogation right may be worthless.

The importance of subrogation differs greatly for various types of insurance. In life insurance, which is a valued contract rather than a contract of indemnity, subrogation is not used at all. Subrogation is commonly used in property and liability insurance and, to a lesser extent, in health insurance.

A common illustration of subrogation is found in auto insurance. If the insurer first pays under collision coverage for damage to the insured's car caused by the negligent driver of another car, then the insurer takes over the rights of the policyowner by subrogation and files a claim against the other driver involved in the accident to receive reimbursement. If the insured does not receive full payment from the insurer because of a deductible in the policy, the insured retains the right to file a claim against the other driver for that deductible. Often the insurer files a joint suit for the loss on its own behalf and on behalf of the insured, but the insurer is not obligated to do so.

Three final points should be made about subrogation. First, insurers often agree in their contracts that they will not pursue a subrogation claim against anyone who is an insured under the policy.

Example:

Suppose Theresa lends her car to Jared, who causes an accident while driving it. Assuming Theresa has collision coverage on her auto policy, the insurer will pay Theresa, the car owner with the insurable interest in the car. The insurer will not subrogate against Jared, because he is also an insured.

Second, some insurance contracts permit an insured to waive rights of recovery before any loss occurs.

Example:

An insured signed a lease agreement that the landlord is not responsible for any damage to the tenant's property. If the landlord's negligence causes a fire that damages the tenant's property, the tenant then has no right to recover from the landlord. The tenant's fire insurance will pay for the tenant's loss. Because the tenant has no rights of recovery to transfer to the insurer, the tenant's insurer cannot take over those (nonexistent) rights and recover from the landlord.

Third, the policy or court interpretations of subrogation may specify the insured's right to retain any subrogation proceeds if the insured has not been fully indemnified for a loss because of deductibles, copayments, exclusions, or inadequate limits. In some cases, the insurer and the insured will share the proceeds on a pro rata basis. In other cases, the insured must be fully indemnified before the insurer is entitled to any recovery.

Effect of Concealment, Misrepresentations, and Fraud

Concealment and misrepresentation are easily confused. *Concealment* is failure to affirmatively disclose relevant information. Concealment occurs, for example, if an applicant for property insurance knows that the building is in imminent danger of collapsing but does not disclose this fact to the insurer. This building's condition is obviously a material fact that would affect the insurer's underwriting decision.

concealment

Figure 6–2 Elements of Fraud

Courts consider six elements when evaluating allegations of fraud. The first five elements must be present to rescind a contract on the basis of fraud. The sixth element must also be necessary for a plaintiff to obtain damages.

The six elements of fraud are as follows:

- *False representation*
A party must misrepresent a past or existing fact.
- *Knowingly made*
A party must know a fact to be false or must have made the representation in reckless indifference toward the truth or falsity of the statement made.
- *Intent to influence or deceive*
One party must have intended to influence or deceive another party.
- *Material fact*
The misrepresented fact must have influenced or induced the other party to enter the contract or affected the terms under which the other party would have been willing to contract.
- *Reasonable reliance*
The innocent party must show justification in relying on the statement.
- *Detriment*
In a suit for damages, the plaintiff must show injury or loss.

Source: Wiening, Eric A., *Foundations of Risk Management and Insurance*, Malvern, PA: American Institute for CPCU, 2002, p. 9.10.

misrepresentation

Misrepresentation, on the other hand, occurs when an insurance applicant makes a false statement of a material fact. The applicant who owns the about-to-collapse building would be guilty of misrepresentation if he or she stated that the building was in sound structural condition. To clarify the distinction between concealment and representation, concealment is concealing material information and misrepresentation is knowingly providing false information. An applicant conceals by maintaining silence when there is an obligation to speak; he or she misrepresents by making an untrue statement.

voidable contract

Either concealment or misrepresentation may make an insurance contract a voidable contract. A *voidable contract* may be affirmed or rejected at the option of one of the parties, although it is binding on the other. If an insurance applicant has concealed or misrepresented material information, the insurer may have a right not to honor the contract. But the insurer may also choose to honor the contract. A policyowner rarely has the right to treat an insurance policy as voidable. Perhaps such a situation could arise if the insurer or its agent has grossly misrepresented the contract benefits.

