Introduction to General Insurance

As an introduction to general insurance, let’s start with a definition of what that means. Insurance is a means of guaranteeing against loss or harm. Another way of looking at insurance is the protection against economic loss. This definition is especially important to us in our daily lives as the exposure to loss surrounds us at all times. Why do we need insurance? It is designed to protect us from catastrophic loss; a type of loss that the majority of the population cannot afford financially. Under an insurance contract, the burden of loss is shifted to another, usually an insurance company for a fee. It is typically a formal contract with specific terms, conditions and exclusions applying to both the insured and the insurer or underwriter.

Consider the following situations to understand better how insurance relates to most aspects of our lives:

You are retired and unable to work at your age

Your home burns down in a fire

You are injured while at work

You hit another car by accident

You overlook a lien or easement in a title search

An employee steals from your escrow account

Your partner dies and you have to buy her portion of the business

All of these situations can be covered by a certain type of insurance. For every type of mistake or error, there is an insurance coverage that can be bought to protect you. For instance, Social Security would be used after you retire. Life insurance would enable you to buy your partner’s portion of the business you shared. Homeowner’s coverage would cover you in the event that your home burns down. Most insurance packages come with some type of fee, called a premium that you pay according to the terms in the contract.

How long has insurance been available?

Insurance or sharing the loss of something valuable has been practiced really since the beginning of time. The formal business of insurance began in London coffeehouses in the sixteenth century. Ship-owners would negotiate insurance contracts with underwriters, investors, or other interested wealthy partners, basically, someone else that could afford to insure you. These investors were known as Lloyds of London syndicates. They would guarantee the safety of ships and their cargo to overseas' destinations or indemnify the ship-owners for any loss or damage. The development of the business of insurance at these syndicates helped the expansion of the British Empire around the world as the economic risks, such as the loss of ships and cargo, would be financially reimbursed in the event of a loss by the syndicates. It was the assumption of a specific risk for a fee or premium and generally, a profit. With that type of guarantee, it made business flourish.

The concept of risk sharing originally developed in the United States through Mutual Insurance Companies. A mutual is owned by its policyholders. Policyholders share in the losses or profits of the enterprise. A loss would be shared through increased premiums; a profit would result in a dividend.

A variation of a mutual is what is known as a Pure Assessment Mutual which could assess its policyholders immediately for losses. Today, most mutuals are non-assessable. Montgomery Mutual and Harford Mutual are MD examples of this type of insurance company.

In the mid 1800s, Reciprocals were a popular form of insurance vehicle in rural farm areas. A reciprocal consists of a group of people who insure each other. Granges, for example, were set up not just for social or protective purposes but also for risk-sharing or insurance. The late 1800s reflected the development of corporate insurance carriers, most of which were operated for a profit and owned by investor stockholders, hence, the term "stock or proprietary companies." Today, many of the large insurance companies are readily recognizable. Examples would be CAN, Aetna, Reliance, Travelers, etc.

As a result of the Great Depression of the 1930s, the Federal Government, recognizing the need to give greater economic stability to its citizens, developed the Social Security Insurance Program. In the 1960s, other social programs developed by Federal and State Governments were the Federal Crop Insurance and Flood Insurance Programs, Automobile Plans, and Fair Plans, which made auto, crime and fire coverage available to urban areas which were otherwise unavailable through standard markets.

Today, there are two broad categories of insurance:

Private AND **Governmental**
Private Insurers can be divided into two groups:

Proprietary: which operates for a profit; examples would be incorporated, Hartford Insurance Co., Stewart Title Insurance Company or unincorporated, i.e., Lloyds of London.

Mutual or Cooperatives: which apply profit/losses to capital surplus and premiums; examples would be mutuals, HMOs, Blue Cross/Blue Shield plans.

The Social and Economic Values of Insurance:

We have learned that insurance is the protection against economic loss, which we all want and need. If your car is stolen, you have lost not only the value of your car, which you are probably paying a loan plus interest on, but also the cost of renting another vehicle temporarily. Business analysts and others view the existence of certain insurances as protecting the allocation of business assets. If fire insurance were not carried don a manufacturing plant, the business CPA would advise the business owner to reserve cash or other assets as a contingency to mitigate the loss that might happen. That reserve or rainy day fund detracts form the businessmen’s ability to utilize those same monies in the other aspects of his business.

Insurance is also a critical component in the credit or lending process. In car and real estate loans, the lender as a good business person wants its interests or loan reasonably protected against loss that either it or the property owner can foresee; hence, the requirement of insurance documentation with loan documents at closing and the lender being named as an additional insured.

Some businesses pay enormous insurance premiums. An example would be a fireworks factory. Yet, the insurance is still a better business option than reserving monies in a no-return bank account. Instead, they will take many increased protective measures such as sprinkler systems, segregated chemical storage bunkers, etc., to reduce both risk and premium. Another example would be homeowner’s insurance. Typically, the insurance company will ask a series of questions to determine your risk profile in order to ultimately assess your risk factor. How many miles do you live from the closest fire station? How many smoke detectors are located in the home? Do you have a security alarm system? All of these questions assess the risk factor that you provide as an insured.

With that being said, insurance is not a cure all. It can cause problems as well as solve problems. A failing business owner who torches his clothing store to collect insurance is certainly not a benefit to society, much less his insurance company. Neither is a driver who drives aggressively or recklessly and feels that his insurance will cover anything that happens as a result.

