**CHAPTER FOUR**

**LEGAL PRINCIPLES OF INSURANCE CONTRACTS**

**4.1. PRINCIPLE OF INDEMNITY**

The principle of indemnity is one of the most important legal principles in the field of insurance. The principle of indemnity states that the insured should not profit from a covered loss but should be restored to approximately the same financial position that existed prior to the loss. Most of the property insurance contracts are indemnity contracts. If a covered loss occurs, the insured should not collect more than the actual amount of the loss.

The principle of indemnity has two fundamental purposes:

The first purpose is **to prevent the insured from profiting from insurance**. The insured should not profit if a loss occurs, but should be restored to approximately the same financial position that existed before the loss. For example, if Ato Melaku has insured his house for 100,000 birr and a loss amounted to 10,000 birr occurs, the principle of indemnity would be violated if 100,000 birr were paid to him; because he would be profiting out of insurance.

The second purpose is **to reduce moral hazard**. If dishonest insured can profit from a loss, they may deliberately cause a loss with the intention of collecting the insurance. Thus, if the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced.

**Actual Cash Value**

In property insurance, the standard method of indemnifying the insured is based on the actual cash value of the damaged property at the time of loss. The Courts have used three major methods to determine actual cash value;

1. Replacement cost less depreciation
2. Fair market value
3. Broad Evidence rule
4. **Replacement cost less depreciation**

Under this rule, actual cash value is defined as replacement cost less depreciation. This rule has been traditionally used to determine the actual cash value of property in property insurance. Replacement cost is current cost of restoring the damaged property with new materials of like kind and quality. Depreciation is a deduction for physical wear and tear, age and economic obsolescence.

For example, machinery has been insured against fire. It burnt out of a fire. Assume that the machinery was bought 5 years ago, and that machinery is 50% depreciated. The similar machinery would cost 10,000 birr. Under the actual cash value rule, the insured will collect only 5,000 birr for the loss of the machinery, because the replacement cost is 10,000 birr, but depreciation is 5,000 birr or 50%. If the insured were paid the full replacement value of 10,000 birr, the principle of indemnity would be violated, because the insured would be receiving the value of new brand machinery instead of one 5 years old. In short, 5,000 birr payment represents indemnification for the loss of 5 years old machinery. This can be summarized as follows;

Replacement Cost   = 10,000 birr

Depreciation   = 5,000 birr (Machinery is 50% depreciated)

Actual Cash Value = Replacement Cost – Depreciation

\ Actual cash value = 10,000 birr – 5,000 birr

                        = 5,000 birr

1. **Fair Market Value**

Fair market value is the price a willing buyer would pay a willing seller in a free market. The fair market value of a building may be below its actual cash value based on replacement cost less depreciation. This may be due to poor location, bad neighborhood or economic obsolescence of the building.

For example, in big cities, large homes in older residential areas often have a market value well below the replacement cost less depreciation. If a loss occurs, the fair market value may be used to determine the value of the loss. In one case, a building valued at $ 170,000 based on the actual cash value rule had a market value of only $ 65,000 when a loss occurred. The court ruled that the actual cash value of the property should be based on the fair market value of $ 65,000 rather than $ 170,000.

1. **Broad Evidence Rule**

The broad evidence rule means that the determination of actual cash value should include all relevant factors an expert would use to determine the value of the property. Relevant factors include replacement cost less depreciation, fair market value, and present value of expected income from the property, comparison sales of similar property, opinions of appraisers and other factors.

Although the actual cash value is used in property insurance, different procedures are followed for other types of insurance. In liability insurance, the amount paid for a loss is the actual damage the insured is legally obligated to pay because of badly injury or property damage to another. In business income insurance, the amount paid is usually based on the loss of profits plus continuing expenses incurred when the firm is shut down because of a loss from a covered period. In Life insurance, the amount paid upon the insured’s death is the face amount of the policy.

**Exceptions to the principle of indemnity**

The important exceptions to the principle of indemnity are as follows;

* Valued policy
* Valued policy laws
* Replacement cost insurance
* Life Insurance

**Valued policy**

A valued policy is one that pays the face amount of insurance regardless of actual cash value if total loss occurs. They are used to insure fine arts & rare paintings. Because of difficulty in determining the actual cash value of the property at the time of loss, the insured and insurer both agree on the value of the property when the policy is first issued. For example, you may have a valuable antique clock that was owned by your great-grandmother.

**Valued policy laws**

Valued policy laws are another exception to the principle of indemnity. The valued policy law is a law that exists in some states that requires payment of the face amount of insurance to the insured if a total loss to real property occurs from a peril specified in the law. The specified perils to which a valued policy law applies vary among the states. Some states cover only fire and others cover fire, lightning, wind storm and tornado. In addition, the laws generally apply only to real property and the loss must be total. For example, a building insured for 200,000 birr may have the actual cash value of 175,000 birr. If a total loss from a fire occurs, the face amount of 200,000 would be paid. Thus, the principle of indemnity would be violated.