void contract

Sometimes people confuse the terms *void* and *voidable*. A *void contract* has no legal effect, and neither party may enforce it. A void contract is void from the beginning; it is as if it never existed. For example, an illegal gambling contract cannot be enforced through the courts; strong-arm enforcement

systems are sometimes used, but that is not the point here. Concealment and misrepresentation make insurance contracts voidable, not void.

fraud

Concealment and misrepresentation often involve *fraud*, as Figure 6–2 explains. If an applicant commits fraud in procuring an insurance policy, the policy may be voidable by the insurer. A policyowner’s fraud in connection with a loss or at any other time may also make an insurance contract voidable by the insurer.

Warranties**warranty**

When an application for insurance is made a part of the policy, the answers to specific questions on the application may be considered *warranties*. If false, they make the policy voidable by the insurer regardless of their materiality. Some warranties may also be specifically added in the policy, such as the promise of the policyowner in a burglary policy that an alarm system will be maintained or a security guard will be required.

representation

The difference between a warranty and a representation is that a warranty is a part of the contract itself and must therefore be strictly complied with, whereas a *representation* is usually an incidental statement preceding the contract, although it may be an inducement to it. The difference, in effect, is that to make the contract voidable, a warranty need only be false, whereas a representation must be both false and material.

To constitute a warranty, a statement must not only be intended, but must also be definitely indicated as a warranty, either by its incorporation into the policy or by specific reference. Where there is any doubt as to whether a warranty was intended, the statement is to be regarded as a representation and must be shown to be material in order to defeat the policy.

Many states have modified by legislative act the strict application of the doctrine of warranties for most kinds of insurance except ocean marine insurance. When the doctrine has been thus modified, the insurance is sometimes voidable only if a loss occurs during a breach of warranty or is caused thereby, or if the breach materially increases the risk. In effect, this causes most warranties in insurance contracts today to be considered representations. In some lines of insurance, the application itself specifies that statements contained in it are representations, not warranties. Warranties incorporated into insurance policies should be complied with to the letter, for some courts still tend to enforce the original strict rule of declaring the policy voidable when a warranty is breached, regardless of how trivial or immaterial the loss.

ANALYZING AN INSURANCE CONTRACT

The typical insurance contract appears to be a long, complex, formidable legal document. However, an insurance policy is much less formidable to

a financial planner who has learned a system or framework for analyzing insurance contracts. The remainder of this chapter provides such a framework. The following discussion includes some examples that involve insurance policy extracts taken out of context. Later chapters, which consider types of insurance that deal more specifically with various coverages, will examine these provisions in context.

The provisions of the typical insurance contract can be grouped into the following categories, depending on the purposes they serve: declarations, definitions, insuring agreements, exclusions, conditions, and miscellaneous provisions. The contract also may be modified by adding endorsements or riders.

Declarations

declarations

Every insurance contract has a set of declarations, although they are not always labeled. *Declarations* are factual statements that identify the specific person, property, or activity being insured and the parties to the insurance transaction; they also provide descriptive information about the insurance being provided. They are usually grouped together in the initial section of the policy and are computer-printed for the individual contract, rather than preprinted for all contracts of the same type.

The declarations section of a life insurance policy typically shows the names of the insurer and the agent, the name and age of the insured, the name of the policyowner if different from the insured, the type of policy, the amount of insurance, the policy number, the effective date, the premium, and a listing of attachments to the policy showing such items as supplementary benefits and the beneficiary designation. In property and liability insurance contracts, the declarations section of the policy shows similar types of information as well as the address of the property or activity covered, a listing of endorsements attached to the policy, the names of additional persons or organizations whose interests are insured (such as a mortgagee), the period of coverage, and any applicable deductibles.

Definitions

definitions

Because an insurance policy is a contract of adhesion, the insurer must define carefully what it covers or does not cover. As mentioned earlier, ambiguities in the contract are likely to be construed against the insurer. The *definitions* in the policy explain the key policy terms and are a major help in precisely defining the insured's intentions.