Insurance Concepts and Definitions:

Insurance is a social device for reducing risk by combining a sufficient number of exposure units to make their individual loses collectively predictable. The predictable losses are shared by all of those in the combination. It is based on:

The Law of Large Numbers which is a mathematical law which states that the greater the number of exposures, the more accurately the occurrence of a given happening (fire, car crash, death) can be predicted. The insurance mechanism itself rests on the Law of Large Numbers. It is this mathematical concept of predictability which is the foundation for:
The Indemnity Principle or purpose of insurance to restore the insured to his or her actual economic condition before the loss. Profit by the insured is not contemplated in the insurance mechanism.

To understand or more fully appreciate the nuances of insurance in general, there are certain terms which generally apply across the board to all lines of insurance. They are as follows:

Risk: uncertainty of loss

Will lightning hit me on the golf course?
Will I survive a helicopter ride?

Speculative Risk: where a chance of both loss and gain exists.

Gambling in Atlantic City
Betting on a horse race

Pure Risk: risk where there is only a chance of loss

Humans will die
My business may burn down. Insurance is an example of pure risk.

Peril: the cause of loss, i.e. fire, wind, flood, undiscovered easement/mechanics' liens.

Hazard: a condition that may increase the risk of loss; smoking in a gas station

> **Moral Hazard**: intent to cause a loss; an owner torches his business or fakes a burglary
>
> **Morale Hazard**: indifference to potential loss; apathetic attitude. Everything's covered by insurance, so who cares?
>
> **Physical Hazard**: worn car breaks or ties, storage of hazardous chemicals near a furnace.

Chance of Loss: the probable number and severity of losses out of a given number of exposures. The largest number of exposures, the greater the predictability.
Insurable Interest: the interest must be of such a nature that should a loss take place, the insured will suffer financially. It could be a property owner and/or a lender. This principle of loss only is a matter of public policy to discourage fraud and willful destruction of property that is why courts have said that one should not profit by insurance.

Insured: is the person to be protected. The landowner, the car owner, or a secondary or contingent insured, i.e. a mortgage lender.

Insurer: is the person or entity to whom the risk of loss is shifted, i.e. a title underwriter, Safeco Insurance Company, Commonwealth Land Title, etc.

The Contractual Side of Insurance:

Insurance Contracts in General Conceptually: insurance policies are legal contracts; as such it is important to understand some legal concepts.

Commutative Contract: a contract in which the amount of consideration given by each party is equal; i.e., you pay 50,000 to a car dealer and you receive a Lexus in exchange.

Aleatory Contract: a contract in which the amount of consideration by each party may not be equal; i.e. an insurance contract where a small premium is paid in exchange for the insurer's promise of performance upon the future happening of an insured event. Your car is stolen, un-recovered, or recovered but damaged.

Contracts of Adhesion: are agreements which are offered by the insurer in a prepared form without negotiation by the prospective insured; i.e. title policies, fidelity policies. In court cases judges will lean generally against the drafter of the document of an ambiguity exists.

Utmost Good Faith: a legal doctrine underlying all contractual transactions which stipulates that both parties must act honestly and in good faith.

Warranty: a promise on the part of the insured which is part of the contract which is assumed to be material and a breach thereof is grounds for voidance of the contract by the insurer.

Representation: is a statement made by the insured, usually on an application, to induce the insurer to write the coverage. If proven to be untruthful, false, and/or material, the insurance may be voidable.

A contract has four essential elements:

Consideration: is a legal term which refers to the value given to each other by the parties to the contract. The policy premium in exchange for the promise to pay; upon the happening of the insured's peril, the 50,000 for the Lexus.

Legal Object: the purpose of the agreement must be lawful. Fidelity coverage for a title agency would not cover the owner of the agency for stealing from the agency escrow account; it would be against public policy to reward a wrong-doer for his wrong doing.

Offer and Acceptance: the insured offers to purchase the coverage by submitting an application. The company's issuance of a binder or policy constitutes acceptance.

Competent Parties: the parties are legally able to rationally enter into the contract; i.e., they are not minors, senile, etc. A binder or commitment is a temporary contract pending the actual issuance of the policy.

The Written Insurance Contract has four basic parts:

Declaration: the statement of who, what when…names, addresses of the parties, property covered, inception/expiration of the policy, etc.

Insuring Agreements: specifies the undertaking or risks protected against in the contract: fire, death, windstorm, title impairment.

Conditions: states the right and duties of both the insured and insurer/underwriter in the contract of insurance whether it be a life, automobile, or title policy.

Exclusions: states the perils (causes of loss) and property not covered; i.e. Errors and Omissions policies, for example, specifically exclude intentional acts and fidelity losses.

The Insurance Company:

Domestic Company: an insurance company whose corporate charter is issued in the State in which it is writing business, i.e. in Maryland, Security Title Corporation and Maryland Casualty.

Foreign Company: an underwriter is domiciled outside of the state in which it is writing business; The Aetna Casualty and Surety in Maryland, Lawyers Title operating in Maryland.

Alien Company: a company which is domiciled outside of the country in which it is writing business in the State of Maryland; Tokyo Fire & Marine, Zurich Insurance Company.

Companies are represented by:

An agent is a representative of the company and usually can bind the insurer. Oftentimes an agent represents only one underwriter. An agent works for his underwriter.

A broker is considered to be a representative of the insured/client and normally cannot bind the insurer. A broker, in the conventional sense, represents one or more underwriters.

This is a property and casualty differentiation which has recently been applied legislatively in title legislation without clarification.

Companies by Internal Functions:

Have a marketing/production/agency department geared to producing new and retaining existing business/clients. Have an underwriting/risk assessment operation which evaluates, rates, approves or declines risks, and also may condition risk acceptance. Have claim departments to pay claims under policy terms.

