INSURANCE LAW
(DIM05)
(PG - DIPLOMA)

ACHARYA NAGARJUNA UNIVERSITY

CENTRE FOR DISTANCE EDUCATION

NAGARJUNA NAGAR,

GUNTUR

ANDHRA PRADESH

Lesson -1

BASIC INSURANCE – STATE CONTROL OF INSURANCE BUSINESS

1.0 Objective:

The lesson is aimed at introducing the basics insurance and prime area in insurance – the insurable risk. Further the evolution of State control of insurance business and the control and decontrol of insurance business by State is explained. The salient features of Insurance Act, 1938 and Insurance Regulatory and Development Authority (IRDA) Act, 1999 are focused in detail.

Contents

1.1 Basic insurance
1.2 Insurable and other risks
1.3 State control of Insurance business
1.4 Salient features of Insurance Act, 1938
1.5 Salient features of Insurance Regulatory and Development Authority Act, 1999.
1.6 Glossary
1.7 Self Assessment Questions
1.8 References

1.1 Basic insurance

Whatever is created is liable to be destroyed. As the universe is created it is natural that it would be destroyed. Destruction involves risk to the person. Therefore, risk is inevitable in life. When the activity of a person is more the risk is bound to be more. When a person is in business he is bound face a variety of risks. Man always strives to save himself from risk. The desire to protect oneself from risk gave origin to the business of insurance. When a person cannot save himself from risk he looks at others in doing so. When the person gets the promise of help from someone it is an occasion of insurance. The person who seeks the protection from risk is called the 'assured' or 'insured' and the person who undertakes to protect the other from risk is called the 'insurer'. Thus, insurance may be defined as a contract whereby one person called the 'insurer' undertakes in return for an agreed consideration called 'premium' to pay to another person called 'assured' a sum of money on the happening of a specified event. The happening of the specified event must cause some loss to the insured or at least should expose insured to adversity which is in law called the 'risk'.

1.2 Risk - Insurable and uninsurable risk

Risk is possibility or chance of meeting danger. Risk means uncertainty. A person from conception to death is exposed to various risks like health hazard, loss in business etc. Risk is

of two types. 1) Dynamic, speculative or business risk 2) Static or pure risk. Dynamic or business risk is the possibility of either gain or loss which cannot be predicted or measured. For example, a business man may suffer loss in his business when the rival business man introduces a new and better product into the market. In other cases due to outbreak of war, inflation, market fluctuations, economic depression etc. loss may be caused. These factors do not obey any statistical formula and these cannot be predicted and measured. Hence, these risks are uninsurable.

Static or pure risk is the possibility of loss which can be predicted and measured. This is the loss caused due to death, fire, flood, theft etc. The loss due to these factors is certain even though there is uncertainty as to the time of its happening. For example, death is certain even though we are not sure when it will strike. As the static or pure risk can be predicted and measured, it is insurable.

Risk is inevitable in life and as it cannot be avoided it has to be met somehow by minimizing its effect. The purpose of insurance is minimizing such effects. Nowadays, insurable risks have enormously increased and it became almost impossible surviving without the protection of insurance whatever is its type. The type of insurance depends on the nature of the risk sought to be protected. The chief varieties of insurance available are a) life b) fire and c) marine. But there is no end to the varieties of insurance available nowadays and everything and anything is being insured.

There are several methods in handling the risk. One method is self help or self insurance in the form of installing fire extinguishers in fighting fire accidents, etc. Another method is, persons exposed to similar risk joining together under a scheme of mutual bearing of loss that may fall upon any of them. This method has certain shortcomings. Yet another method is – throwing the loss on a professional risk-bearer at a premium. In brief it is known as insurance. The primary function of insurance is the equitable distribution of the financial losses of insured from the fund built up by the contribution of all the members exposed to similar risk. The insurance benefits both the insured and the insurer. The insured feel secured as he would be compensated from the fund and the insurer gets the benefit of investing the fund.

1.3 State Control of Insurance Business

Marine insurance was the oldest type of insurance. Even during the Aryan period in India the existence of marine insurance like thing is found. Next to marine insurance, fire insurance and then life insurance got developed. In India the life insurance business was commenced in 1871 with the starting of “Bombay Mutual”. During 1900 to 1912 there was mushroom growth of Indian Insurance companies. The unchecked growth of business resulted in some evils. To check the evils the Indian Life Assurance Act, 1912 was passed. That was the beginning of State control over insurance business. During the two world wars the insurance business struggled for its survival. The partition of the country gave a rude shock to the business. After independence the planned growth undertaken gave confidence to the people in the domestic companies. This gave boost to the insurance industry and the leading insurance companies collected huge funds from the public in the form of premiums. The Government got the idea of using the money for developmental programmes and started nationalizing the insurance business. Firstly, Life Insurance Act, 1956 was passed nationalizing the life insurance business. Life Insurance Corporation was established on 1-9-1956. Then, General Insurance (Emergency Provisions) Act, 1971 was passed nationalizing the general insurance business. The General

Insurance Corporation, with its four subsidiary companies was established for carrying on the general insurance business. In this way the State got absolute control over the insurance business. The nationalization of insurance business ensured better security to the policy holders. The new economic policies introduced in 1990s changed the position once again. State monopoly over insurance business ended and private and foreign insurance companies entered into the insurance market.

1.4 Salient features of Insurance Act, 1938

Insurance Act, 1938 was passed on 26th February, 1938 and it was amended in 1950, 1965, 1968, 1999 and 2002. The Act has elaborately defined the words 'fire insurance business' 'general insurance business' 'life insurance business' 'marine insurance business' etc. The Act contained provisions applicable to insurers, Provident Societies, Mutual Insurance Companies and Co-operative Life Insurance Societies and re-insurance.

Insurer: Section 2 (9) has defined insurer as any body corporate incorporated under any law for the time being in force in India, that carries on the insurance business. The Act has allowed only the public companies and the societies registered under the Co-operative Societies Act to carry on the insurance business and prohibited the individuals from carrying on the insurance business. The company that wants to commence the insurance business has to apply to the Insurance Regulatory and Development Authority (IRDA) (hereafter referred to as Authority) and has to obtain a licence. Every application for registration shall be accompanied by a) a certified copy of memorandum and articles of association of the company b) the name, address and the occupation of the directors c) a statement of the class of insurance business to be done d) a statement of the amount required to be deposited before the application for registration is made and e) a declaration by the authorized officer of the company. On the receipt of the application and after making such inquiry as it deems fit, if the Authority is satisfied that 1) the financial condition and the general character of management of the applicant are sound 2) the capital structure and earning prospects of the applicant will be adequate 3) the interests of the general public will be served if the certificate of registration is granted and 4) the applicant has complied with the provisions of the Act, the Authority may register the applicant as an insurer and grant a certificate of registration. The certificate of registration is grated for a period of one year and is renewed annually. The insurer can have any name he likes. But, an insurer can not be registered by a name identical with that by which an insurer in existence is already registered or so nearly resembling that name as to be calculated to deceive the public. Where the Authority refuses registration, the party aggrieved by the decision may, with in 30 days of such refusal appeal to the Central Government. The decision of the Central Government on such appeal shall be final and shall not be questioned before any court.

The Authority shall cancel the registration of an insurer a) if the insurer fails to comply with the provisions of the Insurance Act or b) if the insurer is adjudged an insolvent or3) if the business of insurer has been transferred to or amalgamated with the business of any other insurer or 4) if the Central Government so directs the Authority or 5) if the insurer carries on any business other than insurance business.

After the commencement of Insurance Regulatory and Development Authority Act, 1999, no insurer carrying on the business of life insurance, general or re-insurance shall be registered unless he has a paid up equity capital of rupees one hundred crores, in case of a person carrying on the business of life insurance or general insurance or a paid up equity capital of

rupees two hundred crores, in case of a person carrying on exclusively the business as a reinsurer.

Every insurer shall in respect of the insurance business carried on by him deposit with the Reserve Bank of India either in cash or in approved securities a) in the case of life insurance business, a sum equivalent to one per cent of his total gross premium in any financial year, not exceeding rupees ten crores, b) in the case of general insurance business, a sum equivalent to three per cent of his total premium in any financial not exceeding rupees ten crores and c) in case of re-insurance business, a sum of rupees twenty crores. The insurer shall not be registered until the full deposit has been made. This measure is aimed at protecting the interests of the policy holders. No insurer shall grant loans or temporary advances to any director, manager of the company etc. For any contravention of the provisions of the Act, the directors and other officers of the company shall be made jointly and severally liable to make good the loss.

The Act has contained detailed provisions regarding the amount that an insurer has to invest and where and how the investments have to be made. Further the Act has explained how the assets of insurer are to be kept. According to Section 31 of the Insurance Act none of the assets of any insurer be kept otherwise than in the name of a public officer approved by the IRDA.

The Act has given enough power to the Authority in exercising control over insurance companies. The Authority may at any time by order in writing investigate into the affairs of any insurer. Where the authority is satisfied that a) in the public interest or b) to prevent the affairs of any insurer being conducted in a manner detrimental to the interests of the policy holders or in a manner prejudicial to the interest of the insurer or c) general to secure the proper management of any insurer, can issue directions as it deems fit and the insurer is bound to comply with such directions. Further the Authority may caution any insurer against entering into any particular transaction and generally give advice to any insurer. The Authority has the power to search the premises of any insurer and seize books, accounts or documents of the insurer.

Insurance Agents: The Authority may issue licences both to individuals and companies to act as insurance agents for the purpose of soliciting or procuring insurance business. The Act has prescribed the commission to be paid to the agents. According to Section 40 (2) no insurance agent shall be paid by way of commission or as remuneration in any form, an amount exceeding, in case of life insurance business, forty per cent of the first year's premium payable on any policy effected though him and five percent of a renewal premium payable on such a policy, or in the case of business of any other class, fifteen per cent of the premium. The Act has provided for registration of principal agents, chief agents and special agents.

Insurance policy – special rules: No policy of life insurance, after the expiry of two years from the date on which it was effect, be called in question by an insurer on the ground that statement made in the proposal for insurance or in any report of a medical officer, or referee or friend of the insured or in any other document leading to the issue of the policy was inaccurate or false, unless the insurer shows that such statement was on a material matter or suppressed facts which it was material to disclose and that it was fraudulently made by the policyholder and that the policy holder knew at the time of making it that the statement was false or that it suppressed facts which it was material to disclose. Where the death of the life insured before the expiry of two years from the date of issue of the policy, it would be open to the LIC to avoid its liability by

showing that the statement in the proposal form was inaccurate as to material matters, thereby vitiating the contract.

In the event of any dispute relating to the settlement of a claim on a policy of life insurance assuring a sum not exceeding two thousand rupees, arising between a claimant under the policy and the insurer, the dispute may at the option of the claimant be referred to the Authority for decision and the Authority may after giving an opportunity to the parties to be heard and after making such further enquiries as it may think fit, decide the matter. The decision of the Authority shall be final and shall not be called in question in any court. All other disputes may be referred to either to a court or to arbitration. In case of general insurance contracts, where the dispute is on the quantum of compensation to be paid by the insurer, the dispute has to referred to arbitration only.

Where in respect of any policy of life insurance maturing for payment an insurer if of opinion that by reason of conflicting claims to or insufficiency of proof of title to the amount secured thereby or for any other adequate reason it is impossible for the insurer to obtain a satisfactory discharge for the payment of such amount, the insurer may apply to pay the amount into the court.