Often words or phrases that are included among the definitions appear in boldface type or quotation marks elsewhere in the policy. The definitions are usually grouped together in an early section of the policy or appear near the end of the policy, serving as a kind of glossary. Examples of a few terms that may appear in the definitions section of insurance contracts are as follows:

- in life insurance—"you," "we," "designated office (of the insurer)," "beneficiary," and "new policy"
- in disability income insurance—"monthly earnings," "qualifying period," and "total disability"
- in auto insurance—"bodily injury," "family member," "occupying (an auto)," "your covered auto," and "trailer"
- in homeowners insurance—"business," "insured," "insured location," "occurrence," and "residence employee"

One of the more important definitions in many policies stipulates who is an insured. This definition is discussed in more detail in later chapters as it applies to specific lines of insurance. In homeowners policies, an "insured" includes the person named in the declarations, his or her spouse and relatives if residents of the household, and persons under age 21 residing in the household and in the care of the named insured, spouse, or resident relatives. Full-time students are also included as insureds, provided they were residents of the household before moving out to attend school, are relatives under the age of 24, or are under the age of 21 and in the care of the named insured or another relative. In the liability section of the personal auto policy, the definition of "insured" includes the named insured and his or her spouse if a resident of the household and for up to 90 days after ceasing to be a member of the household. The definition also includes family members (as defined in the policy) who are residents of the household, anyone using a covered auto, and any person or organization that might be held vicariously liable for use of the auto. Thus, Tom's personal auto policy protects even Tom's employer, as an insured, against liability claims involving Tom's car. If Tom strikes a pedestrian while using his car on business, and the pedestrian sues Tom's employer, Tom's employer is covered as an insured.

Words and phrases not specifically defined in the contract are interpreted according to the following general principles:

- Everyday language is given its ordinary or normal meaning.
- Technical terms are assigned their technical definitions.
- Terms that have an established legal meaning are given that meaning.
- Where appropriate, meanings of words take into account local, cultural, and trade usage considerations.

Insuring Agreements

insuring agreement

The *insuring agreement* is the core of any insurance policy. This insuring agreement (or agreements, as many contracts contain several insuring agreements) spells out the basic promise of the insurance company. Examples of these promises are to pay the face amount of the policy in the event of the insured's death, to defend the insured in any suit alleging liability associated with an auto accident, to pay the actual cash value of personal property damaged by a covered peril, and to pay up to \$250 per day for loss of earnings because of the insured's attendance at a court hearing at the insurer's request.

The main insuring agreements in insurance policies are usually either the open-perils type or the named-perils type. An open-perils agreement, also known as an all-risks agreement, covers all losses except those that the policy specifically excludes. All policies have at least a few exclusions, and some have many. For example, a whole life insurance policy is an open-perils policy because it covers death from any cause except a few specified ones, such as death by suicide during the policy's first 1 or 2 years and, in some policies, death by war or specifically excluded activities, such as skydiving or crop dusting.

The named-perils or specified-perils policy approach to the insuring agreement is used in the personal property coverage of most homeowners policies. This agreement covers only losses that arise from one of the listed perils. If the peril is not listed, the loss is not covered. For example, one homeowners policy form states that it covers direct physical loss caused by fire; lightning; windstorm; hail; explosion; riot; civil commotion; aircraft; vehicles; smoke; vandalism; malicious mischief; theft; falling objects; weight of ice, snow, or sleet; accidental discharge or overflow of water or steam from certain household systems; and a few other perils. Flood is not contained in the list, so loss to personal property due to flood is not covered.

Exclusions

exclusions

As noted earlier, every insurance policy has *exclusions* identifying types of claims that the insurer does not cover. The exclusions usually apply either to certain perils, types of losses, types of property, or types of activities. For example, in major medical expense insurance, loss due to the peril of occupational injury or illness is usually excluded because the loss is covered under workers' compensation insurance. In long-term care insurance, costs of care for which the insured is reimbursed under a government program are excluded. In homeowners insurance, the property of unrelated boarders is excluded. And in auto insurance, losses arising from use of the vehicle in a prearranged or organized racing contest in a facility designed for racing are excluded.