Common Insurance Terms:

Line of Insurance: the type of insurance writers, i.e. title, life, property or casualty insurance

All Lines Carrier: applies to an insurer that underwrites ALL types of policies

Multiple Lines Carrier: an underwriter that writes several types of coverage except for life insurance

Actual Cash Value: property cost less depreciation

Subrogation: the right of recovery against a third party by the underwriters; the insurer inherits the recovery rights form the injured party after payment

A Package Policy: usually has two or more coverages combined in a single policy, i.e. liability and property damage in homeowners and automobile policies.

Deductible: is offered in many forms of coverage including, auto, homeowners, etc. The insured agrees to absorb a portion of any loss for a cheaper premium

Property Insurance: protection against loss of property, i.e. an office building, by an insured hazard, i.e. windstorm, fire, hurricane. An extension of this coverage is the loss of use of the property or Business Interruption coverage which pays to set up shop elsewhere temporarily.

Insurable Interest: refers to a legal right or social interest in the preservation of property. Examples would include: mortgage lender on our home, a business person insuring the life of his partner, an auto lender. The insurable interest must exist at the time of loss.

Umbrella Policy: an excess level of insurance protection over and above existing coverages. Losses reaching the excess level must first be absorbed by the underlying coverages and/or self-absorbed.

Reinsurance: the sharing of risk and premium by an originating underwriter with other underwriters; in the event of a catastrophic loss, the dollar impact is thereby diluted with other players involved.

Treaty Reinsurance: each risk is automatically reinsured

Facultative: individual risks are independently reinsured

Proximate Cause: the controlling cause of loss which leads to the loss in an unbroken chain of events

Negligence: the failure to exercise reasonable care

Fidelity Bond: protects an employer against dishonest acts of an employee, i.e. stealing from an employer's escrow account.

Surety Bond: a three party contract in which one party (the surety) guarantees the performance of contractual or mandates obligations of another party (principal) to a third party beneficiary or oblige. In title, the surety or bonding guarantees to the State that its bonded title agent will properly account for its escrow funds; if not, the State will claim against the $150,000 bond.

Insurance and the Law:

As noted earlier, an insurance policy is a legal contract, as such; rules and regulations have been developed as to the conduct of the business of insurance. Those rules cover the gamut of the business activity from marketing, underwriting and rating practices to the handling of claims.

In 1868 the U.S. Supreme Court tin Paul vs. the State of Virginia ruled that insurance was not commerce and therefore not subject to Federal regulation. In 1944, it reversed itself (U.S. vs. South Eastern Underwriters' Association (SEUS) and held that the business of insurance was interstate commerce and therefore subject to Federal regulation. To resolve the judicial conflict, Congress passed the McCarren Act which in essence states the Federal Government would not regulate insurance if the states themselves did an adequate job of regulation. The states, therefore, have the primary responsibility for the regulation of the business of insurance.

Prohibited Practices:

As in most industries, a certain level of abusive or unethical practices sometimes develops. The Maryland Insurance Administration and other insurance departments as well take a very dim view of certain industry practices in particular; namely,

Rebating: is the illegal practice of returning anything of substantial value (premiums, commission, Orioles/Redskins season tickets, a free week at Ocean City) to a prospective insured as an inducement to purchase insurance.

Twisting: is the illegal practice of replacing the insured's existing coverage with new insurance to the insured's detriment; whether it is differing terms, coverages, and/or rates.

Embezzlement: the act of converting to your own use and benefit funds in your possession that rightfully belong to others (clients and/or underwriters).

Commingling of Funds: Maryland insurance regulations prohibit the mixing of personal funds with insurer funds and/or the mixing of funds of two or more carriers in a common account without the permission of each underwriter.
Related Considerations:

Surety Bonding: a title agency is required by Maryland Insurance Statutes to maintain a bond which protects the citizens of Maryland (through the State) against the default of an agency. Aside from serving as a recovery source ($150,000 bond), it serves as a vehicle to screen out undesirable or otherwise unqualified agents.

Fidelity Coverage: blanket fidelity insurance in the amount of $150,000 is required of all title agents doing business in the State of Maryland. It protects the agents against dishonest acts (theft) of employees (not owners). Where a truly "one-person" operation exists (no employees) a waiver can be requested from the insurance department.

Errors & Omissions Coverage: a policy insuring against losses arising from unintentional mistakes or omissions which result from the conduct of the title agency business. It specifically excludes intentional acts and fidelity coverage. It includes most often legal defense coverage.

In this section, concepts and principles of insurance are considered. These include:

Insurable risks
Adverse selection
Insurable interest
Reinsurance
Agents and agency law
Contracts
Legal interpretations affecting insurance contracts

Insurable Risks

There are certain requirements in order for risks to be insurable. These are:

There must be a large number of exposure units, so that losses are predictable
The loss must be unintentional and accidental
The loss must be definite and measurable
The loss must not be catastrophic

Large Number of Exposure Units

Insurance companies require that several similar exposure units be insured because the chance of loss becomes more predictable as numbers are large. This is known as "the law of large numbers." Insurers can statistically predict the likelihood of loss and calculate premium more accurately when there are large numbers of similar exposures to risk.

Unintentional and Accidental Units

Insurable losses may not be purposely caused, but must be unintentional and accidental. If intentional losses were covered, insureds would have an incentive to cause them. Losses must also be accidental. Accidents occur randomly, so they may be statistically predicted.

Definite and Measurable

An insurable loss must be definite and measurable. This means that a loss occurred at a specific time and place, resulted from a specific cause, and resulted in a specific loss amount. Insured losses must meet the provisions and definitions of a covered loss as described in the insurance contract. The insurer cannot pay a benefit if any of the elements of cause, time, place or amount cannot be defined. When any of these elements cannot be defined, the loss will not meet the policy's coverage provisions.

