Chapter 1
Insurance Concepts & Principles

Chapter Objectives

Your learning objectives are as follows:

- Understand the mechanism of insurance.
- Understand the difference between property and casualty insurance.
- Learn the parts of the insurance contract
- Know all of the insurance terms
- Understand property insurance terms and concepts
- Know the loss adjustment methods (replacement cost vs. actual cash value)
- Understand casualty insurance terms and concepts
- Know the parts of a liability policy
- Understand the principles of risk, elements of insurability and
- Know the parties to a contract
- Know the characteristics of an insurance contract (legal terms must be memorized)
- Understand legal interpretations affecting the insurance contract

I. The Concept of Insurance

Introduction

This section provides the foundation of insurance terms and legal concepts which the licensing candidate must learn and understand. Some of the testing companies test on many of terms contained in this section.

What is Insurance?

Insurance is a social device for spreading the chance of financial loss among a large number of people. By purchasing insurance, a “person” shares risk with a group of others, thereby reducing the individual potential for disastrous financial consequences. Transacting insurance includes soliciting insurance, collecting premiums and handling claims.
Insurance is based on the **law of large numbers**. By combining a large number of homogeneous units, the insurer is able to make predictions of possible loss. Using the law of large numbers, insurers are able to calculate their probable losses and to establish the rates for premiums that will cover their losses and their operating expenses.

**What is Underwriting?**

Underwriting is the process of selecting certain types of risks that have historically produced a profit and rejecting those risks that do not fit the underwriting criteria of the insurer. Good underwriting of risk selection normally produces a favorable loss ratio. This means the premium collected, less loss and expenses, produces a profit for the insurer.

Insurers must carefully underwrite all risks to avoid being the victim of **adverse selection**. Adverse selection is selection against the insurance company. It is the tendency of insureds with a greater-than-average chance of loss to purchase insurance.

In addition, insurers will sometimes use reinsurance as a means of reducing their exposure of loss for a particular risk. Often an insurer will cede part of a risk to a reinsurer to avoid being exposed to a larger than usual loss. **Reinsurance** is a contract of indemnity against liability by which an insurance company procures another insurance company to insure it against loss or liability by reason of the original insurance. Rather than an insurance company accepting the entire risk, the risk is ceded to other companies or pools to spread the risk.

**II. Property & Casualty Insurance Terms and Concepts**

In this section we are going to use the term “property insurance” to describe insurance that pays the insured for loss of property that is named in an insurance policy from a peril insured against. Fire, wind, hail are examples of perils. We will use the term “liability insurance” to describe insurance that pays a third party for a claim caused by the negligence of the insured. An at-fault auto accident is an example. Keep in mind that a single policy can be written to cover both property and liability. The Personal Auto Policy is one example of such a policy. It covers damage to the vehicle (property) and liability coverage.

In this section concepts and topics will be covered that are very important. A grasp of these concepts is necessary to give you, the student, a thorough understanding of the concepts covered in the remainder of the text.

**Parts of an Insurance Contract**

All insurance policies may be divided into various sections. Endorsements are sometimes added to the policy to amend coverages.
1. **Declarations** - The declarations section of a policy includes the identity and address of the named insured, the policy term or period, the amount of insurance or limits of liability, the policy premium, and any applicable deductibles. The declarations will also include either a property description or a schedule of coverage parts, and a list of any endorsements.

2. **Insuring Agreement** - The insuring agreement describes the covered perils, or risks assumed, or nature of coverage, or makes some reference to the contractual agreement between insurer and insured. In package policies each different coverage form includes its own insuring agreement.

3. **Conditions** - Policy conditions set provisions, rules of conduct, duties, and obligations for the parties. A number of common insurance conditions describe such things as the policy period and territory, the insured's obligation to provide proof of loss, how settlements are handled when other insurance is involved, and the right of each party to cancel the policy. Depending on the kind of policy, conditions may be found in a "Conditions" section or scattered throughout the policy forms.

4. **Exclusions and Limitations** - Exclusions may describe property, perils, hazards, or losses arising from specific causes that are not covered by the policy. Exclusions may be found in an "Exclusions" section of a policy or may be scattered throughout the policy. In some cases, exclusions are built into the wording of insuring agreements and the definitions of perils.

   Some policies also include limitations that are less sweeping than true exclusions. A limitation may eliminate or reduce coverage, but only under certain circumstances or when specified conditions apply. For example, after a building has been vacant for 60 days, some types of commercial property losses will not be covered at all, while the amount payable for other types of losses will be reduced by 15%.