The following are the principal reasons for the presence of exclusions in insurance policies:

- Some perils are uninsurable by private insurers.³⁹ Examples of such perils are wear-and-tear losses to auto and losses due to war.
- Some conditions pose a major increase in risk not contemplated in the basic premium for the coverage. Examples of these conditions are, in auto insurance, the use of an auto to carry persons for a fee other than in a simple carpooling arrangement and, in medical expense insurance, the cost of long-term custodial care.
- Some losses are best covered by other types of policies. For example, collision damage to an auto is not covered by a homeowners policy,

39. See the discussion of the requirements of insurable risks in chapter 1.

and losses due to occupational injury may be excluded by a disability income insurance policy.

- Coverage of some losses would pose too great a potential moral hazard. For example, loss of more than a specified dollar amount of cash is excluded by homeowners policies.
- Some coverages are not needed by most policyowners, so they should not have to pay for them. For example, most individual medical expense insurance policies exclude or limit maternity coverage.

A practical reason for exclusions is to hold down the cost of coverage for policyowners.

Conditions

The insuring agreement is not an absolute promise by the company with "no strings attached." Instead, the promise is a qualified one, enforceable only if the policyowner fulfills the conditions spelled out in the policy. Those conditions may be grouped together in a section of the policy labeled "Conditions," or they may be scattered throughout the policy and its endorsements or riders.

The policyowner must fulfill most of the conditions in an insurance policy before the insurer may be held liable for a loss. An example of one of these conditions, called a condition precedent (introduced earlier in this chapter), is timely payment of premiums.

Many conditions relate to claims. Most policies, with the exception of life insurance, contain provisions pertaining to the time period within which the insurer must be notified of a loss and the time period within which the insured must file a formal proof of loss. The information that must be included with the formal proof of loss may also be specified.

The insured must fulfill other conditions, called conditions subsequent (also introduced earlier), after the insurer has become liable in order to avoid releasing the insurer from liability. All policies specify that the insured must cooperate with the insurer. As an example of a condition subsequent, disability income insurance policies include the condition that the insurer can require the insured to submit to examinations by an insurer-selected physician at reasonable intervals during the continuation of a claim. Property and liability insurance policies include the condition that the insured must do nothing to jeopardize the insurer's right to recover from responsible third parties and the condition that the insured must cooperate with the insurer in legal proceedings against the insurer by a third-party claimant.

Miscellaneous Provisions

Some provisions in insurance contracts do not fall into any of the preceding categories of declarations, definitions, insuring agreements, exclusions, or conditions. These provisions may deal with policy continuation, valuation of losses, or other administrative aspects of the policy.

Policy Continuation Provisions

Some of the more important miscellaneous provisions in an insurance policy relate to the policyowner's right to continue the coverage in force. Although policies can be issued for a specific term and terminate at the end of that term, many policies allow the policyowner to renew the policy and/or allow the insurer to refuse renewal. These policy renewal provisions fall into four categories: noncancelable, guaranteed renewable, nonrenewable for stated reasons only, and optionally renewable. In addition, some policies are cancelable.

noncancelable

Noncancelable. Some types of insurance policies are *noncancelable*, giving the policyowner the right to renew the coverage at each policy anniversary date, although possibly only until some stated age, such as age 65. A noncancelable policy may not be terminated by the insurer during the period of coverage. Moreover, in a truly noncancelable policy, the future rates for the coverage are guaranteed in the contract itself. Examples of noncancelable policies are life insurance policies⁴⁰ and some disability income insurance contracts. The term "noncancelable" may not be as broad as it first seems because the National Association of Insurance Commissioners (NAIC) allows the term to be used in a health insurance policy as long as the policy continues to at least age 50 or at least 5 years if issued to a person aged 44 or older.

guaranteed renewable

Guaranteed Renewable. A guaranteed renewable policy provides a bit less certainty for the policyowner regarding the right to continue coverage. Guaranteed renewable policies are most often found in the health insurance area. Like a noncancelable policy, a *guaranteed renewable* policy gives the policyowner the right to renew the coverage at each policy anniversary date, but usually only until a stated age, such as age 65. The coverage may not be canceled by the insurer during the period of coverage. However, in a guaranteed renewable policy, the insurer does not guarantee future rates for the coverage. Instead, the insurer retains the right to raise the rates for broad classes of insureds, but not just for individual insureds with poor claims experience. Again, the NAIC allows the term to be used for policies that are guaranteed renewable only until age 50 or for at least 5 years if issued to persons aged 44 or older.