The Loss Must Not Be Catastrophic

Insurance companies do not generally insure losses that are likely to be catastrophic. If a loss is catastrophic, several exposure units have losses at the some time. Paying for so many losses at once can mean that the insurer would be unable to meet its ongoing financial obligations. The insurer would have to charge high premiums in order to pay for such losses.

There are exceptions to this rule. For example, flood, windstorm and earthquake insurance is available. Flood insurance is largely provided through a federal program, however, so the private insurance industry does not bear the risk of this catastrophe alone. In addition, insurers who cover potentially catastrophic losses often insure in many states and in many different geographic locations. They may also be part of state pools that help cover these risks when they occur. Reinsurance is also used to help spread the risk of catastrophic perils.

Adverse Selection

Another important insurance concept is “adverse selection”. Adverse selection refers to the condition when only people who are at a high risk for a particular type of risk are likely to purchase insurance. For example, people who live in an area that is often flooded are much more likely to purchase flood insurance than those who are at little or no risk of flooding. Those who live in “Tornado Alley” are more likely to want high limits of windstorm coverage than those who live in an area that has very little wind. People who are unhealthy are likely to want to purchase life insurance.

Insurers cannot accept only predominantly high-risk individuals or properties. If they were to they would not be able to cover all losses or would have to charge such high premiums that people would not be able to afford the coverage.

Insurers use underwriting guidelines to reduce adverse selection. For example, certain unhealthy individuals cannot purchase life insurance, are charged very high premiums, or are limited in the amount of coverage they may purchase. The government may also step in when adverse selection is a problem, as it has with flood insurance, so that insurance is available. States also establish pools, where all insurers in a state must participate, to cover high-risk properties, such as those along the gulf coast that need windstorm coverage.

Insurable Interest

Insurable interest is a legal concept underlying insurance contracts. It means that the insured or policy owner has to suffer financially or be harmed in another way if a loss occurs in order for insurance to be issued. If the insured or owner isn't harmed by a loss, insurance should not be issued. For example, the owner of an auto suffers financially if the auto is in an accident, and an owner of a home suffers financially if a fire occurs in the home. These owners have insurable interest in their property.
If people without an insurable interest were allowed to purchase insurance, negative consequences can occur. First, it would make insurance a form of gambling. The purchaser would be hoping for a loss so he could collect his "winnings', the policy benefits. This is not in the best interest of the public. Secondly, an individual without insurable interest is more likely to want to purposefully cause a loss; if insurance were issued without requiring insurable interest, the moral hazard is greatly increased.

Insurable interest is closely tied to the principle of "indemnity". Most insurance contracts are indemnity contracts. This means that the insured can only be compensated for the amount of the loss; he cannot make a profit due to an insured loss. In most contracts, insurance payment cannot exceed the amount of insurable interest in the property, or other item being insured. For example, if a home is insured based on its replacement value and it is totally destroyed by an insured peril, the most the insurer will pay is the replacement value of the home. The insurer may also pay some additional expenses, such as paying for debris removal or lodging while the home is rebuilt, but these still represent the insured's interest in the home. The requirement of insurable interest protects against insurance being used to make a profit.

In title insurance, insurable interest means that the insured must have valuable consideration in the property and that the insured is in a position to suffer financial harm if the title to the property is not as represented as of the date of policy. The lender of a mortgage would suffer loss if the collateral to the mortgage were harmed. Lenders have an insurable interest in the real property for which they fund a loan.

Reinsurance

In some cases, an insurer will shift some of its insurance policies to another insurer. The insurer who originally wrote the policies is called the 'ceding insurer." This practice of shifting policies from one insurer to another is known as reinsurance.

The main purpose of reinsurance is to increase the ceding insurer's capacity to write business. It can write an amount of business that exceeds its financial ability to carry, and place it with reinsurers. Its agents can write large policies, or write many policies that are in high risk geographic areas, or that cover high risk occupations, and the insurer can use reinsurers to reduce its risk.

Law of Agency

Insurance agents have a special relationship with the insurers they represent. The laws that apply to the insurers and agents responsibilities, duties and boundaries are known as the law of agency.

Agents

The agent has the authority to act on behalf of the insurance company. In the agency relationship, the insurance company is known as the principal. The principal is the party who is able to act for himself. The principal gives the agent the authorization to represent him. The principle is then responsible for the agent’s actions, as long as the agent is working within the scope of the authorization given to him by the insurer. The authority given to the agent may be express authority, implied authority and apparent authority.

Express Authority

Express Authority is authority specifically given to the agent. For example, the insurer may use a formal Agent Agreement or Agent Contract that stipulates the agent’s powers, the commissions the insurer will pay, states who owns the contracts that are sold and the customer data collected, and so forth.

Implied Authority

Implied authority is authority given to the agent to perform its express authority. When selling insurance policies, the agent will collect premium and deliver contracts and the authority to do so is implied.

Apparent Authority

The insurer can be bound by the acts of an agent who is acting with apparent authority. A common example of this is when a property agent binds coverage for a risk that actually falls outside of the insurer’s underwriting requirements. The insured does not know that the agent should not be binding the risk, and when a loss occurs, the insurer is responsible. For example, a building does not have a sprinkler system, and an insurer requires that properties of its type have sprinkler systems in order to insure the property. The agent of the insurance company takes an application from the property owner and 60 days worth of premium to bind the coverage. A fire occurs ten days after the coverage was bound. The insurer will generally have to pay for the damage caused by the fire even though the property did not have a sprinkler system.

Insurer

In regards to the Law of Agency, the insurer, also known as the principal, has duties to perform for the agent. The principal must adhere to the contract with the agent in such things as paying commission, reimbursing for expenses or damages resulting from the agency relationship, not interfering with the agent's ability to work, and keeping the agent informed of products, industry, and risks. The insurer/principal will permit the agent to work within the terms set forth in the contract and will comply with the terms as well.

