FUNDAMENTAL PRINCIPLES OF INSURANCE CONTRACT

By
Tarun
Teaching and Research Associate (Law)
Gujarat National Law University

Introduction

Insurance is based on certain principles which form the foundation of an insurance policy. These principles have evolved over the decades. While in several countries, some of them may be adopted after modifications, to provide for better service levels, most of the basic principles would generally still hold good. In many countries also, Insurance is slowly evolving into a financial instrument, especially for large businesses and it would remain to be seen as to how far this aspect can really be taken to.

All insurance purchases involve contracts. In fact, insurance is a distinct branch of contract law.

It would be easier to understand insurance, if general knowledge of contract law is available with a person. It is important to understand the term 'contract' as it is used in general and the distinguishing feature of insurance contract.

A 'contract' is an agreement between two or more parties which, if it contains the elements of a valid legal agreement, is enforceable by law or in other words a 'contract' involves exchange of promise and in case of breach the parties to the contract can avail of legal remedy. The law of contract in India is governed by the Indian Contract Act, 1872.

Meaning Of Valid Contract

A contract may be defined as an agreement between two or more parties to do or to abstain from doing an act, and which is intended to create a legally binding relationship. This could be summarized as 'an agreement designed to have legal consequences'.

According to Indian Contract Act, "An agreement enforceable by law is a contract", which satisfies the following essential elements:

(i) Agreement (offer and acceptance)

(ii) Legal Consideration

(iii) Competence to Contract

(iv) Legal object

(v) Certainty

(vi) Possibility of performance

(vii) Writing and registration.

Elements Of A Valid Contract

All valid contracts must have the following four elements: offer and acceptance, consideration, capacity and legal purpose.

1. Offer And Acceptance

In any valid contract, there should be an offer and acceptance. If we take the insurance policy as an example, the insured makes an offer by way of filling up a proposal and the insurer accepts the offer by quoting rates and terms under which he is willing to accept the offer to insure. It is of absolute importance in a contract that both the offer and acceptance should be expressed in terms which are unambiguous and clear.

It is also important that the acceptance should be on the same terms on which the offer is made. For instance, if an insured makes an offer to cover his house in Karol Bagh, Delhi, then the acceptance should be for coverage of the same house and not a different property. If the second party to whom the offer is made wishes to make a counteroffer, he may do so and the contract is valid only when the first party agrees to the terms proposed by the second party. This is called “consensus ad idem”.

The acceptance of an offer should be unconditional. If any conditions are imposed then those conditions have to be agreed to by both the parties for the contract to come into existence.While it is good for the offer and acceptance to be in writing, both oral and written offer and acceptance are recognised by law.

2. Consideration

Consideration is the price paid by both the parties for the promise and is a key requirement for a valid contract. The logic for this is that each part to the contract should confer some benefit on the other. In insurance, the consideration on the part of the insured is the money he pays as premium and the insurer makes a promise to indemnify the insured in the event of the happening of the contingency insured against.

3. Capacity

The third requirement for a valid contract is the capacity of the parties to enter into a contract. The reason being a person entering into the agreement should have the ability to honour the commitment made under the contract. Minors, a person of unsound mind, those in an intoxicated state etc. cannot enter into a legally binding agreement. The purpose is to ensure that people who are not in a fit state should not be taken advantage of.

Similarly the insurer should possess the necessary qualification to enter into a contract. In India only those insurers who have been licensed by IRDA to carry on the business of insurance can issue insurance policies.

A person who is not competent to enter into a contract by reason of the provisions in Section 11 of the Contract Act, 1872, can still be a beneficiary under a contract of insurance. A minor's property may be insured by persons competent to act for him.

He would be entitled to recover the insurance money.[1] The court rejected the defence of the insurance company that the person on whose behalf the goods were insured was a minor and allowed the minor to recover the insurance money. A minor is allowed to enforce a contract which is of some benefit to him and under which he is required to bear no obligation.[2]

4. Legal Purpose

The purpose of the agreement/contract should be legal. If two parties enter into an agreement the purpose of which is not legal, the same cannot be enforced in a court of law and hence the contract would not be valid. For example, if an insurance policy is issued to cover the results of a race, the contract would become invalid.