5. **Definitions** - Definitions define important terms used in the policy language. Some policies list definitions in a distinct section having that title. Some policies include definitions in the “Conditions” section, while others spread definitions throughout policy sections.

6. **Endorsements** - Some policies also contain endorsements that are used to add, delete, or change any of the policy parts. Endorsements may alter the content of the declarations and insuring agreement, and they may contain conditions, exclusions, and definitions.
Standardized Policies

Standardized policies refer to forms that have been filed by Insurance Services Office, Inc. (ISO) to the individual insurance departments for approval. Many insurance companies use the approved ISO forms rather than filing their own forms in each individual state.

Important Insurance Terms

1. **Peril** – A potential cause of loss. Accident, fire, and theft are common perils.

2. **Hazard** – Anything that increases the seriousness of a loss or increases the likelihood that a loss will occur.

3. **Direct Loss** – A loss that is a direct consequence of a particular peril. Fire damage to an apartment building is an example of a direct loss.

4. **Indirect Loss** – A loss that is a result of a covered peril but is not caused directly and immediately by that peril. Loss of an apartment building by fire is a direct loss. The loss of rental income as a result of the fire is an indirect loss.

5. **Salvage** – If the insurer pays a loss on behalf of the insured, the insurer is entitled to the salvage to reduce the claim.

6. **Abandonment** – The insured cannot simply abandon the property to the insurance company in exchange for the full-insured value.

7. **Pair or Set Clause** – This is a loss settlement condition that appears in many property insurance contracts including inland marine. It states that if part of a pair or set is lost or damaged, the loss will be valued as a fair proportion of the total value of the set, giving consideration to the importance of the damaged article to the set. The insurer is not required to pay for the value of the whole set. Example: A pair of earrings is worth and insured for $5,000. One is lost or destroyed. The company will not pay $5,000 for the set. They will pay a fair proportion of the pair’s full value.

8. **Deductible** – This is the self-insured part of an insured loss. Usually applies to first party claims such as property claims or auto physical damage claims. The insured must bear this loss.

9. **Vacancy and Unoccupancy** – Vacancy means the building is void of contents and people. The building is simply not being used. Perils such as freezing, vandalism and malicious mischief are limited when a building is vacant. In most cases the insurance
can purchase Vacancy Permit coverage to have some of the coverage restored for an additional premium. Unoccupancy means the premises are void of people. In most cases this will not affect the coverage provided by the policy.

10. **Assignment** – An insurance policy cannot be assigned to another party without the consent of the insurance company.

11. **Liberalization** – A clause in property/casualty insurance contracts which states that if policy or endorsement forms are broadened and no additional premium is required, then all existing similar policies or endorsements will be construed to include the broadened coverage.

12. **Binder** – Insurance binders serve as temporary evidence that coverage is in effect until the policy is issued. They usually are either oral or written. Some states such as California require that they must be in writing. Other states such as Minnesota require that an oral binder is legal but must be transferred to a written binder within three days. Some states place restrictions on the length of time a binder can be in force. For example: 30, 60 or 90 days.

13. **Primary Insurance** – In cases where more than one policy is in force, the primary policy pays first.

14. **Excess Insurance** – An insurance policy that pays benefits only when coverage under other applicable insurance policies have become exhausted.

15. **Accident** – A sudden and unforeseen event resulting in a financial loss.

16. **Occurrence** – A sudden and unforeseen event resulting in financial loss. May also be a continuous or repeated exposure to an event that results in a financial loss.

17. **Appraisal and Arbitration** – Policies may contain one or both of these clauses to facilitate an agreement when the insured and the insurer cannot agree on the value of a claim.

   a. **Appraisal Clause** – When the dispute involves a property claim, both parties select an appraiser to determine the value of the loss. If the appraisers cannot agree, then an umpire is selected to make the decision. The insured and insurer each pay for their own appraiser and share the cost of the umpire.

   b. **Arbitration Clause** – This clause usually appears in automobile policies to resolve disputes for uninsured/underinsured motorist claims for bodily injury. It may also be used to settle disputes between insurance companies involving third party liability claims.
18. **Subrogation Clause** – This clause is used when the insurer has paid a covered claim on behalf of the insured that is caused by another party. The insurance company is entitled to the insured’s right of recovery from the negligent party. This clause is sometimes called “transfer of right of recovery against others to us”.