1.5 Salient features of Insurance Regulatory and Development Authority Act, 1999.

The Insurance Regulatory and Development Authority Act, 1999 was passed Indian Parliament and was assented by the President of India on 29-12-1999. It provides for the establishment of 'the Insurance Regulatory and Development Authority' to protect the interests of holders of insurance policies and to regulate, promote and ensure orderly growth of the insurance industry in India.

Insurance Regulatory and Development Authority (IRDA): Section 3 of the Act has provided for the established of the Insurance Regulatory and Development Authority. The Authority shall be a body corporate having perpetual succession and a common seal with power to acquire, hold and dispose of property and to contract and to sue and be sued. The Authority shall consist of a Chairperson, not more than five whole-time members and not more than four part-time members. The Chairperson and members are appointed by the Central Government from amongst persons of ability, integrity and standing who have knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy and administration. The Chairperson and every other whole time member shall hold office for a term of five years from the date on which he enters upon his office. The Chairperson and whole-time members hold the office till they attain the age of 65 and 62 respectively. A part-time member shall hold office for a term not exceeding five years from the date on which he enters upon his office.

The Central Government may remove from office any member who is adjudged as an insolvent or has become physically or mentally incapable of acting as a member or has been convicted of any offence which involves moral turpitude or has acquired such financial or other interest as is likely to affect prejudicially his functions as a member or has so abused his position as to render his continuation in office detrimental to the public interest.

The Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business. The powers and functions of the Authority are – 1) Issue of certificate of registration to the applicants to start and run insurance business and to renew, modify, withdraw, suspend or cancel such registration. 2) protection of the interest of the policy-holders 3) Specifying requisite qualifications, code of conduct and practical training for agents 4) specifying the code of conduct for surveyors and loss assessors 5) promoting efficiency in the conduct of insurance business 6) undertaking inspections of organization connected with insurance business 7) regulating investment of funds by insurance companies 8) adjudication of disputes between insurers etc.

Under Section 18 of the Act the Authority is bound by the directions given by the Central Government on questions of policy. Under Section 19 of the Act if at any time the Central Government is of the opinion that a) the Authority is unable to discharge the functions or perform the duties imposed on it or b) the Authority has persistently defaulted in complying with any direction given by the Central Government or c) out of public interest, may, by notification in the official Gazette supersede the Authority for a period not exceeding six months. On superseding the Authority a person may be appointed as the Controller of Insurance. On or before the expiration of the period of super session, the Central Government shall reconstitute the Authority by a fresh appointment of the Chairperson and other members.

The IRDA may establish a committee to be known as the Insurance Advisory Committee. It shall consist of not more than twenty give members representing the interests of commerce, industry, transport, agriculture, consumer fora, surveyors, agents, intermediaries etc. The Chairperson and the members of the Authority shall be the ex officio Chairperson and ex officio members of the Insurance Advisory Committee. The objects of the Committee shall be to advise the Authority.
The Insurance Regulatory And Development Authority Act, 1999 has amended the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972.

1.6 GLOSSARY

1. Insured= the person who seeks the protection from risk
2. Insurer= the person who undertakes to protect the other from risk
3. Premium= the consideration agreed upon and which can be paid periodically
4. Risk= possibility or chance of meeting danger
5. Indemnity= a promise to save the other from loss caused to a person
6. Wager= money or money's worth upon the determination of an uncertain event
7. Uberrima fides = utmost good faith
8. Contract= an agreement enforceable by law

1.7 Self Assessment Questions

1. Explain how proposal is the basis for the formation of a contract of insurance. Explain how the proposal is made in case of marine and non-marine insurance contracts.
2. Describe the terms and conditions of a policy of insurance. Explain the effects of breach of conditions in an insurance contract.
3. Explain he rules of construction of a policy of insurance.
4. Explain duty of disclosure of insured and insurer.

5. Describe the principle of utmost good faith.
6. Short questions –
    a) Cover note
    b) Slip
    c) Unfair contracts

1.8 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth's Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. Ch. Sudhakara Babu B.Com. M.L. (Madras)

Lesson – 2

LAW RELATING TO INSURANCE CONTRACTS – FORMATION OF CONTRACT OF INSURANCE

2.0 Objective:

The lesson is aimed at defining the contract of insurance. Various types of contracts of insurance are explained. The nature of insurance contract as a contract of speculation, utmost good faith and indemnity is high lighted. The classification of contract of insurance is made. The definition of contract under Indian Contract Act and its essentials are narrated the formation of contract of insurance and the competence of parties to enter into a contract of insurance and the importance of free consent to a contract of insurance is emphasized.

Contents :

2.1 Study of Insurance Contracts
- **2.1.1 Contract of speculation**
- **2.1.2 Contract of utmost good faith**
- **2.1.3 Contract of indemnity**

2.2 Definition of 'Contract of Insurance'
2.3 Classification of Contracts of Insurance
- **2.3.1 Classification on the basis of interest to be protected**
  - **2.3.1.1 Personal insurance**
  - **2.3.1.2 Property insurance**
  - **2.3.1.3 Liability insurance**
- **2.3.2 Classification on the basis of nature of event**

2.4 Formation of Contract of Insurance - Free consent
- **2.4.1 Definition and essentials of contract**
  - **2.4.1.1 Competence of parties**
  - **2.4.1.2 Free consent**

2.5 Self Assessment Questions
2.6 References

2.1 Study of Insurance Contracts

Insurance is a contract. Contract is an agreement enforceable by law. Insurance is a contract between the insurer and insured whereby the insurer agrees to take risk of insured's life, limb, property etc. Even though insurance is a contract, it is a special class of contracts having its distinctive features. Each class of insurance also has individual features of its own. The law governing insurance contracts has thus to be studied in three parts – a) general characteristics of insurance contracts, as contracts b) special characteristics of insurance contracts, as contracts of insurance and c) individual characteristics of each class of insurance. The generals characteristics of insurance contracts, as contracts are explained in this lesson

and in lesson-3 whereas individual characteristics of each class of insurance are explained in sub-head 2.3.

The special characteristics of insurance contracts, as contracts of insurance are – whether insurance contract is contract of speculation or wager, whether it is a contract of utmost good faith and whether it is a contract of indemnity.

2.1.1 Contract of Speculation or wager

It is commonly said that an insurance contract is a contract of speculation or contract of wager. Lord Mansfield said that an insurance contract whatever may be the type is a contract of speculation. A contract of speculation is a contract whose performance depends upon an uncertain event as to its both profit and loss. If we take an example of a person taking fire insurance policy on his house, he pays a little and if the house is not burnt, he loses that small amount, but if the house is destroyed by fire he is entitled to recover a huge amount, the value of the house. Thus it is apparently a gambling in which if it happens in one way the insured will have a small loss, the loss of premium and if the event happens the other way the insurer loses heavily in that, he has to pay the huge sum, the value of the house. Thus there is speculation and so it called a contract of speculation.

A contract of insurance is also called as a contract of wager. Lord Bramwell observed "All life insurance is a sort of wager". According to Sir William Anson all insurance contracts are wagering contracts. A wager is a promise to give money or money's worth upon the determination or ascertainment of an uncertain event. According to Section 30 of Indian Contract Act agreement by way of wager is void.

A contract of insurance is not a wagering contract or a contract of speculation. It is essential in a wagering contract that one party must win and the other party must lose, but in case of an insurance contract the insurance company only may lose. It can never win because if the loss takes place it has to pay and premium cannot be called a profit. The insured neither wins nor loses because if the loss happens he is paid only the compensation. Further, in a contract of insurance the insured has some interest in the subject matter but in the case of wager parties have no interest whatsoever. In the case of an insurance contract, the risk of loss or damage is existing whether there is insurance or not, while in the case of wager the risk is created by the agreement between the parties. For these reasons the insurance contracts cannot be called as wagering contracts or contracts of speculation.

2.1.2 Contract of utmost good faith

The cardinal principle of commercial law is that he who buys should beware i.e *caveat emptor.* In a business transaction each party must take care of his interest when he buys and the parties generally stand on an equal footing. But in a contract of insurance the parties i.e. the insurer and insured do not stand on equal footing either with regard to the knowledge of the subject matter or with regard to the economic aspect of the obligation. The insurer knows nothing whereas the insured knows everything. Hence, the insured at the time of taking out the policy has to make a full disclosure of all the material circumstances to the insurer. This principle is expressed in words utmost good faith *uberrima fides*. Thus, a contract of insurance is called as a contract of utmost good faith or a contract uberrima fides.

The insured must disclose to the insurer, before the contract is concluded, every material circumstances which is known to the insured. The insured is deemed to know every circumstance which in the ordinary course of business ought to be known by him. If the insured fails to make such disclosure, the insurer may avoid the contract.

2.1.3 Contract of Indemnity

According to Section 124 of the Indian Contract Act contract of indemnity is a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of another person. It is said that contract of insurance is a contract of indemnity. But still all contracts of insurance cannot be strictly called contracts of indemnity. The word indemnity means a promise to save another person from harm or loss caused as result of a transaction entered into at the instance of the promisor. The principle of indemnity is associated with the principle of guarantee where there are three parties, the creditor, the principal debtor and the surety. The insurance law does not have the element of guarantee and there are only two parties, the insurer and the insured. Though prima facie the insurer indemnifies the assured, as his liability may be limited in several respects, a contract of insurance cannot be said to be a contract of perfect indemnity. It may be said that though there is a doubt whether a contract of life insurance is a contract of indemnity or not, it may be said without doubt that contracts of fire and marine insurance are all contracts of indemnity.

2.2 Definition of ‘Contract of Insurance’

The Insurance Act, 1938 has defined the words ‘fire insurance business’ ‘life insurance business’ ‘marine insurance business’ and ‘general insurance business’ but not the word ‘insurance’ or ‘insurance contract’. There is no satisfactory definition to insurance. Insurance is a contract. It is a contract whereby one party (the insurer) promises in return for a money consideration (the premium) to pay to the other party (the insured) money or money’s worth on the happening of an uncertain event. Under a contract of insurance, the insurer agrees to take up the risk of another person’s life, property or liability in consideration of a premium.
Section 2 sub-sections 6A, 11, 13A and 6B have defined the words ‘fire insurance business’ ‘life insurance business’ ‘marine insurance business’ and ‘general insurance business’ respectively as follows-

“Fire insurance business” means the business effecting, otherwise than incidentally to some other class of insurance business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies.

“Life insurance business’ means the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death 9except death by accident only0 or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include – a) the granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance; b) the granting of annuities upon human life; and c) the granting of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of persons engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons.

"Marine insurance business" means the business of effecting contracts of insurance upon vessels of any description, including cargoes, freights and other interests which may be legally insured, in or in relation to such vessels, cargoes and freights, goods, wares, merchandise and property of whatever description insured for any transit by land or water, or both, and whether or not including warehouse risks or similar risks in addition or as incidental to such transit, and includes any other risks customarily included among the risks insured against in marine insurance policies.

"General insurance business" means fire, marine or miscellaneous insurance business, whether carried on singly or in combination with one or more of them.

The subject matter of a contract of insurance, specifically may be a physical object like a house, a ship, a motor vehicle or a chose-in-action like a debt or liability like that of a public carrier or may be the life as such. The subject matter of insurance in general is money – payment of money on the occurrence of an event.