40. Term life insurance policies usually may be renewed only to a specified age, such as age 65 or 75, whereas whole life policies may be renewed for the insured's entire lifetime.

Example:

Several years ago, Eric Burton bought long-term care insurance for himself and his wife, Claire. They didn't want all their life savings to be depleted by the cost of nursing home or custodial care if they later needed it. They also wanted to leave their assets to their children and not burden them with providing health care for their parents.

The Burtons were extremely satisfied with their guaranteed renewable policies until a couple months ago when their premiums soared from \$3,250 per year to almost \$5,000. They were shocked, especially because they had believed that the premiums would never increase.

Although the guaranteed renewable provision in their contracts stated that their premiums would never rise based on Eric's and Claire's age or claims history, the insurer had reserved the right to increase premiums based on broad classes of insureds. Experience with long-term care insurance revealed that the insurer had initially underestimated its cost of providing the coverage, so a rate increase became necessary. Unlike in a noncancelable contract, future premium rates are not guaranteed.

Nonrenewable for Stated Reasons Only. Some policies that are otherwise guaranteed renewable allow the insurer to refuse to renew the policy for reasons specifically listed in the policy. These policies are referred to as nonrenewable for stated reasons only. These might include the attainment of a certain age. However, if this is the only condition, the policy still often qualifies as guaranteed renewable. Other possible conditions for nonrenewal include termination of the policyowner's employment in some disability income insurance policies and the nonrenewal of all policies bearing the same form number as the policyowner's.

Optionally Renewable.**optionally renewable**

Provisions in most property and liability insurance policies give the insurer the unilateral right to refuse to renew a policy at the end of any period for which premiums have been paid. These policies are referred to as optionally renewable. Even if the insurer agrees to renew the policy, it has the right to alter the policy's provisions. Some states have enacted legislation that allows an insurer to nonrenew only on annual anniversary dates. Regulations may also

require the insurer to give specified periods of advance notice to policyowners whose coverage will not be renewed.

Cancelable. A few property and liability policies are cancelable during the period for which premiums have been paid. However, midterm cancellation by the insurer is not allowed for auto and homeowners policies in many states. When a policy can be canceled, the policy and/or state law determines the period of advance notice that must be given to the policyowner. If the policy is cancelled by the insurer, a pro rata share of the premium must be returned.

Renewal provisions are summarized in Figure 6-3.

Cancelable	The insurer may terminate the policy at any time for any reason by notifying the policyowner (advance notice is usually required) and refunding any unearned premium. Some states prohibit midterm cancellation for some policy types.
Optionally renewable	The insurer has a right to refuse to renew the policy on its anniversary or premium-due date. Advance notice must be given to the policyowner.
Nonrenewable for stated reasons only	The insurer may refuse to renew the policy, but only for one of the specific reasons stated in the policy.
Guaranteed renewable	As long as premiums are paid, the insurer must renew the policy, sometimes subject to an age limit. The insurer may increase the premium rate for the entire class of policies.
Noncancellable	As long as premiums are paid, the insurer must renew the policy at a guaranteed premium rate specified in the policy, at least until the insured reaches a specified age.

Loss-Sharing Provisions

Another type of miscellaneous provision in several types of insurance policies requires insureds to share in the amount of the loss. For example, dollar deductibles are common in homeowners insurance, auto physical damage insurance, and medical expense insurance. Most common is an initial deductible, under which the insurer will pay claims to the extent that they exceed a specified amount. The amount, such as \$500, may apply to each claim, as is common in property insurance policies, or to a period of time, such as a calendar year, as in medical expense policies. A similar provision is a time deductible in the form of a waiting or elimination period, during which no benefits are payable. Time deductibles are common in equipment breakdown insurance, disability income insurance, and long-term care insurance.