19. **Other Insurance Clause** – If the insured has other sources of recovery for a covered claim, this clause is activated. This is also called “Other sources of recovery on insurance under two or more policies”. Some policies are primary and some are excess depending on the wording in the insurance contract. The clause specifies the obligations of the insurance carrier when other coverage is in force. Some claims are paid based on a pro-rata approach. This means that each insurer will pay its percentage of the claim as limit bears to the total amount of coverage in force. For example: If an insurer is covering 20% of a property risk it will only pay 20% of a loss.

20. **Certificates of Insurance** – It is not uncommon for an insured to be required to provide a certificate of insurance as evidence that coverage is in effect. Many states require evidence of automobile insurance be carried at all times. A certificate contains a general summary of the coverage. Contractors are often required to provide evidence of their auto, general liability and Workers’ Compensation coverage to comply with the terms of a contract in the form of a certificate of insurance.

21. **Transacting Insurance** – The definition of this term may vary in individual states. In most states it means that any person who has contact with an insured involving insurance matters should be licensed. Personnel that quote, sell, service, offer advice, explain coverage or adjust claims would normally be required to be licensed. Attorneys, appraisers and clerical personnel usually are not required to be licensed.

22. **Indemnity** – The principle of indemnity assumes that a claimant should only be restored to the approximate financial condition that existed prior to the loss, no better or no worse. If a claimant makes a profit from their loss, the principle of indemnity is violated. This principle applies to both first party property losses and third party liability claims.

23. **Proximate Cause of Loss** - An unbroken chain of events that causes a loss. An event that, in a natural and continuous sequence, produces a loss. If a fire should occur, followed by smoke and water damage, the entire loss is considered to have been caused by the peril of fire.

24. **Proof of Loss** – This is a form completed by the claimant listing the property that has been either lost or damaged due to a covered loss.

25. **Ambiguity** – Ambiguity (language that is vague and creates doubt) in the policy provisions will usually be resolved by the courts in favor of the insured.
26. **Contribution By Equal Shares** – Type of “Other Insurance” condition found in liability policies. It calls for all insurers to contribute equally up to the limit of the policy having the smallest limit, whereupon that company stops paying. The other companies share in the remainder of the loss until the loss is paid in full or until all policy limits are exhausted.

27. **Nonconcurrency** – Situation that exists when the same property is covered by more than one policy, but the policies are not identical as to the extent of coverage provided.

**Important Property Insurance Concepts**

1. **Cause of Loss forms** – State the perils that are to be insured against.

2. **Named Peril vs. Open Peril** – A named peril form lists the specific perils to be covered in the policy. The open peril form does not list the perils but provides broader coverage. This means that all perils are covered except the perils listed in the Exclusions section of the policy.

3. **Basic Types of Construction** – Refers frame, masonry, metal, brick veneer, fire resistive, etc. The better the construction the lower the fire rate.

4. **Loss Evaluation Methods**

These methods are used determine the value of the loss:

a. **Actual cash value**: The cost of replacement minus depreciation.

b. **Replacement cost**: The current cost to purchase new, the item that was lost, without depreciation.

c. **Functional replacement cost**: As reasonably close to the replacement of the lost or damaged item as possible.

d. **Market value**: Usually antiques claims are adjusted on the basis of market value – the price that the market will support.

e. **Agreed value**: The value to be insured is agreed to by the insured and the insurer. This method is used when the true value cannot accurately be determined.

f. **Stated amount**: An agreed amount of insurance which is shown on the policy.
and that will be paid in the event of a total loss regardless of the actual value of the property.

g. Valued policy: A policy that states that in the event of a total loss, a specific amount will be paid, and that is set as the limit of the policy. It is generally used to insure fine arts, jewelry and furs. This term also applies in some states that have a valued policy law. In case of a total loss the company cannot dispute the amount to be paid under most circumstances except for the normal exceptions such as fraud, etc.

5. Definition of an insured:
   a. Those that have an insurable interest in the property who would suffer a financial loss if the property were damaged by an insured peril.
   
   b. In personal insurance this can include family members without listing their names on the declarations page of the policy.
   
   c. Additional insureds such as a lien holder.