The contract of insurance must be in writing. The document that contained the insurance contract is called insurance policy.

The following are the essentials of a valid insurance policy –

1) There must be a contract between the insurer and insured.
2) The contract must be that the insurer undertakes to protect the insured form any loss or damage caused on the happening of the event.
3) In consideration of such promise, the insured undertakes to make a periodical payment to the insurer which is called as premium.

2.3 Classification of Contracts of Insurance

Due to development of civilization, economic growth and increased activity in different areas, new varieties of insurance are emerging. The insurance contracts are classified on the basis of interest to be protected and nature of the event.

2.3.1 Classification on the basis of interest to be protected

A person may takeout a policy protecting himself from laws likely to be caused by death, injury to his body, loss of property by fire etc. or involvement in liability to others. On the basis of interested to be protected, the insurance contracts may be classified as 1.Personal insurance, 2.Property Insurance and 3.Liability Insurance.

2.3.1.1 Personal Insurance

When a person wants to protect his own life, body or health or another's life, body or health against the risk of death, accident, or hazard, the contract he enters is called as personal insurance contract. It is a contract where by the insurer undertakes to pay a sum of money to the insured or his nominee upon the happening of a particular event agreed upon. This insurance is also called as endowment insurance.

2.3.1.2 Property Insurance

When the interest to be protected is a right against the property, the insurance is known as proprietary or property insurance contract. Fire insurance, Marine Insurance, Insurance against Burglary, House breaking are the examples of Property Insurance.

2.3.1.3 Liability Insurance

When the interest to be protected is the liability of the insured to a third party, the insurance is known as Liability Insurance. The example is Motor Vehicle Insurance where in the liability of the vehicle owner to the victim in case of an accident is taken care by the Insurer. The other insurances under this category are Industrial Insurance, Aviation Insurance etc.

2.3.2 Classification on the basis of Nature of Event

In another perspective, the insurance contracts may be classified according to the nature of the event on the happening of which the insurer would be liable to pay the agreed money to the insured. On these lines, the insurance contracts can be classified as 1.Life Insurance 2.Fire Insurance, 3.Marine Insurance, and 4.Other Insurance. In Other Insurance we get Liability Insurance, Motor Vehicle Insurance, Industrial Insurance, Aviation Insurance etc.

The Insurance Act 1935 has classified, on the basis of the nature of the event, the insurance contracts as 1.Life 2.Fire 3.Marine and 4.General / Miscellaneous Insurances. In India this can be taken as the official classification of the insurance contracts.

2.4 Formation of Contract of Insurance – Free Consent

Insurance is basically a contract. Insurance Act, 1938 deals with the law relating to the business of Insurance, whereas Indian Contract Act, 1872 deals with a contract. Indian Contract Act governs the insurance contract except in regard to the special features of insurance contract. The main features of the contract Act so far as they apply to insurance contracts and the special features of the insurance contracts regarding the formation of a insurance contract have to be studied.

2.4.1 Definition and essentials of Contract

The term ‘contract’ is defined in Section 2(h) of the Indian Contract Act as follows – “An agreement enforceable by law is a contract”. Agreement is defined as ‘every promise and every set of promises forming the consideration for each other’. A promise is defined as an accepted proposal. In other words, when one party makes a proposal and when the other party gives its acceptance, it is said that a promise is made. The promise when supported by consideration becomes an agreement. In simple words acceptance of the proposal is entering into an agreement.

According to Section 10 of the Indian Contract Act an agreement becomes a contract if the agreement is made by the free consent of parties competent to contract, for a lawful consideration and with a lawful object, and is not expressly declared to be void. A concluded contract only can be enforced by courts.

Thus, every contract is an agreement but every agreement is not a contract. An agreement becomes a contract when the following conditions are satisfied –

1) The parties are competent to contract
2) There is consideration
3) The consent of the parties is given free

4) The object is lawful
5) The agreement is not expressly declared to be void by any law.

The essentials of a contract shall as such apply to the contract of insurance. Each essential is explained in brief.

2.4.1.1 Competence of Parties

For every agreement there should be two parties, that is two persons. Persons in law are of two types – natural persons and legal persons. The persons must have competence to enter into a contract. According to Section 11 of the Indian Contract Act every person is competent to contract who is of the age of majority and who of sound mind. This applies to natural persons. The competence or capacity of the legal persons i.e. Corporations, Companies, Societies etc. is determined in accordance with the statute or document by which they were established.

Regarding the natural persons, every major sound person has competence to enter into a contract. The age of majority is generally eighteen years. Minor has no capacity to enter into a contract and minor's contract is void ab initio. But, minor can enter into a contract for necessities. A person is said to be sound mind for the purpose of making a contract if, at the time when he makes it, he is cable of understanding it and of forming a rational judgment as to its effect upon his interests. A person who is usually of unsound mind but occasionally of sound mind may make a contract when he is of sound mind. A person who is usually of sound mind but occasionally of unsound mind may not make a contract when is he of unsound mind.

The general principles of contract law regarding the competence of parties to a contract shall apply to the parties to a insurance contract i.e. insured and insurer. Competence of parties to a contract of insurance can be studied to life insurance contracts and general insurance contracts.

Competence of parties to Life insurance contract

There are two parties to a life insurance contract – the insurer and the applicant for insurance policy i.e. insured.

The insurer: According to Section 11 of the Indian Contract Act, a person is competent to be a party to a contract if he is not disqualified from contracting by any law to which he is subject. Section 10 of the Life Insurance Corporation Act, 1956 declared that on and from 1st September, 1956, the Life Insurance Corporation of India would have the exclusive privilege of carrying on life insurance business in India. Hence, from that date onwards no person other than the LIC of India was competent to be the insurer of human lives in India. Insurance Regulatory and Development Authority (IRDA) Act, 1999 has put an end to the monopoly of LIC of India on life insurance business. IRDA under section 14 of the Act can grant licence to others to take up life insurance business. The Act has opened the life insurance business to private sector.

The insured: In case of life insurance, the proposer or applicant or insured must be a major and of sound mind. The applicant is normally the person – a male or a female- whose life is the subject mater of the contract i.e. the person on whose life a policy is required to be issued. Sometimes, the applicant may wish to take out insurance on the life of another person, in which case the person whose life is insured is not a party to the contract unless he is also a joint applicant.

Even though an insurance policy can not be issued in the name of a child, a child can be the beneficiary of an insurance policy. Various types of policies named Children's endowments, educational endowments, school fees policies, marriage endowments etc. are issued to parents and guardians for the purpose of making provision for education, marriage etc. of the child as it grows in age. These are not in truth policies on the lives of children. The parent or guardian insures his own life and the amount is payable in one lump or in installments at the end of a given period, usually the attainment of a particular age by the child.

A company or corporation or society can be the proposer. It can take a policy on the life of some one in whom it has insurable interest, for instance, the directors or other important officers.

Competence of parties to general insurance contracts

Like to a life insurance contract, for a general insurance contract also there would be two parties namely the insurer and the insured.

The insurer: After 1st January, 1973 the General Insurance Corporation of India together with its four subsidiary companies was given the exclusive privilege of carrying on general insurance business in India. They alone were competent to be insurers of all kinds of general insurance risks. The monopoly has been terminated, like in case of life insurance business, by the Insurance Regulatory and Development Authority Act, 1999. The Authority can now issue licence to any person for carrying on general insurance business.

The Insured: In case of general insurance, even a minor can be the insured. The legal guardian can enter into the contract on behalf of minor.

2.4.1.2 Free consent

A contract of insurance is formed in this manner – One party makes a proposal to enter into an insurance transaction to the other party and such other party must accept the proposal. According to Section 2 of the Indian Contract Act when one person signifies to another his willingness to do or to abstain from doing something with a view to obtain the assent of that other to such act or abstinence, he is said to make a proposal. When the person to whom the proposal is made signifies his assent thereto, the proposal is said to be accepted. A proposal when accepted becomes a 'promise'. The person making a proposal is called the 'promissor' and person who accepts the proposal is called the 'promisee' According to Section 7 of the Indian Contract Act, in order to convert a proposal into a promise, the acceptance must be absolute and unqualified.

Usually, in case of an ordinary contract, the first step in the formation of a contract is negotiations between the parties. During the negotiations one party makes a proposal. The

other party may accept it at once. Otherwise the parties negotiate on the proposal and at the end of the negotiations a renewed proposal is made by one party to the other and such other party accepts the same. The proposal when accepted results in an agreement between the parties. When the agreement is supported by the essentials of a contract, it is said that a contract is entered into between the parties.

In case of insurance contracts, as the insurer is always a Corporation or a legal person negotiation with each customer becomes impossible. For that the insurer offers a 'Standard Form of Contract' and the prospective insured is bound to accept it. In the process the insurer asks for many details of proposer regarding occupation. Habits, family history, personal medical history etc. If the proposer tenders the first premium along with the proposal, the proposal will be regarded as an offer which will become a contract on acceptance by the insurer, provided the acceptance is absolute and unqualified and given free. According to Section 14 of the Indian Contract Act, consent is said to be free when it is not caused by coercion, undue influence, fraud, misrepresentation or mistake.

Coercion: When the consent to an agreement is obtained by coercion, it is said that the consent is not obtained free. Coercion according to Section 15 of the Indian Contract Act is the committing or threatening to commit, any act forbidden by the Indian Penal Code or the unlawful detaining or threatening to detain any property to the prejudice of any person whatsoever with the intention of causing any person to enter into an agreement. When the consent to an agreement is caused by coercion, the contract is voidable at the option of the party whose consent was so obtained. As one party to an insurance contract is always a Corporation or a Company, coercion we cannot find generally in insurance contracts.

Undue Influence: A contract is said to be induced by 'undue influence', according to Section 16 of the Indian Contract Act where the relations subsisting between the parties are such that one of the parties is in a position to dominate the will of the other and uses that position to obtain an unfair advantage over the other. If the relation between the parties is that a mater and servant, employer and employee, spiritual teacher and disciple, doctor and patient etc. the undue influence is generally presumed. When the consent to an agreement is caused by undue influence, the contract becomes voidable at the option of the party whose consent was so caused.

Representations: At the time of formation of an insurance contract parties may take up negotiations and during negotiations each party may make several representations to the other. Representations are the statements of fact made by one party to the other. While making such representations a party may make some false representations. The false representations may be made either innocently or intentionally. Hence, representations made during negotiations may be divided into two – 1) fraudulent misrepresentations and 2) innocent misrepresentations. Fraudulent misrepresentations are known as fraud and innocent misrepresentations are known as misrepresentations.

Fraud: According to Section 17 of the Indian Contract Act fraud means and includes any of the following acts done with 'intent to deceive' or to induce a person to enter into a contract - 1) the suggestion that a fact is true when it is not true and the person making the suggestion does not believe it to be true 2) active concealment of a fact by person who has knowledge or belief of the fact and 3) promise made without any intention of performing it.

At the time of taking an insurance policy, the insured may commit fraud against the insurer. In case of a life insurance policy, the policyholder may state intentionally certain facts which he knows to untrue or conceal certain facts, regarding his health etc. In case of a general insurance policy also the insured may state intentionally certain false facts about his property, regarding his ownership, possession etc. In all these cases the contract becomes voidable at the option of the insurance company. The insurance company also may commit fraud against

the insured regarding the scope of the insurance policy issued, nature of the risk covered etc. In such a case, the contract becomes voidable at the option of the insured.