Section 23 of the Contract Act, 1872 prescribes the requirement that the consideration for and the object of the agreement must be lawful. It has been held that there is nothing unlawful in a vehicle insurance policy providing that no compensation would be payable if the vehicle was being driven at the time of the accident by an unlicensed person or by a learning license holder.[3] Section 64-VB of the Insurance Act, 1938 prohibits the insurer from entering into a contract unless the premium is paid in advance. The court said that such a condition could be waived.[4]

[1] *Great American Insurance Co. v. Madan Lal Sonulal*, ILR (1935) 59 Bom 656
[2] *Zafar Ahsan v. Zubaida Khatun*, (1929) 27 All LJ 1114
[3] *New India Assurance Co. Ltd. v. Kesavan Ramamurthy*, (1977) 2 Andh LD 446 (AP)
[4] *National Insurance Co. Ltd. v. New Darjeeling Union Tea Co. Ltd.*, (2001) 1 Cal LT 218 (Cal)

Insurance Contract

Like any other contract the contract of insurance must fulfill all the essential elements of contracts as laid down in the law of contract of Indian Companies Act, 1872. Insurance is a contract between two parties whereby one party called insurer undertakes, in exchange for a fixed amount of money on the happening of a certain event. At the same time the Insurance Contract must fulfill certain other elements relating exclusively to insurance which are known as Fundamental Principles.

The insurance contract involves:
(a) The elements of general contract.
(b) The elements of special contract relating to insurance.

The special contract of Life insurance involves the following principles:

1. Insurable interest
2. Utmost good faith
3. Material Facts

Nature Of Insurance Contract

The contract of insurance is called an allegory contract because it depends upon an uncertain event. For example, if a house is burnt down or the ship is stranded, the insurer will pay the value of it. At first sight this would seem to be a wagering transaction, the insurer betting with the assured that his house will not be burnt or his ship will not sink and giving him the odds of its value against the premium. It is due to this uncertainty that Lord Mansfield described insurance 'as a contract on speculation'.

According to the modern view, however, insurance contracts are not speculative or wagering contract. Insurance is not merely a gamble on an uncertain future. It is a

perfectly valid contract for the assured is only, indemnified for his loss and he does not gain by the happening of the event insured against, he does not make a profit of his loss. While in a wager no insurable interest is present, in insurance the assured must have an insurable interest on the subject matter insured. Therefore, although insurance is an allegory contract depending upon an uncertain event, it is not a wagering or a speculative contract nor is it a gamble on an uncertain future.

A contract of insurance is entered as soon as the insurance company accepts, the premium after the proposal being accepted. The following essential elements are deemed to be fulfilled after the acceptance of the premium by the insurer. The more important conditions or elements known as fundamental principles must be satisfied for a valid insurance contract. Following are the essentials of a contract which should be fulfilled:

1. **Agreement**: It involves both offer and acceptance at the same time. Filling up of a proposal form by the proposer is an offer and the notice of acceptance of the proposal by the insurer is a valid acceptance of insurance.

2. **Legal Consideration**: To every contract there must be some legal or lawful consideration. In insurance, payment of premium is the valuable consideration in return to get a lump sum on the happening of the event.

3. **Competence to Contract**: If the insured person is of sound mind and has attained majority (18 years of age) he is said to be competent to enter into an agreement or contract. Also he must not have been debarred by any law to which he is subject to enter into agreement. An insurance policy taken on a minor's life by his legal guardian will constitute a valid contract.

4. **Legal Object**: The object of contract must be lawful. It must not be illegal, immoral or opposed to public policy. Thus the object of insurance must be lawful. The assured should pay his premium in time and in turn, the insurer should pay the assured amount at the time of loss or maturity without causing any unnecessary hardship for the assured. The intention of both the parties must be a holy one.

5. **Certainty**: An agreement must not be vague, loose and uncertain. The terms and conditions must be clearly understood by both. If the proposer turns out to be an illiterate, the insurer must analyze or make the terms and contracts clear to him. Otherwise, there will be no mental accord. In insurance the terms and conditions are deemed to be understood as the proposer gives an understanding on the proposal form. The insurance company issues a printed policy document which contains all the terms and conditions of insurance contract.