Responsibilities of the Agent to the Insured

The agent has several responsibilities toward the applicant/insured. These include accurately disclosing product features, benefits, premiums and provisions. The agent is relied upon by the applicant/insured to provide information and answers about the insurer's products and services. The agent has the responsibility to properly handle any premium collected. The agent is not to commingle premiums with his own funds, or misuse them, or to withhold them from the rightful property.

Another responsibility an agent has to the applicant/insured is to assist them with customer service issues. The agent needs to help them in a timely manner. Of special importance is handling claims. Claims must be dealt with according to insurance company standards and state regulations.

Responsibilities to the Insurer

The insurer requires the agent to properly perform all of the following duties:

1. Accurately disclose product features;
2. write business that falls within the insurer's underwriting guidelines
3. Appropriately handle premium
4. Maintain required records; and
5. Consistently transact business in a legal and ethical manner

Contracts

Insurance contracts are subject to contract law. There are four elements of a legal contract. These are:

1. Offer and acceptance
2. Consideration
3. Competent parties
4. Legal purpose

Offer and Acceptance

A legally enforceable insurance contract must have an offer and be accepted. The applicant makes the offer, and the agent or insurer accepts the offer when the policy is issued. It may seem that the agent is making the offer, because he or she is asking for the applicant to purchase insurance, but this activity of the agent is just solicitation of the offer.

Offers and acceptance can be oral, but normally, insurance contracts are in writing. Acceptance usually occurs upon issue of the policy, after the insurer has reviewed and underwritten the risk. But, in property casualty insurance, the agent can bind coverage immediately, before the policy is issued. In this case, acceptance occurs when the agent binds coverage.

Consideration

Consideration is the value given from the party(ies) to the contract to the other party(ies). The premium paid is the consideration from the applicant/insured. The insured also agrees to abide by certain conditions in the policy. This agreement to comply with these is also his consideration. The insurance company's consideration is that it promises to meet the obligations in the policy, such as paying insurance benefits according to the policy terms.

Competent Parties

In order to enter into contracts, parties must be competent. They must meet the legal standards of competency. These include that one cannot be a minor and one must be of sound mind, not insane, mentally incompetent or intoxicated.

Legal Purpose

A contract must have a legal purpose. For example, if a drug lord contracted with a trucker to ship cocaine from New York to Iowa, and the trucker failed to meet the terms of the contract, the drug lord could not turn to the courts to sue the trucker. This contract had an illegal purpose, so is not enforceable.

Insurance contracts are governed by state statutes that require that certain provisions be within them. For example, state law may require that insureds be able to look over an insurance contract for 30 days, and if the insured decides to cancel the contract, the insured receives all premiums back, without penalty. To be enforceable, insurance contracts have to comply with the laws that apply to them.

Contracts of Adhesion

When disputes occur between an insured and the insurer, the courts generally rule in favor of the insured if contract language is unclear or can by interpreted in more than one way. One of the reasons disputes are handled in this manner is because insurance contracts are considered to be contracts of adhesion. A contract of adhesion is a contract whose terms are drawn up by one party and the other party adheres to them. Under other forms of contract, both parties negotiate the terms of the contract. Since the insurer draws up the terms of the insurance policy, and had the ability to make the terms clear, the courts tend to give the insured the benefit of any unclear terms.

Aleatory Contract

Insurance contracts are aleatory. This means that the outcome is affected by chance, and that the values exchanges may not be equal. Only if a peril occurs or other insured cause of loss will payment be made by the insurance company. This is different from a contract for payment for an appliance and its installation, which is known as a "commutative contract". In a commutative contract, the payment will be made upon installation. There is no chance involved.

Under insurance contracts, if a loss occurs, the premium is much less than the benefit received. The value received is not generally equal to the value paid. With a commutative contract, the value of the appliance and installation is considered to be equal to the amount paid by the purchaser.

Personal Contract

Many insurance contracts are personal contracts. This means the contract is between the insured and the insurer. For example, an auto policy insures the auto owner against loss, it does not insure the auto. A homeowners policy insures the homeowner against loss, it does not insure the home.

When insurance is applied for, the applicant's personal characteristics are considered. For example, a credit check may be done, and an insured who has a criminal background may be rejected. Premiums may be higher for those with poor credit, since insuring them may be seen as increasing the risk of moral hazard.

Unilateral Contract

Insurance contracts are unilateral because only one party makes a promise that is enforceable by law. The insurer promises to pay the insurance claim or benefit, to defend the insured from a lawsuit, or whatever other services are in the policy. If the insurer does not do so, it can be taken to court and forced to comply with its policy terms. The insured

must pay premiums to keep the contract in force, but the insured cannot be legally forced to pay the premium. The insured can let the policy lapse, or choose not to renew it.
Conditional Contract

Insurance contracts include conditions. These are provisions that qualify or limit the obligations of the insurer in the insurance policy. For example, when a loss occurs, the policy requires that the insured file a claim. Without a claim completed according to the policy's requirements, the insurer will not pay for a loss.

Legal Interpretations Affecting Insurance Contracts

Reasonable Expectations

Legal cases involving insurance contracts use the doctrine of reasonable expectations in making the court's decision. The courts interpret the insurance contract to mean what a reasonable person would expect it to mean. A reasonable person means a reasonable layperson, not a lawyer or other legal expert.