Misrepresentation: According to Section 18 of the Indian Contract Act misrepresentation means and includes 1) the positive assertion, in a manner not warranted by the information of the person making it, of that which is not true though he believes it to be true 2) any breach of duty which, without any intent to deceive, gains an advantage to the person committing it or any one claiming under him, by misleading another to his prejudice or to the prejudice of any one claiming under him 3) causing however innocently a party to an agreement, to make a mistake as to the substance of the thing which is the subject of the agreement. At the time of entering into an insurance contract, either party may make an unwarranted statement to the other or may commit a breach of duty to the other or may induce the other party to commit a mistake as to the subject matter of the contract. In all these cases the contract becomes voidable at the option of the party so misrepresented.

Mistake: It is essential to the creation of a contract that both parties should agree to the same thing in the same sense. According to Section 20 where both the parties to an agreement are under a mistake as to a matter of fact essential to the agreement, the agreement is void. Mistake is of two types 1) Mistake of law and 2) Mistake of fact. A party may be mistaken as to the identity of the other party or regarding the existence of the subject matter or regarding the nature of the promise made. In all these cases the contract becomes void.
Thus, when a proposal made by the insured is accepted by the insurer in the same sense in which it is made, *consensus ad idem* without any coercion, misrepresentation etc. a valid insurance contract can be formed.

2.5 Self Assessment Questions

1. Define a contract of insurance. Explain the classification of contracts of insurance.
2. Describe the essentials of a valid insurance contract
3. Describe the competence of parties to a contract of insurance. Explain the position of minor under law of Insurance.
4. Describe the importance of free consent of the parties to a contract of insurance. Explain the affect of misrepresentations made at the time of entering into a contract.
5. Short questions –
    1. Contract of speculation
    2. Contract of utmost good faith
    3. Contract of indemnity

2.6 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth's Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. Ch. Sudhakara Babu B.Com. M.L.(Madras)

Lesson – 3

LAW RELATING TO INSURANCE CONTRACTS – PERFORMANCE OF CONTRACT (Contd..)

3.0 Objective:

Continuing with the formation of contract of insurance from the previous lesion, the other essentials of a valid contract of insurance, the consideration and object of contract of insurance are appropriately dealt with in this lesson. When a contract of insurance becomes valid, void and voidable is described. The insurance contracts that can be performed and the effect of refusal to perform are enumerated. When and how the parties to an insurance contract are discharged is described. The grounds of frustration of contract of insurance are explained.

Contents :

3.1 Consideration to and object of Insurance contract
- **3.1.1 Consideration**
- **3.1.2 Object**

3.2 Valid, void and voidable contracts
- **3.2.1 Valid contracts**
- **3.2.2 Void agreements**
- **3.2.3 Voidable contracts**

3.3 Performance of contracts
- **3.3.1 Contracts which need not be performed**
- **3.3.2 Effect of refusal to perform**

3.4 Discharge of contract
- **3.4.1 Discharge by performance**
- **3.4.2 Discharge by agreement**
- **3.4.3 Discharge by breach**
- **3.4.4 Discharge by impossibility of performance and frustration**

3.5 Self Assessment Questions

3.6 References

3.1 Consideration to and object of Insurance contract

One of the important essentials of a valid contract, according to Section 10 of Indian Contract Act is consideration. The other essentials are – competence of the parties to enter into contract, the free consent of parties to the contract, the lawful object of the parties in entering into the contract. According to Section 25 of the Indian Contract Act an agreement made without consideration is void. Another important requirement of a valid contract is lawful object. According to Section 23 of Indian Contract Act an agreement the object of which is opposed to the law of land is void. Hence, the consideration to and the object of a contract in general and of an insurance contract in particular have to be studied.

3.1.1 Consideration

Consideration simply is the recompense given by one party to the contract to the other. It is a price of the promise. Consideration means something which is of value in the eye of law given by one party to the other. Section 2 (d) of Indian Contract Act defined consideration as follows – When, at the desire of the promisor, the promise or any other person has done or abstained from doing, or does or abstain from doing, or promises to do or to abstain from doing, something such act or abstinence or promise is called a consideration for the promise.

The definition of consideration in Section 2 (d) requires three things – 1) the act or abstinence, which is to be a consideration for the promise, should be done at the desire of the promisor 2) that consideration should be done by the promise or any other person and 3) that the act or abstinence may have been already executed or is in the process of being done or may be still executory.

Suppose, A agrees to sell his goods to B and B promises to pay Rs.1,000 to A. A's promise to deliver goods to B and B's promise to pay Rs.1,000 to A constitute consideration to the contract. A made a promise to B to give his gold chain gratuitously. It cannot be called a contract as there is no consideration to the promise. A agrees to pay Rs.1,000 to B and B agrees not to contest a bid. A's payment and B's abstinence constitute consideration. A has agreed to pay each month Rs.1,000 to B and C has made a promise to transfer a piece of land to A. It is a valid contract.

Section 25 which states that an agreement without consideration is void, has recognized three exceptions – 1) an agreement expressed in writing and registered and is made on account of natural over and affection between parties standing in a near relation to each other 2) a promise to compensate a person who has already voluntarily done something for the promisor and 3) a promise made in writing and signed by the person to pay a debt barred by time.

Hence, a contract of life insurance which is constituted by mutual promises of the insurer and the applicant for insurance also requires a lawful consideration for its validity. If we examine a standard policy issued by the Life Insurance Corporation of India which evidences a contract of life insurance, we find that after reciting that the Corporation has received that first premium for an insurance of the amount and on the terms stated in the schedule, the policy witnesses that 'in consideration of the premium and on condition that there shall be duly paid to the Corporation the subsequent premiums as stipulated in the said schedule, the Corporation will pay the sum assured together with such further sum or sums as may be allocated by way of bonus'. Thus, the consideration for the assured's act namely, payment of the first premium and of the future premiums, is the insurer's promise to pay the sum assured with bonus and the consideration for the insurer's promise to pay the sum assured with bonus is the payment of the first premium and the due payment of the subsequent premiums by the insured.

Premiums subsequent to the first premium cannot strictly be called part of the legal consideration for the promise of the insurer to pay the sum assured, because the insurer cannot compel the insured to pay the premiums subsequent to the first, though on payment of the first premium the contract came into existence. They are merely conditions precedent to the continuance of the contract. The insurer's promise is conditional on the continued payment of subsequent premiums by the insured and if the insured defaults in the payment of these, the

insurer is released form the promise to pay the sum assured and bonuses but remains bound to honour the various subsidiary promises contained in the contract.

In case of other types of insurances also the insured's promise to pay the premium is the consideration for the insurer's promise to pay the sum assured.

3.1.2 Object

One of the important essentials of a valid contract is that parties must contract for a lawful object. Every agreement of which the object is unlawful is void. Section 23 of Indian Contract Act declared the following objects of an agreement as unlawful – 1) the object forbidden by law 2) the object that defeats the provisions of any law 3) the object which is fraudulent or 4) the object which involves injury to the person or property of another or 5) the object which the court regards as immoral or opposed to public policy.

Suppose, A promises to obtain for B an employment in the public service and B promises to pay Rs.1,00,000 to A. The agreement is void, as the consideration for it is unlawful. A, being agent for landlord, agrees for money, without the knowledge of his principal to obtain for B a lease of land belonging to his principal. The agreement between A and B is void, as it implies a fraud by concealment by A on his principal. A agrees to let her daughter to hire to B for concubinage. The agreement is void, because it is immoral.

An agreement is unlawful if he court regards it as opposed to public policy. The term 'public policy' in its broadest sense means the public interest, the matters in which the public in general is interested. Trading with enemy, trafficking in women, trafficking in public offices, interference with administration of justice, marriage brokerage contracts and unfair or unreasonable dealings are the matters against public policy.

In the case of an insurance contract the proposer is asked to state in his proposal the object of the insurance. Usually the object stated is that it is a provision for his old age or for his dependants or for the benefit of other spouse or children or for the purpose of paying estate duty or for the education of his children or for the marriage of his family dependants etc.

In legal language these are the motives which prompt him to enter into the agreement and not the object of the agreement referred to in Section 23 of Indian Contract Act. Object in the section means purpose or design that is the ultimate purpose which the contract subserves and this should be a lawful one. To put it in the other way, it should not have a tendency to encourage illegality or immorality or to offend well settled notions of public policy.

But insurance which is recognized to be so beneficial to the society is being resorted to by unscrupulous persons for illegal purposes, as there is always a chance here of obtaining a disproportionately large sum in return for a small payment. In case of life insurance policies, it has been observed that a threat of murder is likely to arise by insurance of one person's life for the benefit of another. If any one can insure the life of anyone else whether he is related to him by blood or not, the temptation to murder the insured cannot be ruled out in spite of the fact that there is the sanction of criminal law which punishes the murder and of civil law which deprives him of the benefits.

It is also possible that a person may take a policy of life insurance on his own life with the ulterior object of enriching his estate by committing suicide soon after taking the policy. Taking care of it, the insurers exclude from the risk, death by suicide occurring within a specified period usually one year or two from the date of the contract.

In other types of insurance also there is a possibility of abuse of insurance policies. What is the type of policy if the object of the parties to unlawful, the policy becomes void.

3.2 Valid contracts, void agreements and voidable contracts

Contracts on the basis of their validity and enforceability are divided into a) valid contracts b) void agreements and c) voidable contracts.

3.2.1 Valid contracts

An agreement enforceable by law is a contract. Under Section 10 of Indian Contract Act the essentials of a valid contract are 1) competence of parties to enter into contract 2) lawful consideration 3) lawful object 4) free consent of the parties to the contract 5) the agreement not being declared as void by law. When an agreement is supported by all the essentials of a valid contract, it is said that a contract is entered into between the parties. Valid contracts only are to be performed.

Proposal is the starting point of a contract. When one person makes a proposal to the other either to do or not to do a thing, such other person can accept the same. A proposal when it is accepted, constitutes an agreement. When the consent to the agreement is given by parties voluntarily and freely, when the parties are competent to enter into contract in law, when there is consideration for the agreement, when the object of the parties is lawful and when the agreement is not declared to be void by law, a valid contract is entered into. Such contract only binds the parties and the party or parties that have the obligation to perform have to perform it.

A valid insurance contract is one whereby one party (the insurer) promises in return for a money consideration (the premium) to pay to the other party (the insured) money or money's worth on the happening of an uncertain event adverse to the interest of the insured.

In case of insurance contracts, first of all, a person has to make a proposal with the insurance company asking for an insurance policy. The other party, the insurer has to accept the proposal. On acceptance of the proposal, the premium has to be paid by the proposer i.e. the insured. When the insurer and insured are competent parties to enter into an insurance contract, when they have given their consent freely and voluntarily and without coercion, undue influence, fraud, misrepresentation or mistake, when the consideration and object of the parties in entering into the insurance agreement is lawful, it is said that a valid insurance contract is entered into. Such valid insurance contract binds the parties. Under such valid insurance contract the insured has to continue paying the premium and the insurer has to cover the risk faced by the insured.