Other loss-sharing provisions are the coinsurance clause and copayment requirement in major medical and other types of medical expense coverage.

Under these types of provisions, the insured is required to assume a portion of certain covered expenses. For example, the insurer may pay 80 percent of certain medical expenses under a coinsurance clause, while the insured assumes 20 percent. Or the insured may pay a \$10 or \$20 copayment for each doctor's visit.

Several types of insurance contain a miscellaneous provision that explains how the insurer will respond if other insurance covers the same loss. This might be referred to as an other insurance clause. For example, the property insurance portion of homeowners policies provides that the insurer will pay only that proportion of the loss that the limit of liability applicable in the homeowners policy bears to the total amount of insurance in all policies covering the loss. The liability section specifies that the homeowners coverage is excess over other valid and collectible insurance, except insurance written specifically to provide excess coverage over that of the homeowners policy. An umbrella policy, described in chapter 18, is the most common example of a liability insurance policy specifically written to provide excess liability coverage. Group health insurance often contains a coordination-of-benefits provision to prevent duplication of benefits when an insured is covered by more than one group health insurance plan. For example, if a wife has coverage as an employee under her own plan and is a dependent under her husband's plan, her coverage as an employee is primary and her coverage as a dependent is excess.

The loss-sharing provisions mentioned here are examined more closely in the context of specific coverages described in other chapters.

Other Miscellaneous Provisions

The following illustrate a few other miscellaneous policy provisions:

- Life insurance policies include a description of the optional modes of settlement under which the beneficiary may receive the death proceeds and a clause explaining the policyowner's right to assign the policy to another. There is also an incontestable clause stating that the insurer does not have the right to dispute a death claim if the policy has been in force for at least 2 years during the insured's lifetime. In addition, policies contain an explanation of how the death proceeds will be calculated if the insured's age or gender has been misstated. If the policy is issued by a mutual insurer, the policyowner's right to vote for the company's board of directors is also described.
- In annuity contracts, a provision allows the annuitant to delay or accelerate the date when the annuity benefits are to begin; a description of how to change the beneficiary of any death proceeds is also included.
- Disability income insurance policies may include a clause specifying to whom the policy benefits will be paid and another clause stating that the policy and the application attached to it constitute the entire agreement between the parties.

- In homeowners policies, several loss-settlement provisions describe losses that are covered on the basis of the cost to replace with new materials, called replacement cost, and losses where coverage includes a deduction for depreciation, referred to as actual cash value, as well as how a dispute between the insurer and insured over the amount of a loss may be resolved through an appraisal process.
- Personal auto insurance policies contain a provision stating that insolvency or bankruptcy of the insured will not relieve the insurer of any of its obligations under the policy, a description of how coverage applies in a state other than the one where the auto is principally garaged, and an explanation of how disputes between the insured and the insurer on matters of coverage may be resolved through arbitration.
- Several types of policies, including life, health, and annuity contracts, provide a grace period of 30 or 31 days. If a premium is paid after its due date but within the grace period, the coverage is still in effect. Note that property and liability insurance policies do not provide a grace period.
- Some types of policies allow for reinstatement of the coverage under certain conditions after the policy has lapsed. In life insurance, for example, the right to reinstate usually is available only for 3 years following the lapse and only if the policy has not been surrendered for cash or the period of extended term insurance has not expired.

Endorsements or Riders

endorsement
rider

An *endorsement*, or in life insurance a *rider*, is a provision added to the policy, sometimes for an extra premium charge or a premium reduction, by which the scope of its coverage is clarified, enlarged, or restricted. An endorsement may alter the declarations, such as identifying a mortgage holder in a homeowners policy. Endorsements also may add new definitions to the policy, or modify exclusions in the policy, such as removing earthquake from the list of excluded perils in a homeowners policy. Endorsements may even modify a policy condition, such as amending a 30-day notice of nonrenewal to conform with the statute of a particular state that requires a 60-day notice, or a miscellaneous provision, such as limiting the insurer's right to cancel the policy to only specified reasons. Similarly, a rider may modify the insuring agreement—for example, adding to a life insurance policy a waiver-of-premium benefit that eliminates the need for a disabled policyowner to pay premiums.