**Replacement cost insurance**

Replacement cost insurance means no deduction is taken for depreciation in determining the amount paid for a loss. For example, assume the roof on your home is 5 years old and has a useful life of 20 years. The roof is damaged by a tornado, and the current cost of replacement is 10,000 birr. Under the actual cash value rule, you would receive only 7,500 birr (10,000 – 2,500 = 7,500 birr). Under a replacement cost policy, you would receive the full 10,000 birr. Since you receive the value of a brand new roof instead of one that is 5 years old, the principle of indemnity is technically violated.

**Life insurance**

Life insurance is another exception to the principle of indemnity. A life insurance contract is not a contract of indemnity but it is a valued policy that pays a stated sum to the beneficiary upon the insured’s death. The indemnity principle is difficult to apply, because the historical actual cash value rule is meaningless in determining the value of a human life.

**4.2. PRINCIPLE OF INSURABLE INTEREST**

The principle of insurable interest states that the insured must be in a position to lose financially if a covered loss occurs. For example, a person has an insurable interest in his automobile because he may lose financially if the automobile is damaged or stolen.

**Purposes of Insurable Interest**

Insurable interest is essential in an insurance contract for the following reasons;

First, an insurable interest is necessary **to prevent gambling**. If an insurable interest were not required, the contract would be a gambling contract and would be against the public interest. For example, one could insure the property of another and hope for a loss to occur. In the same way, one could insure the life of another and hope for an early death.

Second, an insurable interest **reduces moral hazard**. If an insurable interest is not required, a dishonest person could purchase a property insurance contract on some one’s property and then deliberately cause a loss to receive the insurance claims. But, if the insured person stands to lose financially, nothing is gained by causing the loss. Thus, moral hazard is reduced.

Finally, an insurable interest **measures the amount of the insured’s loss**in **property insurance**; most contracts of property insurance are contracts of indemnity. Thus, the measure of recovery is the insurable interest of the insured. The amount of indemnification is measured by calculating the insurable interest in monetary terms. For example, if a person’s property worth 1million Birr is insured and it was destroyed totally after some time, his insurable interest on that property depends on the financial loss met by him. Here, as the entire property is destroyed, his insurable interest tends to be 1 million Birr on that property. Thus, he will be indemnified the 1 million Birr.

**When must an insurable interest exist?**

**In property insurance**, the insurable interest must exist **at the time of loss**. There are two reasons for this requirement;

First, most property insurance contracts are indemnity contracts. If an insurable interest did not exist at the time of loss, financial loss would not occur. For example, if Ato Mesfin sells his car to Ato Yacob, and it was stolen before the insurance on the car is cancelled. Ato Mesfin cannot collect since he has no insurable interest on the car. Also Ato Yacob cannot collect as he is not named as an insured under the policy.

Second, one may not have an insurable interest in the property when the contract is first written, but may expect to have an insurable interest in the future, at the time of possible loss. For example, in a marine insurance, it is common to insure a return cargo by a contract entered into prior to the ship’s departure. However, the policy may not cover the goods until they are boarded on the ship as the insured’s property. Although an insurable interest does not exist when the contract is first written, one can still collect the claims if he has an insurable interest in the goods at the time of loss.

**In life insurance contracts**, the insurable interest requirement must be met only at the **inception of the policy**, not at the time of death. Life insurance is not a contract of indemnity, but it is valued policy that pays a stated sum upon the death of the insured. Since the beneficiary has only a legal claim to receive the policy proceeds, he need not show that a loss has been incurred by the insured’s death. For example, if Martha takes out a policy on her husband’s life and later gets a divorce, she is entitled to the policy proceeds upon the death of her former husband if she has kept the insurance in force.

 **4.3. PRINCIPLE OF SUBROGATION**

Subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance. This means that the insurer is entitled to recover from a negligent third party, any loss payments made to the insured.

For example, assume that a negligent motorist crashes into Admasu’s car, causing damages of 5,000 Birr. If Admasu has the collision insurance on his car, his insurance company will pay 5,000 Birr and then attempt to collect from the negligent motorist who caused the accident. Alternatively, if Admasu directly collect from the negligent motorist, the principle of subrogation does not apply. Because, the loss payment is not made by the insurance company. However, to the extent that a loss payment is made, the insured gives to the insurer legal rights to collect damages from the negligent third party.