Valid Life Insurance Contract: A life insurance contract is defined as a contract of insurance whereby the insured agrees to pay certain sums, called premiums, at specified times, and in consideration thereof the insurer agrees to pay certain sums of money on certain

conditions and in specified way, upon happening of a particular event contingent upon the duration of human life. The essentials of a valid insurance contract are 1) it is contract relating to human life which 2) provides for payment of lump sum amount and 3) the amount is paid after expiry of certain period or on the death of the assured.

Valid Marine Insurance Contract: Section 3 of Marine Insurance Act, 1963 defined a contract of marine insurance as 'an agreement whereby the insurer undertakes to indemnify the assured in the manner and to the extent agreed, against maritime losses, that is to say, the losses incidental to marine adventure'. Thus, it is a contract to be indemnified by the insurer according to the terms of the contract, that is, as promised by the insurer. This may be more or less than the actual loss suffered by the assured.

Valid Fire Insurance Contract: Section 2 (6A) of the Insurance Act, 1938 defined fire insurance business as a business effecting, otherwise than incidentally to some other class of insurance business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies. A fire insurance contract is one 1) whose principal object is insurance against loss or damage occasioned by fire 2)the extent of insurer's liability being limited by the sum assured and not necessarily by the extent of loss or damage sustained by the insured and 3) the insurer having no interest in the safety or destruction of the insured property apart from the liability undertaken under the contract. The special characteristics of a fire insurance contract are – it is personal contract, it is an indivisible contract and the cause of fire is immaterial.

3.2.2 Void agreements

Void agreement under Section 2(g) of Indian Contract Act, is an agreement not enforceable by law. The following are the various void agreements –

1) agreement of which consideration and object are unlawful,
2) agreement with minor
3) agreement without consideration
4) agreement where both parties are mistaken
5) agreement in restraint of marriage
6) agreement in restraint of trade
7) agreement in restraint of legal proceedings
8) uncertain agreements
9) wagering agreements
10) agreement to do impossible acts

Out of the essentials of a valid contract, if the consent is not free the contract becomes voidable. If the other essentials like consideration, competence of parties, legality of object are not complied with, the agreement becomes void. If the purpose of the
Agreement is restraining a person in his marriage, trade or legal proceedings the agreement becomes void. An uncertain agreement and an agreement to do an impossible act are also void. Speculative or wagering contracts with some exceptions like horse races and lotteries are void.

A void agreement cannot create any rights and obligations. An agreement may be void from the beginning (void ab initio) or it may become void subsequently (void ex post facto). An agreement void from the beginning cannot create any obligations at all whereas a contract void

ex post facto may be valid when it was entered into but subsequently because of a change in law and so on may become void.

In case of insurance contracts, where the parties to the contract have no capacity to enter into the contract the insurance contract becomes void. If the proposer for insurance is a minor or where the insurer in a life insurance contract is not the Life Insurance Corporation of India after 1st September, 1956 or the General Insurance Company after 1st January, 1973 in general insurance contract, the agreement is void. Like in ordinary contracts, if the object of the insurance policy is not lawful, the contract becomes void. Where there is no insurable interest in a contract of insurance, the agreement is void. Where both parties are mistaken the agreement is void. Where the subject matter of insurance has ceased to exist and neither party is aware is of when the agreement is entered into, the agreement becomes void.

According to Section 65 of the Indian Contract Act, when an agreement is discovered to be void or becomes void, any person who has received any advantage under such agreement or contract is bound to restore it or to make compensation for it to the person from whom he received it. In insurance contracts also when the contract becomes void, the insurer has to return the premium. A ship which is somewhere in the Sea is insured. Later it is learnt that the ship got sunk in the Sea by the date of insurance itself. The contract is void and insurer is bound to return the premium received.

3.2.3 Voidable contracts

According to Section 2(i) an agreement which is enforceable by law at the option of one or more of the parties thereto but not at the option of the other or others, is a voidable contract. When consent of the parties to the contract is not free, that is, when the consent is obtained by coercion, undue influence, fraud or misrepresentation the contract becomes voidable at the option of the party whose consent was so obtained. Suppose, A purchased B's good at a very price at gun point. If B does not complain the contract becomes valid. If B wants to set it aside, he can file a suit and the contract will be set aside. Here, at B's option the validity of contract is determined. The voidable contract is valid if it not avoided. If it is avoided it becomes a void contract. When one of the parties is mistaken the contract is not voidable.

In insurance contracts, if the insured plays fraud on the insurer regarding health, age etc. the insurance contract becomes voidable at the option of the insurance company. Suppose, A had taken treatment for his heart disease with specialist and wants to insure his life. In the proposal he stated that he did not suffer any disease and he did not take any treatment. On the strength of the statement the insurer agreed to grant a policy. Later insurer came to know of the disease. The contract becomes voidable at the option of the insurer.

According to Section 64 of the Indian Contract Act, when a contract is avoided by a party, if that party has received any benefit under the contract, it has return such benefit. When the insurer comes to know that the insured had committed fraud regarding age, health etc. the insurer may refuse to receive the premium and rescind the contract by duly informing the insured about recission. Under Section 64 of the Contract Act the insurer has to return the premiums already received. But, the insurer can forfeit the premiums received, if the policy contains a condition to that effect. Such a condition is included in all life insurance policies.

3.3 Performance of Contracts

A valid insurance contract creates binding obligations to the parties. The parties to such a valid insurance contract are bound to perform their respective obligations under the contract.

According to Section 37 of Indian Contract Act the parties to a contract must either perform or offer to perform their respective promises, unless such performance is dispensed with or excused under the provisions of law. Promises bind the representatives of the promisors in case of the death of such promisors before performance, unless a contrary intention appears from the contract.

The promisor must therefore offer to perform his part of the obligation under the contract to the promise. This offer is called 'tender of performance'. It is then for the promisee to accept the performance. A tender of performance is equivalent to performance. The tender of performance must be unconditional. The tender must be made at proper time and place and under such circumstances that the person to whom it is made may have a reasonable opportunity of ascertaining that the person by whom it is made is able and willing there and then to do the whole of what he is abound by his promise to do.

Generally the contract has to be performed by the promisor. But the promisee may accept performance of the promise form a third person. When he accepts performance by third person, he cannot afterwards enforce it against the promisor. Where time is the essence of the contract, the performance must be within the time agreed upon. Where time is not the essence of the contract, with in a reasonable time contract may be performed. When a contract consists of reciprocal promises to be simultaneously performed, no promisor need perform his promise unless the promise is ready and willing to perform his reciprocal promise.

Regarding the performance of insurance contracts, it is insured or his representatives that must pay the premium and not any stranger. It is however open to the insurer to accept performance from a stranger. Promises bind the representatives of the promisors in case of death of such promisors before performance, unless a contrary intention appears form the contract. For instance, where the periodic premium on a life policy is payable on the due date or within the period of 30 days thereafter and would lapse if remaining unpaid and the insured dies after the due date without paying the premium, his representative may pay it within the grace period to and prevent the policy from lapsing. Where the assignee of the policy paid the premium due within the grace days and was held entitled to the sum assured. If the insurer refuses to accept the premium duly offered by the insured, the insured does not thereby lose his rights under the policy so that if a loss occurs thereafter the insurer is still liable to indemnify the insured.

3.3.1 Contracts which need not be performed

Section 62 of the Indian Contract Act provides that if the parties to contract agree to substitute a new contract for it or to rescind or alter it, the original contract need not be performed. When the parties to a contract agree to substitute the existing contract with a new contract, it is called as Novation. In such a case the new contract becomes binding and the old contract need not be performed. The substituted new contract must be a valid and enforceable contract. Where the old one is cancelled and is replaced by a new one, the old one is not revived only for the reason that there has been a failure to keep the new promise.

The parties may even agree to cancel the existing contract. In such a case the contract need not be performed.

The parties may alter the provisions of the existing contract. In such a case the original contract need not be performed and the altered contract binds the parties.

An agreement to do an act impossible in itself is void and cannot be performed. Suppose, A agrees with B to discover treasure by magic. The agreement is void. A contract to do an act which after the contract is made becomes impossible by reason of some event which the promisor could not prevent, becomes void and need not be performed.

In case of insurance contracts also where a new policy substitutes the old one, the old policy need not be performed. But, such a thing is not common with insurance contracts.

3.3.2 Effect of refusal to perform

The party that has an obligation to perform under the contract has to perform or tender to perform his part of the obligation to the other party. If such party fails to do so, such other party shall have a right of filing a suit for performance of the contract or for discharge of contract or for damages for breach of contract. If it appears from the nature of the case that it was the intention of the parties to any contract that any promise contained in it should be performed by the promisor himself, such promise must be performed by the promisor. In other case the promisor or his representatives may employ a competent person to perform it. When a promise accepts performance of the promise form a third person, he cannot afterwards enforce it against the promisor. Where a party to a contract has refused to perform or disabled himself from performing his promise in its entirety, the promise may put an end to the contract.

When a contract consists of reciprocal promises to be simultaneously performed, no promisor need perform his promise unless the promise is ready and willing to perform his reciprocal promise. When a contract contains reciprocal promises, and one party to the contract prevent the other from performing his promise, the contract becomes voidable at the option of the party so prevented and he is entitled to compensation from the other party for any loss which may sustain in consequence of non performance of the contract.

When a contract consists of reciprocal promises, such that one of them cannot be performed, or that its performance cannot be claimed till the other has been performed and the promisor of the promise last mentioned fails to perform it, such promisor cannot claim the performance of the reciprocal promise and must make compensation to the other party to the contract for any loss which such other party may sustain by the non performance of the contract.

Where the promisor has made an offer of performance to the promise and the offer has not been accepted the promisor is not responsible for non performance nor does he lose his rights under the contract. Every such offer must be made unconditional and must be made at a proper time and place.

The general principles of contract law regarding effects of refusal to perform, with necessary changes shall apply to insurance contracts. The obligation of the insured is to pay

premiums as per the contract. If he fails to do so, even after the grace period, the insured is entitled to cancel the contract. The obligation of the insurer arises on the occurrence of the risk. If the insurer refuses or fails to pay the sum assured on the occurrence of the risk in accordance with the contract, the insured is entitled to sue for the assured sum.

3.4 Discharge of Contract

With the formation of a valid contract, the parties become bound by the obligation to perform their respective parts under the agreement. When the contract is performed the parties are discharged from the contract. That means, the contractual obligation and the contract as such comes to an end. There are other ways of discharge also. The following are the various modes of discharge – a) discharge by performance b) discharge by agreement c) discharge by breach and d) discharge by impossibility of performance.

3.4.1 Discharge by performance

.

Refer to notes under section 3.3. By performance the parties are absolutely relieved from the contract. Where the claim arises in a life insurance policy by maturity or by death of the insured, the policy comes to an end and is discharged by performance that is payment of the sum assured or whatever is payable. Where a loss occurs in a non-life insurance policy and the insured is duly indemnified, the policy is fully discharged if the indemnity covers the full sum insured. Otherwise it is discharged to the extent of the sum insured paid as indemnity and the policy continues to be in force up to its normal term for the balance of the sum insured.