As a general legal principle, whenever the wording in an endorsement or rider conflicts with the terms of the policy to which it is attached, the endorsement or rider takes precedence. This principle is based on the assumption that an alteration of the basic agreement between the policyowner and insurer more accurately reflects the true intent of the parties than does the basic agreement itself.

Contents of an Insurance Contract

- Declarations—statements of fact that identify the parties to the insurance transaction, the amount of insurance, the property or activity being covered, the effective date of the coverage, etc.
 - Definitions—precise meanings of terms used in the contract, like "family member," "disability," "covered auto," etc.
 - Insuring agreements—the promises made by the insurer, such as to pay, to defend, to reimburse, etc.
 - Exclusions—the perils, properties, types of losses, circumstances, etc. that the insurance does not cover
 - Conditions—the duties that (usually) the insured must fulfill before the other party is held to the terms of the contract
 - Miscellaneous provisions—other clauses that do not fall into the above categories, such as those concerning policy continuation, loss valuation, optional modes of settlement, etc.
 - Endorsements or riders—provisions added to the policy to modify or clarify the coverage, sometimes for an extra premium or a reduced premium
-

MINI-CASE: AMY AND JOHN SCHULTZ

Case Facts

Because their cars were getting old, Amy and John Schultz decided to trade in Amy's Saturn and buy a new car before going on a 2-week cross-country vacation. As soon as they got home from the dealership, they called their insurance agent, provided the necessary information on the new car, and discussed their coverage options. The agent said they would receive a bill for the additional premium involved in insuring their new car and assured them coverage on the new car was now bound, and they were protected immediately.

Amy and John also asked their insurance agent if they could obtain some life insurance coverage before they left on their trip next week. The agent informed them that they should come down to her office, complete an application, and pay the premium, but that she could not assure them that the policy would be in force in time for their vacation trip. On the way to the agent's office, John instructed Amy not to tell the agent that Amy had recently been treated for depression.

Case Analysis

1. If Amy and John complete life insurance applications today, pay the premiums, and have their applications approved, when will their policies become effective?

2. In completing a life insurance application, Amy provides an incorrect answer to the question about whether she had ever been treated for depression. How, if at all, will this affect Amy's life insurance coverage?

Case Solution

1. If the insurer determines that Amy's and John's applications are acceptable without physical exams, Amy's and John's life insurance policies will become effective as of the date of the application because they paid the premiums with the application. Therefore, they would be covered if either of them dies during the vacation—even if their application is not approved until later—but only if the insurer determines that they meet the insurer's underwriting standards. If they do not, the insurer may make a counteroffer, such as offering coverage at a higher premium or in a more limited amount.
2. Because the application specifically asked about depression and Amy provided a false answer to that question, Amy is guilty of misrepresentation. If the insurer accepts the application based on the false information, and she dies while on vacation, her survivors would not be able to enforce the contract. As we will see in chapter 9, a life insurance policy also contains an incontestable clause that will prohibit the insurer from disputing the validity of the policy after it has been in force for a specified period of time, such as 2 years.

SOURCES FOR FURTHER IN-DEPTH STUDY

- For a detailed discussion of the legal aspects of life insurance policies:
 - Graves, Edward E., and Christensen, Burke A. (editors), *McGill's Legal Aspects of Life Insurance*, 6th ed., Bryn Mawr, PA: The American College Press, 2008. Phone 888-263-7265. Web site address theamericancollege.edu.
- For a detailed discussion of insurance contract analysis, with emphasis on property-liability insurance:
 - Wiening, Eric A., and Malecki, Donald S., *Insurance Contract Analysis*, Malvern, PA: American Institute for Chartered Property Casualty Underwriters, 1992. Chapter 2, "Reading an Insurance Policy," provides a detailed framework for policy analysis. Phone 800-644-2101. Web site address aicpcu.org.
 - Wiening, Eric A., *Foundations of Risk Management and Insurance*, Malvern, PA: American Institute for Chartered

- Property Casualty Underwriters, 2002. Chapter 11 contains a less detailed version of the material in the preceding listing. Phone 800-644-2101. Web site address aicpcu.org.
- Wollner, Kenneth S., *How to Draft and Interpret Insurance Policies*, West Bloomfield, MI: Casualty Risk Publishing, LLC, 1999. Phone 800-862-9792. Can be ordered at irmi.com.