6. **Possibility of Performance**: The agreement must be capable of being performed. A promise to do an impossible thing cannot be enforced. In insurance contract there is every possibility of its performance. The insurer must be able to pay the money on happening of the event. The insured is expected to make regular payment of premium; otherwise it would defy the meaning of the insurance plan.

7. **Writing and Registration**: The contract law requires certain formalities of writing and registration etc. For insurance the agreements must be in writing, properly signed, stamped and registered. These formalities are fulfilled as the proposer makes his proposal through a printed form, duly signed by him. The insurer issues the original policy document, properly signed and stamped.

Distinguishing Characteristics Of Insurance Contracts

While all the contracts should have the abovementioned four features to be legally binding, an insurance contract has some special characteristics while at the same time adhering to the above mentioned features.

The special contract of insurance involves principles:

1) Utmost Good Faith.
2) Insurable Interest.
3) Indemnity.
4) Subrogation
5) Proximate Cause
6) Contribution
7) Warranties.

I. Principle Of Utmost Good Faith (Uberrima Fides)

Insurance contracts are based upon mutual trust and confidence between the insurer and the insured. Hence, they are said to be *uberrimae fidei, i.e., of* the utmost good faith. Utmost good faith in insurance means that each party to a proposed contract is legally obliged to reveal to the other party all information which would influence the other's decision to enter the contract, whether such information is requested or not.

Though the insurance contract are subject to good faith and are based upon mutual trust and confidence, it is not possible to apply any doctrine or *caveat emptor* (let the buyer beware) because of the fiduciary nature of insurance. The information necessary for the parties to assess the contract adequately cannot be ascertained as with contracts of sale where the buyer before contracting to purchase anything must satisfy himself as to the nature and quality of goods he needs.

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

Thus one of the important basic principles of insurance is known as 'utmost good faith'. The Insurance contract being a promise to pay in the case of a peril operating is a unique type of contract between the Assured and the Insurer.

Explaining the reason for this stringent rule in an early case Lord Mansfield said:[5]

"Insurance is a contract upon speculation. The special facts upon which the contingent chance is to be computed lie most commonly in the knowledge of the insured only; the underwriter trusts to his representation, and proceeds upon confidence that he does not keep back any circumstance in his knowledge, to mislead the underwriter into a belief that the circumstance does not exist, and to induce him to estimate the risk as if it did not exist. The keeping back of such a circumstance is a fraud, and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention, yet still the underwriter is deceived and the policy is void; because the risk run is really different from the risk understood and intended to be run at the time of the agreement...Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain into his ignorance of that fact and his believing the contrary."

Very often, the Insurer has to rely only on the description and details filled in the proposal form. The Insurer has no way of verifying these details and after an insured peril has operated, the subject matter of the insurance may very well have gone up in smoke or washed away. Therefore any mis-description, misrepresentation or blatantly false declarations made by the Assured would result in the Insurer paying wrong claims.

[5] *Carter v. Boehm*, (1558-1774) All ER Rep 183

Obviously, in the longer term no Insurer can survive payment of wrong claims or charging of wrong premiums for the risk. Such payment of claims also imposes a burden on the rest of the premium paying community, since ultimately claims have to be paid out of the premium pool.

It is therefore an implied condition or principle of insurance that the Assured be required to make a full disclosure of all material particulars within his knowledge about his risk.

However today, especially with imminent privatization, it would be logical to expect that insurers would attempt to become increasingly more customer friendly and provide risk survey and assessment, appraisal, etc. services, directly or through brokers, surveyors, etc. Whether these factors may dilute this principle and to what extent remains to be seen. Our opinion yet would be that the Assured knows his business and risk best and whenever in doubt, must attempt to disclose that particular aspect.

A corollary to this would be that even after taking out an insurance policy, during its validity period, if there are any alterations or changes to the business or risk - say alteration of process or storage of any hazardous material - which increases the risk, the Assured must inform the Insurer of the same and get their acceptance for the same. At times, additional premium payment may be required.

If it is found that an Assured has not disclosed or attempted to conceal any material aspects of the risk, the Insurer would obviously be entitled to avoid any payment of claims or monies under the Policy. If it is found that the Assured had misrepresented any aspect of the risk, then the Insurer would again obviously be entitled to avoid any payment of claims or monies under the Policy. However, in certain cases of misrepresentation, where the effect may only have been increased premium, it is possible that the Insurer may partly pay the claim.