6. Basis for Insuring Property:
   a. Specific Basis – A separate limit per insured item applies. Example: A separate limit on the building and/or one for the contents.
   
   b. Blanket Basis – One limit that applies to both building and contents. With blanket insurance, usually more than one location is insured under a single limit. Blanket insurance is more often written on contents coverage with one blanket limit applying to more than one building or location. This assists the insured in avoiding underinsurance at a particular location in case of loss.
   
   c. Reporting Form – This allows the insured to report values to the company (usually on a monthly basis) of the insured contents. This allows the insured to pay for coverage on what is actually reported to the company. This form requires a 100% coinsurance clause.

7. Coinsurance Clause - With commercial insurance the coinsurance clause is a method of requiring the insured to insure at least 80% of the value of the property in exchange for a premium discount. If the insured's policy contains this clause and the insured carries less than this amount, a penalty will occur in case of partial losses. The insured can always insure for more than 80% of the value of the property. As an example, if a person insures property with an actual cash value of $100,000 on a policy with an 80 percent coinsurance requirement, the insurance required is $80,000 (80 percent of $100,000). If the insured elects to carry a limit of only $60,000 (60 percent of the
actual cash value), then he or she becomes a partner with the insurance company on partial losses.

8. **Third party provisions** found in property insurance policies:

   a. **Standard mortgage clause**: Protects the interest of the financial institution against loss to real property caused by perils insured against. It also grants coverage even if the insured intentionally caused the loss. The institution can also provide a proof of loss or pay premiums in case the insured cannot or refuses to do so. They must also be advised if the contract has been cancelled or non-renewed by the insurer.

   b. **Loss payable clause**: Similar to the mortgagee clause but applies to chattel property.

   c. **No benefit to bailee**: An insured’s property insurance policy protects the insured and not a bailee of the insured’s property. If the insured’s property were destroyed by fire while at the dry cleaners, the insurance company would only protect the insured. If the dry cleaners are negligent the insurance company could pay the insured and subrogate against the dry cleaners.

### Important Liability Insurance Concepts

1. **Liability Losses** - A liability loss occurs when a person or entity is determined to have been responsible, or legally liable, for injury or loss to another person or liable for damage to another’s property and the law requires them to make financial restitution. These are called third party losses. Liability losses are paid by casualty insurance type policies. These include:

   - Personal auto policies
   - Commercial auto policies
   - General liability policies
   - Professional liability policies
   - Umbrella policies
   - Personal liability (including boats and yachts)

2. **Constructive Total Loss** – Occurs when the damage to repair exceeds the value of the vehicle after repairs have been made. The vehicle is considered to be a “constructive total loss”. Constructive total loss applies to other types of property losses as well.
3. **Negligence** - For a liability policy to respond the insured must be guilty of "negligence" and coverage must be granted by the policy. Intentional acts are never covered by liability policies. Negligence is defined as the lack of reasonable care that is required to protect others and/or their property from the unreasonable chance of harm. This could also be a failure to act or not to act as a reasonable person under the same set of circumstances. Note: Gross negligence is defined as willful and wanton negligence or misconduct without the slightest degree of care.

4. **Tort** - A tort is a civil wrong that violates the rights of others. A person becomes legally liable by committing a tort. Generally (but not always), a court of law must determine negligence. There are usually four factors involved to establish negligence.
   - Legal duty is owed.
   - Breach of legal duty owed.
   - Proximate cause
   - Damages

5. **Punitive Damages** – Casualty policies cover bodily injury and property damage caused by the insured as a result of his/her negligence. Punitive damages (sometimes referred to as “exemplary damages”) are often awarded by the court and intended to punish the defendant. An example would be “gross misconduct” and the court wants to make an example of the defendant to discourage others from behaving in a like manner. In some states, the insurance company is prevented from paying punitive damages because payment by the insurance company would fail to penalize the defendant and defeats the purpose of the penalty imposed by the court.

6. **Defenses Against Negligence:**
   a. **Contributory Negligence** – Common law defense against negligence that states that if an individual contributes to his or her own loss in any way, then another cannot be held liable for the loss.
   b. **Comparative Negligence** – Law that allows an injured party to collect from another party for a loss, even when the injured party contributed to his or her own loss. Damages are reduced to the extent of the injured party’s negligence. This is the defense used in most states.
   c. **Assumption of Risk** – In some states, a doctrine known as assumption of risk may apply. Assumption of risk applies when a person knowingly exposes himself or herself to danger or injury. When a person assumes this risk, he or she may be prevented from recovering from a negligent party. This doctrine is frequently associated with injuries incurred by spectators at sporting events.