CHAPTER REVIEW

Key Terms and Concepts

unilateral contract	fraud
conditional contract	warranty
contract of adhesion	representation
parol evidence rule	declarations
contract of indemnity	definitions
principle of indemnity	insuring agreement
valued contract	exclusions
insurable interest	noncancelable
subrogation	guaranteed renewable
concealment	optionally renewable
misrepresentation	endorsement
voidable contract	rider
void contract	

Review Questions

Review questions are based on the learning objectives in this chapter. Thus, a [6-3] at the end of a question means that the question is based on learning objective 6-3. If there are multiple objectives, they are all listed.

- 6-1. Your client, Maria, complains that buying insurance is just like buying a new car in that you shop around, trying to get the best deal, but you don't get to enjoy the new car until you actually close the deal and drive it home. What unique aspects of an insurance contract differentiate it from other goods and services? [6-1]
- 6-2. Define the following legal requirements of an enforceable contract:
 - a. offer and acceptance [6-2]
 - b. legal purpose [6-2]
 - c. competent parties [6-2]
 - d. consideration [6-2]

-
- 6-3. Define the following legal characteristics of an insurance contract:
 - a. unilateral nature [6-3]
 - b. personal nature [6-3]
 - c. conditional nature [6-3]
 - 6-4. Your client, Sue Litigator, would like to know her legal rights concerning the following situations:
 - a. Sue claims that one of the provisions in the insurance contract is unclear. [6-3]
 - b. Sue wants to ignore a portion of the contract she did not read. [6-3]
 - c. Sue claims that the insurance agent told her something that contradicts the language of the contract. [6-3]
 - 6-5. Teddy, your client's son, says he has heard that if he has an accident with his old car, the insurance company will buy him a new car. How does Teddy's insurance work as a contract of indemnity? [6-3]
 - 6-6. After her accident-prone cousin's second car accident within 2 months, your client, Julie, asks you if she could buy insurance on the cousin's new car. Julie thinks this might be a good investment, because the cousin is such a bad driver that she will probably have another accident, and the insurance company will then have to pay Julie if Julie has insured the car. You tell Julie that she cannot insure somebody else's car. What are three reasons for requiring an insurable interest in insurance contracts? [6-3]
 - 6-7. Does your client have an insurable interest in the following situations?
 - a. Your client lent a large amount of money to a friend who is starting a business. [6-3]
 - b. Your client owns and drives a fancy red sports car. [6-3]
 - c. Your client owned a precious stone that was destroyed soon after he gave it to his girlfriend. [6-3]
 - 6-8. Cheryl Eng, a client of yours, was responsible for an auto accident that damaged the other driver's car. Cheryl was pleased to hear that the other driver had insurance that paid for the damage to his car. Cheryl has just learned that the other driver's auto insurance company has asked Cheryl's insurer for reimbursement. "Can they do that?" she asks you. How does the doctrine of subrogation apply to insurance contracts? [6-3]
 - 6-9. What is the difference between concealment and misrepresentation by an applicant for insurance? [6-3]
 - 6-10. What is the purpose of each of these components of a typical insurance contract?
 - a. declarations [6-4]
 - b. definitions [6-4]
 - c. insuring agreements [6-4]
 - d. exclusions [6-4]
 - e. conditions [6-4]

- 6-11. What is the major distinction between a noncancelable policy and a guaranteed renewable policy? [6-4]
- 6-12. The wording in an endorsement to your client's insurance policy conflicts with the terms of the policy itself. What is the significance of this conflict for your client? [6-4]

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