Material Fact

The definition of Material Fact is:

Every circumstance is material which would influence the judgment of a prudent insurer in fixing the premium or determining whether he will take the risk.

The duty extends not only to facts which the insured knows, but also to those which he, as a reasonable person, ought to have known and which are in fact material, whether he thinks them to be so or not.[6]

There has been some criticism of the use of the term 'prudent underwriter' and there has been a tendency to substitute 'reasonable underwriter' in applying the rule. In some quarters it has been suggested that the view of the 'reasonable insured' rather than a 'reasonable underwriter' should be the test of whether a fact is material or not. However, it is not a question of whether the proposer regards the matter as material or even whether the insurer regards a fact as material. The test will be a view of a prudent or reasonable underwriter.

Facts Which Must Be Disclosed

Those facts, which must be disclosed, are any circumstances which would influence the insurer in accepting or declining a risk or in fixing the premium or terms and conditions of the contract.

The fact must be material at the date at which it should be communicated to the insurer. A fact which was immaterial when the contract was made, but becomes material later on need not be disclosed. There is one exception to the rule and it occurs when there is a policy condition requiring continuous disclosure. This would

[6] *Joel v. Law Union and Crown Insurance Co.*, (1908) 2 KB 863

be an usual condition to find in most general insurance policies. The categories of facts which must be disclosed are:

a) facts which show that the particular risk represents a greater exposure than would be expected from its nature or class;
b) external factors which make the risk greater than would normally be expected;
c) previous losses and claims under other policies;
d) any declinature or special terms imposed on previous proposals by other insurers;
e) the existence of other non-indemnity policies such as life and accident;
f) Full facts relating to the description of the subject matter of insurance.

Some examples of such facts are

a) Fire Insurance: The construction of the building, the nature of its use, fire detection and firefighting equipment.
b) Theft insurance: The nature of stock, its value and the nature of security precautions.
c) Motor insurance: The type of car, whether it has been specially adapted, details of regular drivers.
d) Marine insurance: Cargo insurance-the terms of sale, mode of carriage, whether containerized.
e) Life insurance: Age, previous medical history, occupation, smoking/drinking habits.
f) Personal accident insurance: Age, height, weight, previous medical history, occupation.

These are only examples and not exhaustive. In all classes of insurance there will be a need to have details of previous loss experience and all facts which the proposer is reasonably expected to know. As an example, a landlord should know the nature of occupancy of his property by his tenant.

Facts Which Need Not Be Disclosed

There are, however, certain facts which it is no duty of the insured to bring to the notice of the insurer for example facts which the insurer knows or is deemed to know. They were summed up by Lord Mansfield in an early case:[7]

"Good faith forbids either party by concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary.

There are some circumstances which are material but it is not necessary to disclose. The areas concerned are:

a) Facts of law: Everyone is deemed to know the law;
b) Facts of common knowledge: An insurer is deemed to know about such things as the strife in any part or normal processes within a particular trade;
c) Facts which lessen the risk: the existence of an alarm system for a theft risk or sprinkler for fire risk;
d) Facts which could reasonably be discovered: This occurs where an insurer has bean put on inquiry by, for example, a statement on a proposal form. The most common example of this would be where a proposer inserts a phrase 'see your records' instead of completing fully the previous claims history;
e) Facts which a survey should have revealed: If an insurer carries out a survey then any material facts which are clearly visible, or which any reasonable surveyor would enquire about do not need to be disclosed by the proposer. However, the proposer is not permitted to conceal material matters from the surveyor;
f) Facts covered by policy conditions: These would be facts, which it is superfluous to disclose because of an express, or implied warranty e.g. that burglar alarms are regularly maintained.

[7] *Carter v. Boehm*, (1558-1774) All ER Rep 183

II. Principle Of Insurable Interest

The second principle of insurance is that the subject-matter of the insurance must be of insurable interest. This means that the insured stands in such relation to the subject-matter of insurance that he suffers loss by its destruction or damage and is benefited by its safety, or existence. An insurable interest is "an interest of such a nature that, if the event insured against takes place, the insured might suffer a financial loss. If the happening of the event insured against cannot cost the insured money, then there is no insurable interest." Thus insurable interest means proprietary or monetary interest. It is the legal right to insure as an insurance policy does not cover property, but relates to the insured's interest in the property. In every contract of insurance, the law regards possession of an insurable interest in the subject-matter of insurance to be a necessary pre-requisite. The insured must own either own part or whole of it or he must be in such a position that injury to it would affect him adversely.

