Contract Law

In this section, you will examine some important concepts that are pertinent to the insurance contract law. First, you will learn about special characteristics of an insurance contract, and the required elements that must be included in each. Next, you will focus on legal concepts and definitions that apply to all insurance policies. This section is full of insurance terms; be sure that you can explain them without having to refer to the text.

A. Contract Law Vs. Tort Law

I.B.1. Be able to compare contract law and tort law.

Contracts are written agreements that are legally enforceable by law.

Insurance is the transfer of risk from the insured to the insurance company. This is accomplished through a contractual arrangement under which the insurance company, in consideration of the premium paid by the insured and his or her promise to abide by the provisions of the contract, promises to indemnify the insured or pay an agreed amount, in the event of the specified loss. The instrument through which this transfer of risk is accomplished is the insurance policy.

A great deal of the law that has shaped the formal structure of insurance and influenced its content is derived from the general **law of contracts**. However, because of the many unique aspects of the insurance transaction, the general law of contracts has had to be modified to fit the needs of insurance.

A **tort** is a private, civil, non-contractual wrong for which a remedy through legal action may be sought. A tort can be either intentional or unintentional. Insurance generally will only respond to unintentional torts (losses other than those acts by an insured that are deliberate and intended to cause loss or damage).

An **intentional tort** is a deliberate act that causes harm to another person regardless of whether the offending party intended to injure the aggrieved party. For purpose of this definition, breach of contract is not considered an intentional tort.

An **unintentional tort** is the result of acting without proper care. This is generally referred to as negligence.

B. Four Elements Of A Contract

I.B.2. Be able to identify the four major elements of a contract.

A **contract** is defined as "an agreement between two or more parties enforceable by law." In order for a contract to be legally binding or enforceable by law, it must have certain essential elements. The following are 4 essential elements of all legal contracts:

- Agreement: offer and acceptance;
- Competent parties;
- Legal purpose; and
- Consideration.

1. Agreement

There must be a definite offer by one party, and the other party must accept this offer in its exact terms. In insurance, the applicant usually makes the **offer** when submitting the application. **Acceptance** takes place when an insurer's underwriter approves the application and issues a policy.

2. Consideration

The binding force in any contract is the **consideration**. Consideration is something of value that each party gives to the other. The consideration on the part of the insured is the payment of premium and the representations made in the application. The consideration on the part of the insurer is the promise to pay in the event of loss.

3. Competent Parties

The **parties to a contract** must be capable of entering into a contract in the eyes of the law. Generally, this requires that both parties be of legal age, mentally competent to understand the contract, and not under the influence of drugs or alcohol.

4. Legal Purpose

The purpose of the contract must be **legal** and not against public policy. To ensure legal purpose of a Life Insurance policy, for example, it must have both: insurable interest and consent. A contract without a legal purpose is considered void, and cannot be enforced by any party.

C. Special Characteristics Of An Insurance Contract

I.B.3. Be able to identify the meaning and effect of the following special characteristics of an insurance contract: *contract of adhesion, conditional contract, aleatory, unilateral, and personal.*

1. Contract of Adhesion

A ***contract of adhesion*** is prepared by one of the parties (insurer) and accepted or rejected by the other party (insured). Insurance policies are not drawn up through negotiations, and an insured has little to say about its provisions. In other words, insurance contracts are offered on a take-it-or-leave-it basis by an insurer.

2. Conditional Contract

As the name implies, a **conditional contract** requires that certain conditions must be met by the policyowner and the company in

order for the contract to be executed, and before each party fulfills its obligations. *For example*, the insured must pay the premium and provide proof of loss in order for the insurer to cover a claim.

3. Aleatory

Insurance contracts are **aleatory,** which means there is an exchange of unequal amounts or values. The premium paid by the insured is small in relation to the amount that will be paid by the insurer in the event of loss.

Life and Health Example:

John purchases a life insurance policy for $100,000. His monthly premium is $100. If John only had the policy for 2 months, which means he only paid $200 in premiums, and he unexpectedly died, his beneficiary will receive $100,000. A $200 contribution on the part of the insured in exchange for $100,000 benefit from the insurer illustrates an aleatory contract.