**Purposes of Subrogation**

Subrogation has three basic purposes;

1. **Subrogation prevents the insured from collecting twice for the same loss**. In the absence of subrogation, the insured could collect from the insurer and from the person who caused the loss.
2. **Subrogation is used to hold the guilty person responsible for the loss**. By exercising its subrogation rights, the insurer can collect from the negligent person who caused the loss.
3. **Subrogation tends to hold down insurance rates**. Subrogation recoveries can be reflected in the rate making process, which tends to hold rates below where they would be in the absence of subrogation.

**Importance of Subrogation**

1. The general rule is that by exercising its subrogation rights, the insurer is entitled only to the amount it has paid under the policy. Some insured may not be fully indemnified after a loss because of insufficient insurance. Many policies currently have a provision stating how a subrogation recovery is to be shared between the insured and the insurer. However, in the absence of any policy provision, the courts have used different rules in determining how a subrogation recovery is to be shared. One commonly held view is that the insurer is entitled to any remaining balance up to the insurer’s interest, with any remainder going to the insured.

For example, Andrew has Birr 100,000 home insured for only Birr 80,000 under a home owner’s policy. Assume that the house is totally destroyed in a fire because of faulty wiring by an electrician. The insurer would pay Birr 80,000 to Andrew and then attempt to collect from the negligent electrician. After exercising its subrogation rights against the electrician, the insurer has a net recovery of 50,000 Birr. Thus, Andrew would receive 20,000 Birr and the insurer can retain the balance of 30,000 Birr.

1. The insured cannot impair the insurer’s subrogation rights. The insured cannot do anything that prejudices the insurer’s right to proceed against a negligent third party. For example, if the insured waives the right to sue the negligent party, the right to collect from the insurer for the loss is also waived.
2. The insurer can waive its subrogation rights in the contract. This may be to meet the special needs of some insured. For example, in order to rent an apartment house, a land lord may agree to release the tenants from potential liability if the building is damaged. If the land lord’s insurer waives its subrogation rights, and if a tenant negligently starts a fire, the insurer would have to reimburse the land lord for the loss, but could not recover from the tenant since the subrogation rights were waived.
3. Subrogation does not apply to life insurance and to most individual health insurance contract. Life insurance is not a contract of indemnity, and subrogation has relevance only for contracts of indemnity. Individual health insurance contracts usually do not contain subrogation clauses.
4. The insurer cannot subrogate against its own insured. If the insurer could recover a loss payment for a covered loss, the basic purpose of purchasing the insurance would be defeated.

**4.4. PRINCIPLE OF UTMOST GOOD FAITH**

Utmost good faith means that a higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts. This principle has its historical roots in marine insurance. The marine insurer had to place great faith in statements made by the applicant for insurance concerning the cargo to be shipped. The property to be insured may not have been visually inspected. The principle of utmost good faith is supported by three important legal principles;

* + - Representations
		- Concealment
		- Warranty

**Representations**

Representations are statements made by the applicant for insurance. For example, if a person wants to apply for life insurance, he may be asked questions concerning his age, weight, height, occupation, state of health and other relevant questions. The answers given by that person are called representations.

The legal importance of a representation is that the insurance contract is voidable at the insurer’s option if the representation is (a) material, (b) false, and (c) relied on by the insurer.

Material means that if the insurer knew the true facts, the policy would not have been issued, or would have been issued on different terms. False means that the statement given by the insured is not true or it is misleading. Reliance means that the insurer relies on the misrepresentation in issuing the policy at the specified premium.

For example, Alemayehu may apply for life insurance and state in the application form that he has not visited a doctor within the last 5 years. But, he may have undergone surgery six months earlier. In this case, he has made a statement that is both false & material and the policy is voidable at the insurer’s option.

Finally, an innocent or unintentional misrepresentation of a material fact, if relied on by the insurer also makes the contract voidable.

**Concealment**

Concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer. Here, the applicant for insurance deliberately withholds material information from the insurer. The legal effect of a material concealment is also voidable at the insurer’s option.

To deny a claim based on concealment, an insurer must prove two things; (a) the concealed fact was known by the insured and (b) the insured intended to defraud the insurer. For example, Mr. Joseph DeBellis applied for a life insurance policy on his life. 6 months after the policy was issued, he was murdered. The death certificate named the deceased as Joseph De Luca, his true name. Thus, the insurer denied payment on the ground that Joseph had concealed a material fact by not revealing his true identity, and he had also an extensive criminal record. Thus, the court held that intentional concealment of his true identity was material and the insurer need not pay the claim.

**Warranty**

The doctrine of warranty also reflects the principle of utmost good faith. A warranty is a statement of fact or promise made by the insured, which is part of the insurance contract and which must be true if the insurer is to be liable under the contract. For example, in order to pay a reduced premium, the owner of a shop may warrant that an approved burglary and robbery alarm system will be operational at all times. The conditions describing the warranty become part of the contract.

A warranty is a harsh legal principle. Any breach of the warranty allows the insurer to deny payment of a claim. However, the courts have softened and modified the harsh common law of doctrine of warranty.