For example, a man who insures his scooter against accident has insurable interest in it because he uses it for official and non-official visits and is thus benefited from its existence. If the scooter is damaged or is totally lost, it would cause him financial or pecuniary loss. He will have to incur huge expenses on its repairs, if it is damaged, or has to replace it, if it is totally lost, or will have to pay hire of alternative modes of transport. Similarly, a person has insurable interest in the house he lives in. A businessman has insurable interest in the goods he deals in. A person has insurable interest in his own life. A wife has insurable interest in the life of her husband. A creditor has insurable interest in the debtor. The partners have insurable interest in the lives of one another. To be valid the insurable interest must be recognized as such under the law in operation in the country. It must satisfy the following conditions:

(i) There must be a physical object (life or limb or property) which is subject to risk and the risk can operate on such object and cause damage or destruction.

(ii) There must be a potential liability (death of a pedestrian by a motor car) and this must be caused by the operation of the insured risk or by the happening of an event which is insured.

(iii) The subject-matter of insurance must be the physical object or potential liability.

(iv) The insured must be in a legally recognized relationship with the subject-matter of the insurance, whereby he benefits from its continued safety or the absence of liability and is prejudiced by its damage or destruction, or the creation of liability.

In the case of *Wilson v. Jones*[8] a policy taken out by a shareholder for the success of his company's adventure was held to be valid.

In life insurance, insurable interest should exist at the commencement of the policy, but it need not continue to exist up to the occurrence of the loss. A creditor may, for example, insure his debtor's life and the policy remains valid even after the debtor has paid off the creditor.[9] But where the debtor dies without payment and the payment was subsequently made by his executors, the assured could not recover anything on the policy of his life.[10]

When Insurable Interest Exists

Insurable interest exists in the following cases:

I. **Owners**: Owners have got insurable interest to the extent of full value.

II. **Part owners or joint owners**: They have insurable interest to the extent of their part or financial interest.

[8] (1867) LR 2 Ex 139

[9] *Dalby v. India and London Life Insurance Co.*, (1854) 15 CB 365

[10] *Gadsall v. Baldero*, (1807) 9 East 72

III. **Mortgagor/Mortgagee**: Mortgagor, being the owner of the property, has got insurable interest. Mortgagee though not owner, has got insurable interest to the extent of the money advanced, plus interest and an amount to cover up insurance premium.

IV. **Ballees**: They have got insurable interest because of a potential liability being created if goods belonging to others get lost or damaged whilst in their custody.

V. **Carries**: Like bailees, carries have also got insurable interest in view of potential liability that might devolve on them for any mishap to the goods belonging to others, but whilst in their custody.

VI. **Administrator, Executors & Trustee**: They have insurable interest in view of responsibility put on them by law.

VII. **Life**: A person has got insurable interest in his own life. A husband has also got insurable interest in the life of his wife and vice-versa. No other relationship as such merits existence of insurable interest. However, insurable interest has been created up to $30 on the lives or parents, step-parents and grand-parents, under the Industrial Assurance & Friendly Societies Act, 1984 & 1958 of U.K., for funeral expenses.

VIII. **Debtors and Creditors**: A debtor has insurable interest in his own life, but he has no insurable interest in the life of his Creditor. A creditor on the other hand has insurable interest in his own life and he has also insurable interest in the life of his debtor to the extent of the loan, interest and something to cover up premium. This is because of the financial interest being created by advancing money.

IX. **Insurers**: They have got insurable interest because of a potential liability undertaken from the insured under a policy, and this justifies taking out a reinsurance policy.

X. **Liability**: The creation of a potential liability justifies existence of insurable interest. The best examples are third party motor insurance, public liability insurance etc.

It should be remembered that a person in the lawful possession of goods of another has got insurable interest so long responsible for goods. More possession without responsibility does not carry any insurable interest. Similarly a person having illegal possession of goods has got no insurable interest, e.g., thieve.