Property and Casualty Example:

John purchases a homeowners insurance policy for $100,000. His monthly premium is $100. If John only had the policy for 2 months, which means he only paid $200 in premiums, and the home was unexpectedly destroyed by a covered peril, John will receive $100,000. A $200 contribution on the part of the insured in exchange for $100,000 benefit from the insurer illustrates an aleatory contract.

4. Unilateral

In a **unilateral contract,** only one of the parties to the contract is legally bound to do anything. The insured makes no legally binding promises. However, an insurer is legally bound to pay losses covered by a policy in force.

5. Personal

In general, an insurance contract is a **personal contract** because it is between the insurance company and an individual. Because

the company has a right to decide with whom it will and will not do business, the insured cannot be changed to someone else without the written consent of the insurer, nor can the owner transfer the contract to another person without the insurer's approval. Life insurance is an exception to this rule: A policyowner can transfer (or assign) ownership to another person. However, the insurer must still be notified in writing.

D. Legal Terms

I.B.4. Be able to identify the term *insurance policy* (CIC 380)

I.B.5. Be able to identify the meaning and effect of each of the following on a contract: *concealment, warranty, representation, misrepresentation and materiality.*

1. Insurance Policy

The **insurance policy** is the written instrument in which a contract of insurance is set forth.

2. Representations and Misrepresentations (CIC 350-361, 780-784)

Representations are statements believed to be true to the best of one's knowledge, but they are not guaranteed to be true. For insurance purposes, representations are the answers the insured gives to the questions on the insurance application.

Untrue statements on the application are considered **misrepresentations** and could void the contract. A **material misrepresentation** is a statement that, if discovered, would alter the underwriting decision of the insurance company. Furthermore, if material misrepresentations are **intentional**, they are considered fraud.

Know that a representation may be **changed or withdrawn** prior to the effectuation of the policy, but not after. Misrepresentations that are pertinent to underwriting the insurability, level of risk, and decisions of either party are grounds to void a contract. However, it must be determined that the information was given under a false pretense, done so with

the intent to commit fraud, and was material in making the decision to enter the contractual terms.

According to CIC 782, any person violating this provision is guilty of a **misdemeanor** punishable by a maximum **fine** of $25,000, **imprisonment** in a county jail for a period no longer than 1 year, or by **both a fine and imprisonment**. If the loss to the victim exceeds $10,000, the fine should not exceed three times the amount of the loss. In addition, the Commissioner may suspend the license of the agent for a maximum period of **3 years.**

3. Warranty (CIC 440-445, 447)

A **warranty** is a statement considered to be guaranteed to be true and becomes part of the contract. According to the California Insurance Code, a certain format of words is not necessary to create a warranty. Warranties can either be *expressed* or *implied.* Statements in a policy are considered express warranty. Every express warranty becomes part of the insurance contract. Implied warranty is an unwritten or unspoken guarantee presumed to be made based on the circumstances of a transaction.

Note: A representation cannot qualify an express provision in a contract of insurance; but it may qualify an **implied warranty** (CIC 354).

The creation of the warranty will take place at or before the execution of the policy and will be contained in the policy itself. The warranty is not limited by time; therefore, it may relate to the past, the present, the future or any combination of these time frames. **Violation of a material warranty on either party entitles the other to rescind the policy.**

Furthermore, the breach of an immaterial provision (meaning that it is not important) does not void the policy unless specified by the policy itself. In addition, if the policy contains a statement implying that there is an intention to do or not to do that which affects the risk, it will be taken as a warranty that such an act or omission will take place.

4. Materiality (CIC 334)

The concept of **materiality** is based on the idea that all parties to a contract are entitled to all information necessary to make an informed decision about the quality or nature of the contract. Materiality is determined by the "probable and reasonable influence of the facts" that they would have on the party that needs the facts to make a decision, whether that party is the insurer or the insured. Failure to disclose material information may entitle the "injured" party to rescind the contract.

Of paramount importance is the weight of **disadvantages** on either party. Disadvantages are always material information. Every contract has disadvantages for both parties, but they may not be compelling when it comes to deciding whether or not to accept the contract. Insurers are entitled to know material information about prospective insureds: *Have they been diagnosed or treated for cancer, heart disease, or diabetes? Have they ever been hospitalized? Do they fly an aircraft? Have they ever been convicted of a felony?*

If an insured intentionally conceals information about a recent heart attack, this would probably have a larger impact than if the insured had misrepresented his age by 5 years. **The materiality of a given concealment determines the importance of a misrepresentation.**

Insureds, however, are also entitled to know the disadvantages the contract has for them: cash value surrender charges, principal exclusions (war, terrorism, aviation, suicide), length of term, increase in premium at end of term, internal fees and expenses, or a substandard rating, for example. Producers have a responsibility to share disadvantages with the prospect, not just the advantages of the contract.