3.4.2 Discharge by agreement

When the parties to the contract come to an agreement regarding the discharge from the contract, the parties are discharged from the contract. Discharge by agreement may take place in different ways. They are 1) rescission 2) alteration and 3) novation. Rescission means going back, cancellation of the contract. Section 62 of the Indian Contract Act permits parties to rescind their contract. As a contract creates only personal relation between the parties, the parties at any time can cancel the contract. Suppose A agrees to sell his goods to B at a price. Before the contract is performed, both parties agree to cancel the contract. The parties are relieved of their obligations under the contract. When the agreement to cancel is not vitiated by the factors like coercion etc. the agreement to cancel becomes valid and the contract comes to an end. While agreeing on rescission, the parties can agree even on compensation that may be paid by one party to the other on rescission.

Discharge may also take place by alteration. If the terms and conditions of the existing contract are altered by the parties, by agreement, the parties are discharged from their obligations under the earlier contract and they become bound by the altered contract. Section 62 permits the same.

Another mode of discharge by agreement is novation. Novation is the substitution of a new contract. According to Section 62 if the parties to a contract agree to substitute a new contract for the old one, the original contract need not be performed. Such substituted contract must be a legal and valid one. Novation may take place in two ways – 1) novation involving change of parties and 2) novation involving substitution of a new contract in place of the existing

one. If A is a debtor and the creditor agrees to accept B in his place as the debtor, the original contract between the creditor and A comes to an end. Where the old contract is substituted by a new one, the old one will not revive only for the reason that there has been failure to keep the new promise.

When the insured surrenders his policy for cash payment to which the insurer must consent, the policy is discharged by agreement. A fire or motor policy may be terminated by either party before its normal term if that is a condition of the policy. This is also a case of discharge by agreement. By agreement a policy may also be substituted by a new policy with different terms.

3.4.3 Discharge by breach

If the party that has an obligation to perform, fails to perform his obligation it is said that he committed breach. A breach of contract occurs when a party thereto renounces his liability under it, or by his own act makes it impossible that he should perform his obligations under it or totally or partially fails to perform such obligations. Breach of contract is of two types. 1) anticipatory breach 2) present breach. When on of the parties to the contract announces his intention not to perform, even before the date of performance, it is known as anticipatory breach. An anticipatory repudiation occurs when prior to the promised date of performance, the promisor absolutely repudiates the contract. When such anticipatory breach takes place, the other party to the contract is exempted form further performance and he is entitled to immediate action. He need not wait till the date fixed for performance.

In case of present breach, the breach may be either partial or total. Every minor irregularity in the performance of a contract cannot be taken as a breach. When a party to a contract has refused to perform or disabled himself from performing his promise in its entirety, the promisee may put an end to the contract, unless he has signified by words or conduct his willingness in its continuance. In a contract for supply of 100 bags of rice of particular quality, if one bag is below the quality agreed upon it generally cannot be considered as breach. A, a singer enters into a contract with B, the manager of a theatre, to sing at his theatre two nights in every week during the next two months, and B engages to pay her 1,000 rupees for each night's performance. On the sixth night A willfully absents herself from the theatre. B is a liberty to put an end to the contract.

The party in default must have refused altogether to perform the contract and the refusal must go to the whole of the contract, otherwise the other party would not be justified in putting an end to the contract. When there is a partial breach, if the breach goes to the root of the contract, the other side is entitled to put an end to the contract. Where the landlord has promised continued supply of water and electricity and cuts down water supply, the tenant is entitled to terminate the tenancy.

The party who is injured by the breach of a contract may bring an action for damages. Damages means compensation in terms of money for the loss suffered by the injured party. According to Section 73 of the Indian Contract Act when a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damaged caused to him thereby which naturally arose in the usual course of things from such breach or which the parties knew, when they made the contract, to be likely to result from the breach of it. The party that committed breach is liable for all the

proximate consequences of breach. He is not liable for remote consequences. The damages are measured taking into consideration that actual damage suffered, inconvenience caused by breach, mental pain and suffering etc. The party that has brought an action for damages for breach, has to restore to the other party the benefits he might have received under the contract.

In insurance contracts, if the insured failed to pay the premiums on time or if the insurer refuses to accept the premium duly tendered, the policy comes to an end. Where the insured is guilty of breach of warranty and the insurer rescinds the contract on that ground, the policy comes to an end.

3.4.4 Discharge by impossibility of performance and frustration

Impossibility in doing a thing is of two types – 1) initial impossibility and 2) subsequent impossibility. According to Section 56 of Indian Contract Act an agreement to do an act impossible in itself is void . A contract to do an act which after the contract is made, becomes impossible or by reason of some event which the promisor could not present, unlawful, be comes void when the act becomes impossible or unlawful. Sometimes the performance of a contract is quite possible when it is made by the parties. But some event subsequently happens renders its performance impossible or unlawful. In either case the contract becomes void. For example, where a contract is made for the import of goods and the import is thereafter forbidden by Government order, the contract is void.

Where one person has promised to do something which he knew and which the promisee did not know, to be impossible or unlawful, such promisor must make compensation to such promise for any loss which such promisee sustains through the non performance of the promise. On many occasions the performance of the contract may become impossible. Some of such occasions are – a) destruction of the subject matter b) fundamental change in circumstances c) non occurrence of a contemplated event d) death or incapacity of party e) Government or legislative intervention f) declaration of war etc. A contract whose performance became impossible need not be performed and parties are discharged from the contract.

3.5 Self Assessment Questions :

1. Explain the important of consideration to a contract of insurance.
2. Describe the contracts which are to be performed and contracts which need not be performed.
3. Describe the effects of refusal to perform a valid contract of insurance.
4. Short questions –
   a. Frustration b. Void and voidable contracts c. Object of insurance contract

3.6 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth’s Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. Ch. Sudhakara Babu B.Com. M.L. (Madras)

LESSON – 4

PROPOSAL AND POLICY – TERMS, CONDITIONS AND EXCEPTIONS OF POLICY

Contents :

4.1 Proposal
- **4.1.1. Proposal in Non-marine and marine insurance**
- **4.1.2 Cove note**
- **4.1.3 The slip**

4.2 The policy
- **4.2.1 The terms of policy**
- **4.2.2 The conditions of policy**
  - **4.2.2.1 Conditions precedent**
  - **4.2.2.2 Conditions subsequent**
- **4.2.3 Exceptions to policy**

4.3 Construction of policy
4.4 Effect of breach of conditions
4.5 Principle of Utmost good faith
4.6 Duty of disclosure
- **4.6.1 Insured's duty of disclosure**
- **4.6.2 Insurer's duty of disclosure**

4.7 Inherent and contractual duties of good faith
4.8 Remedy for unfaith contract.
4.9. Glossary
4.10 Self Assessment Questions
4.11 References

4.1 Proposal

The insurance policy is prepared after the formation of the contract. The contract is formed when a proposal is accepted. In insurance contracts the proposal by a party is based on a prospectus issued by an insurance company. Prospectus is any notice, circular, advertisement or other invitation offering to the public for subscription or purchase of any policy. In a prospectus by an insurance company the different types of policies, privileges and conditions of the policies, procedures of insurance contract and settlement of claims and rules and regulations of insurance contract are explained. It is an invitation to the public to offer for insurance.

Out of the different types of policies offered by the insurance company, the person selects the one and makes a proposal with the company. According to Section 2 (a) of Indian Contract Act proposal is one person signifying to another his willingness to do or abstain from doing anything with a view to obtaining the assent of that other to such act or abstinence. A person makes a proposal with an insurance company in the form of submitting a proposal form. The proposal form is important because statements in it are the basis of the contract between

the parties. Different types of proposal forms are presented for different types of policies like policy with or without medical examination, children's policies, annuities etc. The proposal form includes information pertaining to the amount, kind and term of policy. The proposer has to disclose all the material facts truly and fully. He should answer all the questions in good faith. If any information is not asked in the proposal form, but the information is material to the contract, the insured should explain the information. The material information of the proposal form is supplemented by a personal statement, medical report and agent's report. The proposal form if accompanied by premium will be an offer of insurance and if the premium is not accompanied with the proposal from, it would be a case of an invitation to offer. The acceptance letter issued by the insurer on the usual term would be an acceptance. Similarly, if the insurer wants to alter the terms and conditions of offer it would be a case of counter offer which the insured should accept.

4.1.1 Proposal in non-marine and marine policies

Non –marine policies: It is the usual practice in non marine insurances for the insurer to require the applicant for insurance to complete a proposal form containing a number of questions put with a view to ascertaining the exact nature of the risk to be assessed and covered. The applicant declared that he warrants the truth of the statements made in the proposal form and agrees that it shall be the basis of the contract and that he will accept the usual form of the policy issued by the insurer in such cases. On the strength of this declaration the insurer relies on the statements in the proposal form, assesses the risk and fixes the premium and informs the applicant that he is agreeable to enter into a contract if the proposer pays the first premium quoted in the acceptance letter. The unqualified acceptance of this offer is indicated by the proposer by his paying the premium in accordance with the letter. This gives rise to the contract of insurance form the date of such payment. The terms of the contract are then embodied in a policy issued by the insurer.

Marine policies: In England, in marine insurance there is not practice of taking a proposal form from the proposer. On the other hand, under instructions form the proposer, the broker prepares an original slip mentioning all the bare essentials of the proposed risk and clauses defining the liabilities to be assumed by the underwriter and submits it in the first instance to the underwriter. A broker supplements the facts with all the material information furnished by the proposer. The broker and the underwriter sign it and lodges it with Lloyd's policy signing office.

In India, there are no insurance brokers as in England. Here the proposer himself or through agent, has to approach the insurers, before 1973 several but after 1973 the General Insurance Corporation of India. The G.I.C. can accept any risk however large and reinsure any part of the risk.

4.1.2 Cover note

Cover note is a distinct contract of insurance for the short period. It is a temporary contract. It is used in non-life policies. A contract of insurance is a species of commercial transactions and there is a well established practice to send cover notes even prior to the completion of a proper proposal or while the proposal is being considered or policy is in preparation for delivery. It contains the terms and conditions of the future policy. Sometimes the proposer requires insurance protection immediately on making proposal as in the case of motor

vehicles which cannot be sued in a public place without an insurance policy. To provide for giving such cover, insurer of non-life policies have empowered their agents to grant Letter of Cover or Cover note valid for not less than 15 or 30 days at the most, after satisfying themselves about the acceptability of the proposal. It automatically expires at the end of the stated period unless it is earlier superseded by the issue of a regular policy or the proposal is declined by the insurer.

The cover note usually mentions that the interim cover is under the same terms and conditions as the policy that is usually issued for such proposals. The insurer then examines the proposal and if acceptable issues a policy for the required period or declines the proposal and informs the proposer before the cover note period expires. Any claim arising during the currency of the cover note will be determined by reference to the terms of the cover note and not to the terms of the subsequent policy.

4.1.3 The Slip

The slip is a document containing short particulars of the risk and the nature of the cover required, in the customary shorthand prepared by the insurance broker who acts as the agent of the insured and takes it to a leading underwriter and negotiates its acceptance. The underwriter signifies his acceptance in full or part by initialing the slip. Unlike the cover note, the slip is an acceptance of the proposal and binds the underwriter to issue a policy in accordance with it terms. According to Section 23 of Marine Insurance Act, 1963 no action can be brought on the slip, but for the purpose of showing when the proposal was accepted, reference may be made to the slip or covering note or other customary memorandum of the contract. The policy may be executed and issued either at the time when the contract is concluded or afterwards. Where there is a duly stamped policy, reference may be made as to the slip or cover note in any legal proceeding.