Indemnity

Title insurance policies, like many other insurance contracts, are contracts of indemnity. This means that the insurer contracts with the insured to restore the insured to the financial condition the insured enjoyed prior to the loss or damage covered by the policy. Stemming from the legal principle of indemnity are other characteristics of the insurance:

1. Indemnity precludes the insured from making a profit from a loss
2. The insurer must be able to determine the amount of loss that actually occurred, so must be provided with sufficient documentation if loss occurs in order to indemnify the loss.
3. The insurer must be able to anticipate the extent of possible losses so that appropriate premium can be collected to indemnify losses.
4. Payment for loss can only be made to a party who actually suffers loss, so the insured must have interest in the title sufficient that he or she is at risk for financial loss.
5. An actual financial loss must occur as the result of the occurrence of an insured event, because if there is no loss, there is nothing to indemnify.

Utmost Good Faith

Parties to insurance contracts must act with utmost good faith. The applicant/insured must have a high degree of honesty in completing the application. The insurer must not do anything less than honest to avoid paying a claim, may not coerce an insured to take a lower claim payment than is payable under the policy, etc.

There are three important legal doctrines related to utmost good faith. These are representations, warranties and concealment.

Representations/Misrepresentations

A misrepresentation is an intentionally or sometimes negligently false representation made verbally, by conduct, or sometimes by non-disclosure or concealment and often for the purpose of deceiving, defrauding, or causing another to rely on it detrimentally.

If the insured makes a misrepresentation, the policy may be void. If the insured misrepresents a material fact, the policy is void, at least as it pertains to that fact. A material fact is one that, if it had not been misrepresented, the insurer would have declined the insurance application or would not have covered the risk related to the fact. If fraud in procuring insurance is established on the part of the insured, the policy is automatically void.

Warranties

A warranty is a statement made by an insured that must be true in order for the insurer to be obligated under the contract. For example, the insured in a policy for a retail store may warrant that the store will have an operational security system at all times. This warranty may be part of the contract.

Courts have interpreted breach of warranty issues in a way so that immaterial breaches of warranty cannot be used to remove the insurer's liabilities under its policies. Information on applications is considered representations, and misrepresentations cannot be used to deny the insurer's liability unless the misrepresentation is material. For example, if an applicant to a life policy stated that he had never had a heart attack when he actually had, and then died of a second heart attack, this could be considered a material misrepresentation and the death benefit would not be paid.

Fraud

Two types of fraud affect real estate transactions: actual fraud and constructive fraud.
Actual Fraud is an act or statement intentionally made in order to deceive. It is often accomplished by misstating or hiding a material fact. Constructive Fraud arises from a breach of duty, negligence, or an unintentional misrepresentation. It differs from actual fraud because it is not intentional.

Parties to Fraud

In a real estate transaction, any of the parties could commit fraud. The buyer could misrepresent his ability to finance the purchase or what is his true identity. The seller could conceal a serious bug infestation problem. The real estate broker could conceal material information or break confidentiality in order to make the sale. The appraiser

could falsely inflate the value of the property. If any of the parties commit fraud, they can be taken to court and sued for damages.

Intent

In most cases, courts only award damages for fraud if the person committing the action in question intentionally deceived the plaintiff. If the person relied on credible evidence to make the false statement or conceal the material fact, etc., most courts do not find fraud. However, a minority of courts have found fraud even when actions are unintentional, if the fraud involves the sale, rental or exchanges of real estate. Damages are awarded based on the true value for the real estate based on true statements and full knowledge.

Honest Misrepresentation

If an honest misrepresentation was made, the affected party can rescind the agreement or transaction.

Statements That Are Not Credible

Courts do not view all misstatements as fraud or misrepresentations. For example, courts assume if parties to a contract are competent, the parties should know better than to believe certain statements, or should understand that certain statements are just opinions.

For example, a real estate agent who has no knowledge of any structural problems with a home may say that the type of construction used in the home she is trying to sell is excellent. If, after the home was sold, problems were found with the construction, a court would likely consider the agent's statement an opinion, not misrepresentation or fraud.

Another type of speech the courts do not consider fraud is puffing. Puffing is when a seller speaks highly of an item he is selling. It is expected that a seller will have a high opinion of the item he sells. When a seller says, "This house is one of the most historic homes in the city," or, "this type of construction lasts forever," or similar statements, a court is likely to consider them puffing and expressions of opinion only. If however, an expert made these statements and they were incorrect, they could be considered fraud. If an architect who specializes in restoring historic homes were hired by the buyer and the architect made statements concerning the home's historic value knowing they were false, he could be found guilty of fraud.

Concealment

If an individual purposefully conceals a material fact, courts may find him guilty of fraud or misrepresentation. However, if an individual is merely silent, they are generally not charged with fraud or misrepresentation. In the case of real estate transactions, many states now require sellers to make certain disclosures to purchasers, unless the purchaser agrees to buy the property, AS IS. In addition to these required disclosures, a court could find a seller guilty of fraud or misrepresentation unless he discloses items he has knowledge of in the following areas:

When a hidden defect could likely result in personal harm to persons using the property
When a hidden defect will limit the buyer's intended use of the property
When the seller has a confidential relationship with the buyer
When the seller has given an answer to a buyer that at the time was true, but circumstances have changed, so now the answer is false.

Concealment is the act of an applicant who purposefully does not reveal a material fact to the insurer. If the homeowner knows there is a problem with mold in his home and does not disclose this on his homeowner's insurance application when asked, he is guilty of concealment. Materiality is important to courts when determining whether concealment will cause an insurer to be able to deny liability.

Statute of Frauds and Real Estate Contracts

Certain kinds of contracts must be written in order to be enforceable in the courts. The types of contracts that must be written are found in the Statute of Frauds. Contracts for the sale of real estate including a lease for a period of one year are required under the Statute of Frauds to be in writing. If an agreement to sell real estate is not in writing, it is voidable by either party and the courts will not enforce it. A real estate contract does not have to be lengthy in order to be enforceable. The minimum requirements for a contract under the Statute of Frauds are that the agreement:

Identifies the parties; they can be identified by names or initials
Adequately describes the subject matter
Sets forth the material terms of the agreement, and its conditions
Is signed by the party to be charged

Waiver and Estoppel

Under the legal doctrines of waiver and estoppel, an insurer may be required to pay claims it normally would not have to pay.