**4.5. PRINCIPLE OF CONTRIBUTION**

Contribution is the right of the insurer who has paid under a policy, to call upon other insurers equally or otherwise liable for the same loss to contribute to the payment. Where there is over-insurance because a loss is covered by policies effected with two or more insurers, the principle of indemnity still applies. In these circumstances the insured will only be entitled to recover the full amount of his loss and if one insurer has paid out in full, he will be entitled to nothing more.

Like subrogation, contribution supports the principle of indemnity and applies only to contracts of indemnity. Therefore there is no contribution in personal accident and life policies under which insurers contract to pay specific sums on the happening of certain events. Such policies are not contracts of indemnity, except to the extent that they may incorporate a benefit by way of indemnity, for example, payment of medical expenses incurred, in which respects contribution would apply.

It is important to understand the difference between contribution and subrogation. Subrogation is concerned with the rights of recovery against third parties or elsewhere in respect of payment of indemnity, and need not involve any other insurance, although it frequently does. Contribution necessarily involves two or more insurance each covering the interest of the same insured.

**Basis of Contribution**

At the time of a claim, insurers usually inquire whether any other insurance exists covering the loss, where other insurances do exist and each policy is subject to a valid claim, contribution will apply so that the respective insurers share the loss ratably. This term allows two constructions, both of which are found in insurance;

1. Contribution according to Independent Liability:

This means that the amount payable by each insurer is assessed as if the other insurances do not exist. If the aggregate of the amounts so calculated exceeds the loss, each insurer’s contribution is scaled down proportionately, so that an indemnity is provided. This method is usually found where for some reason one or more policies will not cover the loss in full. This happens particularly in many fire policy contributions.

1. Contribution according to the Sums Insured:

This is the normal method of contribution. Insurers will pay proportionately to the cover they have provided, in accordance with the following formula;

$$contribution=\frac{sum insured with the particular insurerXloss}{total sums insured with all insurers}$$

Example: Assume that Kebede has insured his house, which is worth 80,000 Birr against fire with three insurers namely A, B & C for 60,000 Birr, 40,000 Birr, and 20,000 Birr respectively. Kebede’s house was completely destroyed by a fire caused by Alemayehu’s negligence. The amount of indemnity that Kebede will be entitled to receive would be 80,000 Birr, the value of the actual loss or the amount of insurance covered.

Solution:

 The amount that each insurer is entitled to contribute would be as follows;

$$A^{'}s share of loss=\frac{60,000X80,000}{120,000}=40,000$$

$$B^{'}s share of loss=\frac{40,000X80,000}{120,000}=26,667$$

$$C^{'}s share of loss=\frac{20,000X80,000}{120,000}=133,333$$

                    **Total Indemnity =Br.80, 000**

**4.6. PRINCIPLE OF PROXIMATE CAUSE**

The rule is that immediate and not the remote cause is to be regarded. The maxim is “ sed causa proxima non-remota spectatuture”, i.e., see the proximate cause and not the distant cause. The real cause must be seen while payment of the loss. If the real cause of loss is insured, the insurer is liable to compensate the loss; otherwise the insurer may not be responsible for loss.

The efficient cause of a loss is called the proximate cause of the loss. For the policy to cover, the loss must have an insured peril as the proximate cause of the loss. The proximate cause is not necessarily the cause that was nearest to the damage, but is rather the cause that was actually responsible for loss. Example, In marine insurance, sea water.

Determination of proximate cause:

1. If there is a single cause of the loss, the cause will be the proximate cause and further if the peril ( cause of loss) was insured, the insurer will have to indemnify the loss.
2. If there are concurrent causes, the insured perils and excepted perils have to be segregated. The concurrent causes may be separable or inseparable. Separable causes are those which can be separated from each other. The loss occurred due to a particular cause may be distinguishing known. In such a case, if any cause is excepted peril, the insurer will have to pay up to the extent of loss which occurred due to insured perils.

If the circumstances are such that the perils are inseparable, then the insurers are not liable at all when there exists any excepted peril.

1. If the causes occurred in form of chain, they have to be observed seriously.
2. If there is unbroken chain to excepted and insured perils have to be separated. If an excepted peril precedes the operation of the insured peril so that the loss caused by the insured peril is the direct and natural consequences of the excepted peril, there is no liability. If the insured peril is followed by an excepted peril there is valid liability.
3. If there is a broken chain of events with no excepted peril involved, it is possible to separate the losses. The insurer is liable only for that loss which is caused by an insured peril; when there is an excepted peril, the subsequent loss caused by an insured peril will be a new and indirect cause because of the interruption in the chain of events. Similarly, if the loss occurs by an insured peril and there is subsequently loss by an excepted peril, the insurer will be liable for loss occurred due to the insured peril.