One important point with regard to insurable interest is that it must be capable of being valued in terms of money. Sentimental value is co criteria.

When Insurable Interst Must Exist

When insurable interest must exist varies depending on the type of insurance. The position is as follows:

Marine: Insurable interest must exist at the time of claim although. It need not exist at the time of effecting the policy.

Fire: Insurable interest must exist both at the time of effecting the policy and at the time of claim.

Life: Insurable interest must exist at the time of effecting the policy and it may not exist at the time of claim.

Accident: Like fire, insurable interest must exist both at the time of effecting the policy and the time of claim.

In fire or accident policies, however, the interest should continue to exist down upon to the occurrence of the loss. Thus where a person took out a policy of indemnity against loss that may be caused by his motor car or any other car being driven in its place, he could not recover, because he had sold the car and the loss was caused by new car purchased by him. His interest in the car ceased when he sold it and the new

car was not being used instead of it.[11] In marine insurance, interest should exist at the time of the loss.

III. Proximate Cause

Insurable interest and utmost good faith apply to all insurance contracts, the primary application being at the time the contract is being arranged (policy inception). Proximate cause is also likely to be important with all types of insurance, but its application will be exclusively related to *claims*. Some of its features to be noted are as follows:

Definition

The classic definition is taken from a law case nearly a hundred years ago:

"*The active efficient cause that sets in motion a train of events which brings about a result, without the intervention of any force started and working actively from a new and independent source.*"

2/5

This is very impressive, but what does it mean? In simple terms, it means it is necessary to determine the real *effective* cause of the loss, because not every cause of loss will be insured.

Types Of Peril

A cause of loss is known as a *peril*. There are essentially **three** kinds of peril:

(a)*Insured peril*: which is covered by the policy and must occur with any claim, e.g. fire under a fire policy, collision with a motor policy etc.

(b)*Excepted (or excluded) peril*: this is a peril that would be covered, but is specifically removed from cover by a policy exclusion, e.g. fire caused by war, death from suicide etc.

[11] *Rogerson v. Scottish Automobile and General Insurance Co.*, (1931) 146 LT 26

(c)*Uninsured peril*: this is a peril that is neither insured nor excluded, it is *outside* the cover provided by the policy, e.g. accidental damage with a policy covering fire only.

Determination Of Proximate Cause

The determination of real cause depends upon the working and practice of insurance & circumstances to loss. Also-

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 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 first, separable and second, inseparable. Separable causes as those which can be separated from each other. The loss occurred due to a particular cause may be distinguish known. If the circumstances are such that the perils are inseparable, then the insurers are not liable at all when there exists any excepted peril
3. If the causes occurred in form of chain, they have to be observed seriously--

a) If there is unbroken chain the excepted and insured perils have to be separated. If an excepted peril precedes the operation of the insured peril so that the loss cause by the latter is the direct and natural consequences of the excepted peril, there is no liability.
b) 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 caused by an insured peril; where 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.

Policy Modification Of The Principle

Great care must be taken with this principle, as individual circumstances can be very important in determining whether the loss is recoverable or not. One complication can arise from policy wordings which modify proximate cause:

(a)*to reduce the normal application*: some fire policies might for instance have a wording that allows a claim for fire damage caused by, say, earthquake or explosion, when impact damage from such risks is in fact excluded;

(b)*to extend the normal application*: proximate cause is normal only concerned with the *direct* or *dominant* cause. For example, a policy exclusion may say that damage *"directly or indirectly"* arising from a particular peril is excluded. This will mean that the loss may not be recoverable even if the excluded peril is only a *remotely* contributory factor.

IV. Indemnity

This is a principle which will not apply to every kind of insurance, for reasons that will be explained. In very simple terms we may think of it as *compensation* for the loss sustained. More detailed consideration is, however, necessary.

Definition

As mentioned above that we may think of indemnity as **compensation**. To be more accurate perhaps we should say that it is *an exact financial compensation* for a loss, no more no less.

Implications

If we accept the definition of "an exact financial compensation", we can see at once why indemnity cannot apply to all types of insurance. Some types of insurance deal with "losses" that cannot be measured precisely in *financial* terms. Specifically, we refer to **Life Insurance** and most **Personal Accident Insurances**. Both are dealing with death or injury to human beings, and there is no way that these things can be

measured precisely. Thus, full compensation cannot be given, *indemnity* cannot normally apply to these classes of business.