Waiver
Under the doctrine of waiver, if an insurer voluntarily relinquishes or waives a known right, it cannot later deny payment of a claim due to that right. For example, an insurer requires its agents to obtain pictures of a homeowner's property and submit them to underwriting in order for a policy to be issued. The agent does not submit the pictures, but the policy is issued anyway. The insurer cannot use the lack of submission of the pictures as a reason to deny a claim.

Estoppel
Estoppel is the legal principle that prevents a person from alleging a fact that the person has already denied by his behavior, or from denying a fact that the person had already confirmed by his behavior. If an agent regularly allows insures to pay premiums a few days late, and then the insurer tries to deny a claim to an insured because the premium was a few days late, the doctrine of estoppel will not allow the claim denial.

Introduction of General Insurance Review Exam

1. Lloyds of London types of insurance are based on

a. a pure assessment mutual
b. a syndicate of wealthy partners providing indemnities
c. a mutual company
d. all of the above

2. A mutual insurance company is owned by the

a. policy holders
b. stockholders
c. the Affordable Housing Trust
d. none of the above

3. An example of insurance which is made available in area in which it would otherwise be unavailable from the standard markets is called a

a. Proprietary program
b. Lloyds program
c. Fair Plans program
d. None of the above

4. The general idea of insurance is based on the principle that

a. the insureds are protected against catastrophic financial loss
b. economic loss should be compensated with profit for the insureds
c. that is expressed as let the buyer beware
d. guarantee against loss or harm

5. The law of large numbers is a principle which states that the greater the number of exposures, the

a. less accurately the loss occurrence can be predicted
b. the more accurately the loss can be predicted
c. the more loss will occur
d. none of the above

6. The term for the uncertainty of loss is called:

a. peril
b. risk
c. moral hazard
d. morale hazard

7. When there is a chance for loss or gain, it is an example of:

a. risk
b. pure risk
c. hazardous risk
d. speculative risk

8. When there is only the chance of loss, it is referred to as:

a. pure risk
b. risk
c. peril
d. speculative risk

9. Insurance is based on the indemnity principle. This principle is based on the goal of:

a. restoring the insured to a condition before loss
b. profitability for the victim
c. accumulated depreciation
d. none of the above

10. An insurance company is said to be domestic when its charter has been issued in

a. a country outside of the U.S.
b. the state in which it is writing business
c. any state in the U.S.
d. none of the above

11. A company which is domiciled outside the state and country in which it is writing it’s business is called a

a. alien company
b. foreign company
c. domestic company
d. subsidiary company

12. The internal departments of an insurance company include:

a. underwriting, risk assessment
b. marketing, production and agency
c. claims department
d. all of the above

13. An all lines insurance provider and a multiple lines provider are mutually interchangeable terms:

a. False
b. True

14. The right of recovery against a third party by the underwriter, inherited after payment to the insured is called the right of:

a. subrogation
b. reinsurance
c. actual cash value
d. negligent recovery rights

15. A surety bond is a three party contract in which

a. surety may be liable for the face amount of the bond to a beneficiary
b. the surety guarantees performance of principal
c. A & B
d. None of the above

16. The McCarron Act resolved the judicial conflict regarding:

a. US vs. SEUA (1944)
b. Paul vs. State of Virginia (1868)
c. The confusion of whether insurance was interstate commerce
d. The confusion of whether insurance was domestic policy

17. The illegal practice of giving anything of substantial value to a prospective insured as an inducement to purchase insurance is called:

a. rebating
b. twisting
c. embezzlement
d. commingling

18. Fidelity bonds are

a. required for title agencies in which a non-attorney conducts settlements
b. protects an employer against dishonest acts of employees
c. A & B
d. A nor B

19. Underwriters avoid suffering catastrophic losses by spreading the risk among other underwriters. This is described as:

a. subrogation
b. reinsurance
c. equitable risk
d. reissue

20. The illegal practice of replacing insured's' existing coverage with new, detrimental insurance or provisions is called:

a. commingling
b. rebating
c. twisting
d. embezzlement

21. Personal or operating funds may not be mixed with escrowed funds. The mixing of these funds is referred to as:

a. commingling
b. embezzlement
c. twisting
d. rebating

22. Errors & Omissions policies cover the intentional mistakes or omissions which occur in the conducting of the title business. It also covers fidelity issues and supplements the bonds that are in place.

a. False
b. True

23. Insurance in the nature of fidelity coverage does not apply to which of the following examples:

a. theft of $1000 by the owner of the insurance business
b. theft of $1000 by an independent contractor of the firm
c. theft of $1000 by a secretary of the firm
d. Both B & C

24. An insured has an insurable interest in the property under which of the following examples:

a. a tenant in an office building
b. the mortgage lender on the property
c. the insured has an ownership interest in the property
d. all of the above

25. Which of the following is not an example of a permitted E&O claim?

a. title agent has constructive notice of a lien not reflected in the search
b. an easement is omitted from a title policy
c. a gas line easement is omitted from the lender's policy after the agent discovers the transaction will fail if known
d. B & C

26. A deductible usually has the following features:

a. is mandatory on all insurance policies
b. the insured absorbs a portion of the loss
c. cheaper premium for the coverage
d. A & B

27. Proprietary insurance companies are:

a. Run fair plans
b. Examples of mutual companies
c. Are operated for profit
d. Federally regulated