5. Concealment (CIC 330-339)

Concealment is the legal term for the intentional withholding of information of a material fact that is crucial in making a decision. In insurance, concealment is the withholding of information by the applicant that will result in an imprecise underwriting decision. Concealment may void a policy.

Concealment is the failure to disclose known facts. An injured party is entitled to rescind the policy regardless of whether the concealment was intentional or unintentional. Each party should have the reasonable expectation that the other is acting in good faith without attempting to conceal or deceive the other. Neither party of the contract is legally bound to provide information pertaining to matters of their own judgment or opinions, even in matters in question. The right to rescind the policy is permissible for an intentional and fraudulent omission on the part of either party.

The following information does **not** need to be communicated in a contract:

- Known information;
- Information that should be known;
- Information that the other party waives;
- Information that is excluded by a warranty and not material to the risk;
- Information that is excepted from insurance and not material to the risk; and
- Information based on personal judgment.

E. Rescission

I.B.6. Be able to identify when an insurer has the right of rescission (CIC 331, 338, 359, 447)

a. Know that either intentional or unintentional concealment entitles an injured party to rescission of a contract (CIC 331).

Rescission is the revocation of a contract.

An injured party is **entitled to rescind the contract** if any of the following occurs:

- A false material representation (rescission is effective from the time the representation becomes false);
- Concealment (regardless of whether the concealment is intentional);
- Violation of a material warranty or any other material provision of a policy.

F. Six Specifications For Insurance Policies (CIC 381)

I.B.7 (Life/Health); I.B.6 (Property/Casualty/Personal Lines). Be able to identify six required specifications for all insurance policies (CIC 381).

Every contract of insurance is required to identify the following 6 specific elements:

1. The parties to the contract;
2. The persons or property being insured;
3. A statement of the insurable interest that exists if the insured is not the owner;
4. The risks insured against;
5. The time period during which the policy will be in force or continue; and
6. The stated annual, semi-annual, quarterly, or monthly premium or a statement of the manner in which a premium rate and total premium will later be calculated, if it can only be determined at the termination or expiration of the contract.

Note that an insurer's financial rating is not required to be specified in an insurance policy - *CA Educational Objective.*

G. Important Terms

I.B.8. Given an insurance situation, be able to identify the following terms correctly:

a. Application, policy, rider;
b. Cancellation, lapse, grace period;
c. Rate/premium, earned and unearned premium.

Application -- A written request for coverage to an insurance company. It must truthfully represent the facts regarding the person or property to be insured. Otherwise the policy will be voided.

Policy -- A contract between a policyowner (often the insured) and an insurance company which agrees to pay for loss caused by specified covered events.

Riders are added to a policy to modify provisions that already exist (usually used in Life and Health insurance). **Endorsements** are printed addendums to a contract that are used to change the policy's original terms, conditions, or coverages (usually used in Property and Casualty insurance).

Cancellation is the act of revoking or terminating one's insurance policy.

A policy that is terminated because of nonpayment of premiums is known as a **lapsed** policy.

Renewal is the continuance of an insurance policy beyond its original term. **Nonrenewal** is the discontinuance of an insurance policy beyond its original term. The renewal or nonrenewal may occur on a date specified in the contract (usually on the policy anniversary or premium due date).

A **grace period** is the period of time after the deadline or due date of a premium in which a late premium payment may be made without penalty, or without the policy lapsing.

The price of insurance for each exposure unit is called the **rate.** The **premium** is the payment required by the insured to keep the policy in force. The **premium** is determined by multiplying the **rate** by the number of units of insurance purchased.

Premium = Rate x Units of Insurance

An **earned premium** is the portion of a premium that belongs to the insurance company for providing coverage for a specified period of time. The **unearned premium** is the portion of the premium the insurance company has collected but has yet to "earn" because it has not yet provided coverage for the insured. *For example*, if an insured pays an annual life insurance premium and dies before that year is up, the insurance company would have to return the portion of the premium that was "unused" or "unearned."