4.2 The Policy

The term policy is derived form Italian word ‘polizza’. It is a formal document which evidences the contract of insurance which has been formed by the mutual agreement between the parties. Great care should be taken in drafting a policy**.** It must truly and completely reflect the intention of the parties. The words used in the policy, as far as possible, should be plain, simple and ordinary and must be used in the popular sense.

4.2.1 The terms of policy

The terms of Life Insurance policy: Life Insurance policies are of two kinds in form namely a) narration type and b) schedule type. In narration type the contract is expressed in a long narration containing continuous details. In modern times this is not used. Schedule type is modern and its contents are – date of the deed, names of the parties, the preamble, consideration i.e. a statement regarding the payment of premium, covenants of title and conditions, schedule of property, execution by the corporation with its seal and attestation of the signatures. The policy deed with all these details has to be delivered to the insured otherwise it will not operative.

The terms of Fire Insurance policy: Fire insurance policy like many standard form of contracts is a printed document containing the terms and conditions of the contract, with gaps

for the inclusion of the relevant details of the individual contract. The following are the details of the policy – a) the heading b) recitals c) the name of the insured d) the description of the subject matter e) the amount of the insurance f) the contract of indemnity g) the peril insured against h) the duration of the policy i) the signature of the insurer j) the schedule k) the special terms if any.

Any misdescription of the parties or terms agreed upon and alteration to the policy shall render the policy invalid. The policy document has to be retained by the policy holder. In case of loss of the document, the burden of proving the loss will be on the insured.

4.2.2 The conditions of policy

Conditions are the stipulations agreed upon by the parties and which are to be performed by the parties. A condition is different form a contingency. In case of contingency the party will not be performing anything but he waits for the happening of an event. Parties can agree upon any conditions. But the conditions must be reasonable and proper. Unreasonable, impossible, illegal or immoral conditions will make the contract void. Conditions are of two types - a) express conditions and b) implied conditions. Express conditions are those which are expressly stated or set forth in the policy. They are of two types – a) general and b) special. General conditions are those which are common to all policies of that class which are printed on the policy. Special conditions are those which are applicable to that particular policy, which are generally handwritten or typed.

Implied conditions are those which are implied by law to apply to every contract of insurance irrespective of any specific inclusion or reference. The implied conditions in an insurance contract are – 1) that the parties must observe good faith towards each other at all stages of the contract 2) that the subject matter of insurance is in existence at the time the contract comes into existence 3) that the insured has an insurable interest in the property insured and 4) that in case of loss, the property destroyed is the property intended to be insured. Implied conditions may be explicitly expressed in the policy or may be excluded or modified by the express conditions.

Conditions express or implied can again be divided into two – a) condition precedent and b) condition subsequent.

4.2.2.1 Conditions precedent

Condition precedent is the condition that has to be complied with before the contract is concluded. If the condition is not complied with no valid contract is formed. The parties may agree upon certain conditions as conditions precedent. Such conditions may be complied with to a substantial extent. The statutory conditions prescribed regarding the validity of a contract like competence of the parties, consideration, legality of object etc. are conditions precedent. Unless these conditions are fulfilled no contract is formed. When once a valid contract is constituted then question of compliance of conditions agreed upon by the parties shall arise.

In an insurance contract the following shall be the conditions precedent – a) that the statements made in the proposal must be true and complete b) that the subject matter of

insurance must be adequately described and must be in existence when the policy comes into force c) that the insured has capacity to enter into the contract of insurance etc.

There are certain conditions which must be complied with by the assured when a loss occurs. Otherwise, the insurer will not be liable for the claim, even though a loss is covered by the policy. These conditions are – a) the insured must give notice of the loss to the insurer immediately upon its occurrence b) the insured must forward to the insurer every notice or claim received by the insured c) the insured must render all assistance to the insurer in the investigation of the cause of loss d) the insured must not make any admission of liability or promise of payment e) proof of age and of death in case of life insurance. If these are complied with the insurer cannot be held liable under the policy in respect of that particular claim, but the breach will not avoid the policy as a whole.

4.2.2.2 Condition subsequent

Condition subsequent is a condition which is to be complied after the formation of the contract. Actually these are the essence of the contract. Condition subsequent has to be complied with in its fullness. If the condition subsequent is not fulfilled by the party that has the obligation to fulfill, the other party gets a right to avoid the contract and to sue for damages for breach. The difference between condition precedent and subsequent is – in case of condition precedent if the condition is not fulfilled the contract is not formed at all whereas in case of condition subsequent the contract is formed and the party that suffered breach condition gets his rights under law.

In an insurance contract the following are considered as conditions subsequent – a) the assured shall not transfer his interest in the subject matter of the insurance with out the consent of the insurer b) the assured shall not alter the risk as originally described c) the assured shall not take a similar policy with any other insurer etc. If such a condition is contravened the policy ceases to be valid and the insurer can avoid the policy with effect form the date of breach.

4.2.3 Exceptions to policy

The policy of insurance is the evidence of the terms of the agreement between the insurer and the insured. The promise of the insurer to indemnify the insured is subject of terms, conditions and exceptions of the policy. Some of the terms of the policy are of the nature of exceptions, exempting the insurer from liability and some are of the nature of conditions subject to which the insurer will be liable.

Insurers undertake to indemnify the insured against losses caused by certain perils arising under normal conditions whose effects are statistically estimated. During abnormal times, such perils may cause losses of great magnitude for which the insurers do not wish to accept liability, for instance, fire caused during riots or war or by earthquake etc. Therefore, exceptions are inserted for the purpose of excepting the liability of the insurer for which he would otherwise be liable.

In motor insurance, certain general exceptions to the insurer’s liability are inserted, for example where the vehicle is used in an unroad worthy condition or by an unauthorized driver and so on. In fire policies, losses from abnormal fires like riot fire, forest fires and in personal accident insurances, liability for death or disablement form disease is usually excepted.

4.3 Construction of policy

Construction or interpretation of a policy is knowing the sense in which the parties have used various terms in a contract. Construction of a policy is the job of the court. Even parties have to know the correct meaning of what they meant in the contract. The following are the principles in constructing an insurance policy.

(1) The policy of insurance evidences a contract and must therefore be construed like any other contract. The intention of the parties must be gathered in the first place from the words used in the policy taking it as a whole and putting a reasonable construction on each clause.

(2) Effect must be given to every word and phrase used in the policy.

(3) Words printed or written are to be taken on equal footing. Incase of any conflict between the printed and written clauses grater consideration is to be paid to the written words as these words are selected by the parties.

(4) Where a clause in the policy is ambiguous it must be construed against rather than in favour of the insurer.

(5) Warranties are inserted for the protection of and if the language of a warranty is ambiguous it will be strictly construed against the insurer.

(6) A contract cannot be construed by reference to the subsequent conduct of the parties.

(7) The words and the phrases used in the policy have to be given their ordinary and grammatical meaning.

(8) When a word is used in the technical sense, technical meaning is to be given.

4.4 Effect of breach of conditions

If a condition subsequent is broken the policy ceases to be operative from the date of breach. The breach of a condition precedent to the liability of the insurer prevents the insured from recovering indemnity for the loss. However if he complies with the condition where it can still be performed, he can hold the insurer liable. The breach however does not affect the validity of the policy and so it continues in force. If another loss occurs before the policy expires the insured is not precluded from recovering indemnity provided he complies with the conditions on that occasion.

Waiver of breach: The insurer can waive the breach of the condition by the insured. That means the insurer can give-up the wrong committed by the insured by accepting the continuation of the policy and by accepting the premium. In such a case the effect will be the same as a condition had been fulfilled by the insured. The insurer can also waive the breach by accepting a letter from the insured.

4.5 Principle of Utmost good faith

Insurance contracts are a special class of contracts, having distinctive features such as utmost good faith, insurable interest, indemnity, subrogation and contribution and doctrine of

proximate cause which are more or less common to all branches of insurance. One of the important features of contract of insurance is the principle of utmost good faith—*uberrima fides*. In case of an ordinary contract both the parties to the contract have to be careful. One party generally doesn't have any duty to the other to take care of such other. Each party is expected to inform himself of all relevant facts, making enquiries as he may think prudent. The rule of law that guides the relation in case of an ordinary contract is "Caveat Emptor". It means that the buyer has to be aware of his interests. Except where the opposite party has a duty of informing, the buyer has to take all the care that is required of an ordinary buyer. If he suffers any loss he can not blame the opposite party. All the patent defects he has to learn for himself. Only for latent defects he can rely on the opposite party. Suppose, A purchases a horse by inspecting the horse. Later, he wants to cancel the sale on the ground that the horse was old. He is not allowed to do so as he had to inspect the same while purchasing the horse. The other party has no duty of informing the same.

The principle of utmost good faith does not apply to contract of insurance. Law demands a higher standard of good faith in case of insurance contracts. In case of an ordinary contract both parties are exposed equally to the facts. Whereas in case of insurance contracts, the insured is well versed with all the facts as the subject matter is his interest, whereas the insurer can not know any thing about the subject matter. The insurer can learn the subject matter only on information from the insured. Suppose, A wants to take a policy on his life. The Life Insurance Corporation of India has no chance of knowing any thing about A's health, age etc., On A's information only the corporation knows the matters. Hence, A is expected to be of utmost good faith while giving information to the corporation.

Good faith forbids either party, by concealing what he privately knows, to draw the other into a bargain from his ignorance of the fact and his believing the contrary. The utmost good faith requires that there shall be no concealment, misrepresentation or misstatement as to the material facts. The proposer must disclose all material facts truly and fully. There should not be any false statement or half-truths or any silence on a material fact. All the material facts are to be disclosed. A material fact is that fact which would affect the judgment of a prudent insurer in fixing the premium or in considering whether he would enter into the contract at all. If the assured has knowledge of a fact which is material and ought to be disclosed, it will not aid him if he failed to make disclosure of it because he thought it not material. The test is what would a reasonable man have thought and, consequently disclosed.

It is fundamental principle of insurance law that utmost good faith must be observed by the contracting parties. Good faith forbids either party from concealing (non-disclosure) of what he privately knows, to draw the other into a bargain from his ignorance of that fact and his believing the contrary. Just as the insured has a duty to disclose, it is the duty of the insurers and their agents to disclose, all material facts within their knowledge, since obligation of good faith applies to them equally with the assured.

4.6 Duty of Disclosure

The principle of utmost good faith requires that there shall be no concealment misrepresentation or misstatement has to be material facts. Both parties have to disclose to each other all the facts within their knowledge and their wish. The duty to make a full and complete disclosure starts during the period of negotiation and continues up to the movement a binding contract is concluded. It is the duty of both the parties to disclose all material facts until

the completion of the contract. If either party fails to disclose the material facts to the other, such other party gets a right to repudiate the contract. The utmost good faith may be broken either intentionally or unintentionally, when it is intentional it would be a case of fraud and will be void *ab-initio*. In case of unintentional breach, it is voidable at the option of the policy not at fault.

4.6.1 Insured's duty of disclosure

What the insured should disclose in the absence of an enquiry are laid down in sections 20 and 21 of Indian Marine Insurance Act, 1963. The assured must disclose to the insurer, before the contract is concluded, every material circumstances which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known to him. If the assured fails to make such disclosure, the insurer may avoid contract. The agent of the insured also has the same duty.