28. A broker is considered to be the representative of the

a. Client/insured
b. Third party
c. Company/insurer
d. All of the above

29. In real estate, marketability is often used as a synonym for:

a. unacceptability
b. transferability
c. insurability
d. agreeability

30. If a loss is intentional:

a. it is insurable
b. an insurance policy pays only half the normal benefit for the loss
c. it is generally uninsurable
d. it is illegal

31. When a court interprets an insurance contract to mean what a reasonable person would expect it to mean, what kind of reasonable person is the court referring to?

a. a reasonable insurer
b. a reasonable lawyer
c. a reasonable legal expert
d. a reasonable layperson

32. An agent regularly allows insureds to pay premiums a few days late and then the insurer tries to deny a claim to the insured because the premium was a few days late. What legal doctrine would be applicable to this case?

a. Waiver
b. Estoppel
c. Arrete
d. Warranty

33. A seller conceals a serious bug infestation problem. What kind of fraud is this an example of?

a. Actual fraud
b. Constructive fraud
c. Intentional fraud
d. Liability fraud

34. What is puffing?

a. When a seller speaks highly of an item he is selling
b. When a buyer acts dissatisfied with an item he secretly wishes to buy in order to drive the price down
c. When an expert makes a fraudulent statement regarding an item in his area of expertise
d. The opinion of an enamored buyer upon purchase of an item

35. What is an aleatory contract?

a. a non-insurance contract
b. a contract which is written by a certain type of attorney
c. a contract whose outcome is affected by chance
d. a commutative contract

36. What does insurable interest protect against?

a. a catastrophic loss
b. an unfair premium being demanded by an insurer
c. Government interference in private insurance matters
d. An individual being more likely to purposefully cause a loss

37. What is the consideration of an insurer?

a. the premium paid
b. a promise to meet the obligations in the policy
c. legal competence
d. legal purpose

38. In a contract of adhesion, if there is a dispute between the insurer and the insured, who will the courts generally rule in favor of?

a. the insurer
b. the insured
c. whoever wrote the terms to the contract
d. it is not foreseeable

39. Which of the following is not a part of the law of agency?

a. Laws that apply to insurer's responsibilities
b. Laws that apply to agents' duties
c. Laws that apply to the boundaries of both insurers and agents
d. Laws that apply to policy forms approved by the state in which the policy was issued

40. The seller believed he had good and clear title to the real estate property when he sold it. Later, it was found that a lien from the prior owner still encumbered the property, and the seller did not have the power to convey the property. The seller:

a. committed actual fraud
b. committed constructive fraud
c. committed a felony
d. committed a misdemeanor

41. A person the age of 16:

a. may enter into a contractual agreement
b. may enter into a contractual agreement in some states
c. may enter into a contractual agreement if the contract deals with real estate
d. may not enter into a contractual agreement

42. In an insurance contract, what is a material fact?

a. a fact which would prompt an insurer to decline an insurance application or not cover the risk related to the fact
b. a statement made by a witness to the signing of the insurance contract
c. a circumstance which directly and accidentally causes loss or damage to property
d. a misstated zip code in the applicant's address

43. In reinsurance, which party is the ceding insurer?

a. the insurer who originally wrote the policies
b. the insurer to whom the policies were shifted
c. the third party, presiding insurer
d. the government

44. Which of the following authorities is a name for authority specifically given to an agent?

a. apparent authority
b. express authority
c. implied authority
d. meditated authority

45. Which of the following is not a minimum requirement for a contract under the Statute of Frauds?

a. that the agreement identify the parties
b. that the agreement sets forth the material terms of the agreement
c. that the agreement is signed by the party to be charged
d. that the agreement be oral as well as written

46. In a real estate transaction, which party(ies) may be taken to court and sued to damages arising from fraud?

a. the buyer and seller only
b. the real estate broker only
c. the appraiser only
d. any of the parties in the transaction who committed fraud

47. What is adverse selection?

a. the decision by an insured to purchase only minimal insurance
b. the condition when only people who are at a high risk for a particular type of risk are likely to purchase insurance
c. another way of describing underwriting guidelines
d. a state pool, in which all the insurers in the state must participate

48. If a lender is the insured in a title policy and has an actual loss of $350,000 due to a forged deed, because of the concept of indemnity, the title insurer:

a. will only pay the lender half the loss amount
b. will not pay the lender for the loss
c. will pay the lender the amount of the actual loss, and no more, up to the limits of the insurance policy
d. will pay the lender double the amount of the loss

49. If a loss is intentional:

a. it is insurable
b. an insurance policy pays only half the normal benefit for the loss
c. it is generally uninsurable
d. it is illegal

50. When an agent goes to work for an insurer and signs a formal Agent Agreement, the insurer is giving the agent:

a. implied authority
b. express authority
c. apparent authority
d. unlimited authority

51. Which of the following is not a requirement for a loss to be insurable?

a. a loss that is accidental
b. a loss that is measurable
c. a loss that is catastrophic
d. a loss that is predictable via a large number of exposure units

52. Which of the following statements about agent responsibility is not true?

a. the agent must accurately disclose product features
b. the agent must assist an applicant/insured with customer service issues
c. the agent may have to make up premiums with his own funds if it is in the best interest of the applicant/insured, without liability
d. the agent must help the applicant/insured in a timely manner

53. Why would an insurer not be able to cover catastrophic losses?

a. several exposure units would have losses at the same time, meaning that the insurer would not be able to meet its ongoing financial obligations
b. the insurer would have to charge low premiums, due to the insured's inability to afford high premiums
c. catastrophic insurance is never aided by federal programs, leaving the burden on the insurer
d. insurers are not permitted to insure in many different states, or many geographic locations, at once