How Indemnity Is Provided

With policies undertaking to *indemnify* the insured, the extent of any loss must be measured as accurately as possible, but indemnity may be given in different ways, as follows:

(a)*Cash payment* (to the insured): this is always acceptable and in some cases may be the only practical option (e.g. reimbursement of medical bills - which incidentally is an *indemnity*, even though it may be covered under a personal accident policy).

(b)*Repair*: payment to a repairer is a perfectly acceptable way to provide indemnity, and is the norm, for example, with non-total loss motor claims.

(c)*Replacement*: with new items, or articles that suffer little or no depreciation, giving the insured a replacement item may be a very suitable method, especially if the insurer can obtain a discount from the supplier.

(d)*Reinstatement*: this is a word that has a number of meanings in insurance. As a method of providing an indemnity, its usual meaning is *rebuilding* or reconstructing property after damage. (In some cases, e.g. with damaged machinery, the term is used when *replacement* is involved.)

Almost all contacts other than life and personal accident insurance are contracts of indemnity. Where the promise to indemnify is an absolute one, a suit can be filed immediately on failure of performance, irrespective of actual loss. If the indemnity holder has incurred liability and that liability is an absolute one, he is entitled to call upon the indemnifier to save him from that liability by paying it opt.[12]

Uses

To avoid intentional loss:

[12] *New India Assurance Co. Ltd. v. State Trading Corpn. of India*, AIR 2007 (NOC) 517 (Guj)

According to the principle of indemnity insurer will pay the actual loss suffered by the insured. If there is any intentional loss created by the insured the insurer's is not bound to pay. The insurer's will pay only the actual loss and not the assured sum (higher is higher in over-insurance).

To avoid an Anti-social Act

If the assured is allowed to gain more than the actual loss, which us against the principle of indemnity, he will be tempted to gain by destruction of his own property after it insured against a risk. So, the principle of indemnity has been applied where only the cash-value of his loss and nothing more than this, through he might have insured for a greater amount, will be compensated.

To maintain the Premium at Low-level

If the principle of indemnity is not applied, larger amount will be paid for a smaller loss and this will increase the cost of insurance and the premium of insurance will have to be raised. If premium in raised two things may happen –

- First, persons may not be inclined to insure and
- Second, unscrupulous persons would get insurance to destroy he property to gain from such act.

Conditions Of Indemnity Principle

The following conditions should be fulfilled in full application of principle of indemnity.

- The insured has to prove that he will suffer loss on the insured matter at the time of happening the event and the loss is actual monetary loss.
- The amount of compensation will be the amount of insurance. Indemnification cannot be more than the amount insured.
- If the insured gets more amount then the actual loss; the insurer has right to get the extra amount back.

- If the insured gets more amount then from third party after being fully indemnified by insurer, the insurer will have right to receive all the amount paid by the third party.
- The principle of indemnity does not apply to personal insurance because the amount of loss is not easily calculable there.

V. Contribution

This is one of the two important *corollaries* (sub-principles) of **indemnity**. As such, it will only apply if indemnity applies. It is therefore another principle connected with claims. Its major features are as follows:

Definition

In simple terms, **contribution** means that if *two* (or more) insurers are contracted to provide an **indemnity** to the same person (interest), the insurers should *share* ("**contribute**" towards) the indemnity payment. The net effect is that the insured does not recover **more** than he has lost.

How Arising

The criteria that need to be satisfied before contribution exists are:

(a) the respective policies must each be providing an *indemnity*;

(b) they must each cover the same financial *interest*;

(c) they must each cover the same *peril* giving rise to the loss;

(d) they must each cover the same *subject matter*;

(e) each policy must *cover* the loss (i.e. not be subject to a policy exclusion or limitation preventing contribution).

How Applicable

As mentioned, contribution will only apply if **indemnity** applies. Thus, if a person dies whilst insured by two or more separate *life insurance* policies, each must pay in full, because the insurances are not subject to indemnity.

Conditions/When Contribution Operates

Before contribution can operate the following conditions must be fulfilled:

I. There must be more then one policy involved and all policies covering the loss must be in force.
II. All the policies must cover the same subject-matter. If all the policies cover the same insured but different subject-matters altogether then the question of contribution would not arise.
III. All the policies must cover the same peril causing the loss. If the policies cover different perils, some common and some uncommon, and if the loss is not caused by a common peril, the question of contribution would not arise.
IV. All the policies must cover the same interest of the same insured.

It should be remembered that if any of the above four factors is not fulfilled, contribution will not apply.

VI. Subrogation

This is the other important *corollary* of indemnity. Its meaning and features are considered below.

Definition

Again in simple terms, subrogation provides that an insurer who provides an indemnity is entitled to take over and use for his own benefit any *recovery rights* the insured may possess against third parties.

Suppose, for example, that the insured is covered by a motor insurance and his car is damaged by the negligence of a building contractor when faulty scaffolding falls on to the car. The motor insurer must pay for any insured damage to the car, but the insured also has rights against the contractor. These rights become *subrogated* (transferred) to the motor insurer.

From this, it will easily be seen how subrogation seeks to protect the parent principle of indemnity, by ensuring that the insured does not get paid twice for the same loss.

How Arising

(a) In *tort*: this usually arises where a third party is negligent (the main "tort", or civil wrong) and causes loss or damage to be indemnified by the policy. This is undoubtedly the most common source of subrogation.

(b) In *contract*: a hirer or leaseholder may make certain contractual promises regarding damage to the owner's property. If the owner is insured for that damage, subrogation arises against the hirer/leaseholder in question.

(c) Under *statute*: this is not common here, but for example if a workman is injured at work by the actions of a third party, the employer will have to pay an *employee compensation* benefit to the injured man. The Employees' Compensation (EC) Ordinance, however, will grant subrogation rights to the employer, who must in turn pass these to the EC insurer.

(d) In *salvage*: this we have already considered (see **2.4.5**). The insurer may be said to have subrogation rights in what is left of the subject-matter (salvage), arising under the circumstances already discussed.

How Applicable

As with contribution, **subrogation** can only apply if **indemnity** applies. Thus, with our previous example, if an insured under a life policy is killed by the negligence of a motorist the life insurer must pay under his policy, but he is not entitled to subrogation rights for this payment, as it was not an indemnity.

Essentials Of Doctrine Of Subrogation

Corollary to the Principle of Indemnity

If the damaged property has any value left, or any right against a third party the insurer can subrogate the left property or right of the property because it the insured is allowed to retain, he shall have realized more than the actual loss, which is contrary to principle of indemnity.

Subrogation is the Substitution

The insurer, according to this principle, becomes entitled to all the rights of insured subject-matter after payment because he has paid the actual loss of the property. He is substituted in place of other persons who act on the right and claim of the property insured.

Subrogation only up to the amount of payment

The insurer is subrogated all the rights, claim, remedies and securities of the damaged insured property after indemnification, but he is entitled to get these benefits only to the extent of his payment.

The Subrogation may be applied before payment

If the assured got certain compensation from third party before being fully indemnified by the insurer can pay only the balance of the loss.

Personal Insurance

The doctrine of subrogation does not apply to personal insurance because the doctrine of indemnity is not applicable to such insurance. The insurer has no right of action against the third party in respect of the damages.

VII. Warranties

There are certain conditions and promises in the insurance contract which are called warranties. A warranty is that by which the assured undertakes that some particulars thing shall or shall not be done, or that some conditions shall be fulfilled, or whereby he affirms or negatives the existence of a particular state of facts.

Warranties which are mentioned in the policy are called express warranties. There are certain warranties which are not mentioned in the policy. These warranties are called express warranties.

BIBLIOGRAPHY

1. C. L. Tyagi and Madhu Tyagi, *Insurance Law and Practice*, 1st Edition, Atlantic Publishers, 2007

2. M N Srinivasan and S V Joga Rao, *Principles of Insurance Law*, 9th Edition, LexisNexis India, 2009

3. Jyotsna Sethi and Nishwan Bhatia, *Elements of Banking and Insurance*, 2nd Edition, PHI Learning, 2012

4. Dr. Avtar Singh, *Law of Insurance*, 2nd Edition, Eastern Book Company, 2010

5. Lord Justice Mance Iain Goldrein, Qc, *Insurance Law: An Introduction*, Informa Law From Routledge, 2007