The insurer need not disclose certain facts. They are – (a) Any circumstances which diminish the risk. (b) Any circumstances which are known or presumed to know matters of common notoriety or knowledge and matters which an insurer in the ordinary course of his business, as such ought to know. (c) Any circumstances as to which information is waived by the insurer. (d) Any circumstances which are superfluous to disclose by reason of any express or implied warranty.

4.6.2 Insurer's duty of disclosure

The duty on the part of the insurer to disclose is less severe. In an ordinary contract both parties shall have duty of disclosure. In view of the special features of insurance contract the duty is caste more on the insured than on the insurer. The insured shall have the knowledge of the facts whereas the insurer does not have. But still there are occasions where the insurer has to disclose the facts to the insured. Justice Slade held that the duty falling on the insurer must at least extend to disclosing all facts known to him which are material either (a) to the nature of the risk sought to be covered, or (b) the recoverability of a claim under the policy which a prudent insured would take into account in deciding whether or not to place the risk for which he seeks cover with the insure.

The insurer must also inform the insured about the terms and conditions of the policy that is going to be issue to him. He must issue the policy in conformity with the terms mutually agreed with the insured. Insurer must act fairly and honorably to the insured, explaining properly the implication of the declaration to be signed by the insured and the range and amplitude of the questions required to be answered.

4.7 Inherent and contractual duties of good faith

In contracts of utmost good faith, contracting parties are placed under a special duty towards each other, not merely to refrain from active misrepresentation but to make full disclosure of all material facts within their knowledge and the principle of caveat emptor has no place. This is the *inherent* or common law duty of good faith and is distinct from the *contractual* duty of good faith. The common law duty is the basis and it is open to the parties entering into an insurance contract to extend the duty or restrict it by the terms of the contract. The inherent

duty of the insurer is invariable got extended as his contractual duty, by requiring him to declare that he warrants the truth of his answers in the proposal form.

4.8 Remedy for unfaith contract

There is no equality between the two parties to the insurance contract in the first instance, as the insurer is the richest corporation and the insured an ordinary individual. The insured's position is made more vulnerable as result of the duty of disclosure and the practice of converting statements in the proposal form into warranties. There was need for such a practice fro protecting the insurers in the middle of the eighteenth century when the insurance market was in its infancy, but not now because the insurers have improved methods to assess risks and protect themselves.

In England, the insurance companies voluntarily offered equal position to be insured. In India also the same position is uphold. The proposer's answers to the various questions in the proposal and personal statement are all representations on the strength of which the insurer may be induced to enter into the contract. Representation, if any, made after the contract is concluded cannot have any connection with inducing the insurer to enter in the contract and will not affect the validity of the contract. The general rules of liability between the insurer and the insured are – (a) if a statement is material to the risk and untrue and fraudulent. The contract is void. (b) if a statement is material to the risk and untrue, but with no fraudulent intent, the contract is voidable at the option of the assurance. The remedies available under contract law shall be made applicable to both the insurer and the insured in case of unfair contracts.

4.9 GLOSSARY

1. Insured= the person who seeks the protection from risk
2. Insurer= the person who undertakes to protect the other from risk
3. Premium= the consideration agreed upon and which can be paid periodically
4. Risk= possibility or chance of meeting danger
5. Indemnity= a promise to save the other from loss caused to a person
6. Wager= money or money's worth upon the determination of an uncertain event
7. Uberrima fides = utmost good faith
8. Contract= an agreement enforceable by law

4.10 Self Assessment Questions

1. Explain how proposal is the basis for the formation of a contract of insurance. Explain how the proposal is made in case of marine and non-marine insurance contracts.
2. Describe the terms and conditions of a policy of insurance. Explain the effects of breach of conditions in an insurance contract.
3. Explain he rules of construction of a policy of insurance.
4. Explain duty of disclosure of insured and insurer.
5. Describe the principle of utmost good faith.
6. Short questions –

a. Cover note
b. Slip
c. Unfair contracts.

4.11 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth's Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. Ch. Sudhakara Babu B.Com. M.L. (Madras)

Lesson – 5

INSURABLE INTEREST

5.0 Objective :

The Meaning and importance of insurable interest in a contract of insurance. The requirements of insurable interest. The types of insurable interest i.e., contractual interest and statutory interest under different kinds of insurance viz. life, fire, marine and liability insurance are discussed in this chapter.

Contents :

5.1 Insurable interest - Definition and Requirements
5.1.1 Insurable interest - Definition
5.1.2 Insurable interest – Requirements
5.2 Types of insurable interest
5.2.1 Contractual interest
5.2.2 Statutory interest
5.3 Insurable interest under different insurances
5.3.1 Insurable interest under Life insurance
5.3.2 Insurable interest under Fire insurance
5.3.3 Insurable interest under Marine insurance
5.3.4. Insurable interest under Liability insurance
5.4. Self Assessment Questions
5.5. References

5.1. Insurable Interest – Definition and Requirements

Insurable interest is an essential prerequisite in insurance contract. The insured must possess an insurable interest in the subject matter of insurance; otherwise, the contract of insurance becomes wagering and void under section 30 of Contract Act. “No insurable interest – no insurance” is the maxim of insurance law.

5.1.1 Insurable interest - Definition

Insurable interest means an interest which can be or is protected by a contract of insurance. This interest is considered as a form of property in the contemplation of law. It is assimilated to an actionable claim transferable to the same extent and with in the same limitations.

Insurable interest means some pecuniary interest. The object of insurance is to protect this pecuniary interest of the insured in the subject matter of insurance.

“Benefit from its existence and prejudice from its destruction” is the test of an insurable interest vis-à-vis the subject matter of insurance.

Lawrence J. in “ **Lucena Vs. Craufurd**” has given a classical definition of insurable interest thus “ A man is interested in a thing to whom advantage may arise or prejudice happen from the circumstances which may attend it; interest does not necessarily imply a right to the whole or a part of a thing. Where a man is so circumstanced with respect to matters exposed to certain risks or dangers; but for those risks or dangers, he may be said to be interested in the safety of the thing. To be interested in the preservation of a thing is to be so circumstanced

with respect to it as to have benefit from its existence and prejudice from its destruction". Interest has been defined to mean " if the event takes place, the party would gain advantage; and if it is frustrated, the party would suffer a loss." This decision lays emphasis on the beneficial and detrimental aspects of the legal interest that an assured must necessarily possess to be a genuine party to take out a valid policy of insurance.

According to Patterson, " Insurable interest is a relation between the insured and the event insured against, so that the occurrence of the event would result in a substantial loss or injury of some kind to the insured."

According to Rodda, " Insurable interest is an interest of such a nature that the occurrence of the event insured against would cause financial loss to the insured."

Thus, it is any interest which the assured is deemed to have in the subject matter of insurance if in the event of its loss, damage or destruction, that person will be subject to the risk of losing some economic benefit or advantage. It is an interest or right which the law will recognise in the preservation of the thing or the continuance of the life which has been insured. It need not be a legal interest. The test laid down by the courts is whether the insured stands in such a relation to the subject matter that by the happening of the event insured against he will sustain some pecuniary loss.

The definition of insurable interest has been continuously expanding. A study of the modern cases reveals that a vested or proprietary interest is not essential, but such interest may be merely possessory, inchoate, contingent, defeasible, equitable or expectant. In respect of expectant interest, there must be a subsisting right or title in the insured at the time of loss with respect to the subject matter out of which the expectancy arises; but a mere expectation of profit without any interest in the goods will not however be sufficient to constitute insurable interest. It is not always the legal interest or a full interest that is required by the courts, but it should be such that it would be sufficient if it is recognised by court of law or equity as such interest.

Insurable interest is the legal right of the insured in insurance. The taking of an insurance policy does not protect the insured property from loss or damage, but only protects the insured's interest in the property.
Thus an insurable interest is a property in the nature of an actionable claim.

5.1.2 Insurable interest - Requirements

Insurable interest is required to be in the following ways:

I. Emotional or sentimental interest cannot constitute insurable interest.
II. It may be contingent or equitable
III. It should not be mere hope or expectation.
IV. It should not be illegal, immoral or opposed to public policy.
V. It must be pecuniary i.e., capable of estimation in terms of money. Mere disadvantage, inconvenience or mental distress cannot be regarded as insurable interest.

5.2 Types of insurable interest

There are two types of insurable interest:

1. Contractual – where insurable interest is required by parties,
2. Statutory – Where insurable interest is required by statutes.

5.2.1 Contractual interest

According to contract act, contract is an agreement enforceable by law. Agreement is a promise or every set of promises forming consideration for each other. It is a principle of public policy that persons who enter into contractual relationships should be required to fulfill them.

The above principles apply to contracts of insurance as well. An express or implied term of contract itself may require that the insured should have an interest in the subject matter at the time of loss, as for instance, in a policy of indemnity. In such a case, if the insured has no interest at the time of loss, the claim will fail. Thus, this is the interest required by the policy or contractual interest. Even if this is wanting, the insured may enforce the contract, if the insurer does not raise this as a defence.

5.2.2 Statutory interest

Insurable interest is required by law itself for the validity of policy, whether by express statutes such as Indian Marine Insurance Act or by implied statute as by S.30 of Indian Contact Act which declares that wager contracts are void. This is interest required by statute or the statutory interest. If this interest is absent, the insurance is illegal, void and no agreement between the parties dispensing with this requirement can be effective.

In an action upon such a contract, if the insurer does not raise the plea of want of insurable interest, nevertheless the court of its own motion may refuse to enforce the contract. It has also been held in some cases that there is nothing illegal about the insurer paying on a policy without insurable interest, as the objection or want of insurable interest is purely technical and has no real merit as between the insurer and the insured.

The case of “ **Macaura Vs. Northern Assurance Company”** is a good illustration of two types of insurable interest. In that case, Macaura insured timber in his estate against fire. He sold the timber to a company of which he was the sole substantial shareholder. Thereafter, most of the timber was destroyed by fire and he claimed to be indemnified. The insurer succeeded in refusing the claim. The insured has neither statutory interest because as a shareholder he has no insurable interest in the assets of the company though he would suffer loss on the company losing its property, nor had he contractual interest under the policy because he could not prove interest at the time of loss. The policy is unenforceable by an uninterested assured.

5.3 Insurable interest under different insurances

Insurable interest is not limited to absolute ownership of property but may arise in other ways also. It may be based on ownership whether absolute, partial, limited, legal, equitable or in joint owners, mortgager or mortgagee, trustee or beneficiary. Even mere lawful possession alone such as that of a lessee, bailee, carrier of goods or warehouseman can give insurable interest. It may also be founded upon contract, as in the case of reinsurance by the insurer.

In Life insurance, close relationship such as husband and wife, which cannot be strictly described as pecuniary, parent and child, employer and employee, creditor and debtor, partners in business, may give an insurable interest in the life of each other.

Secs. 7 to 16 of Marine Insurance Act give some instances of insurable interest as illustrations which hold good in other branches of insurance also. Thus, a defeasible interest or a contingent interest is insurable as it is a valid interest until it is defeated.

Insurable interest is not confined to legal ownership only. The legal liability of common carriers to make good the loss or damage to the goods in transit to the bailor of goods is also an insurable interest.

Insurance covering other interests

A person with a limited interest in a property may insure to cover his interest only or so as to cover the interests of others as well who are interested in the property. For instance, a carrier or bailee may insure to cover his own loss or personal liability to the owner of the goods or upto the full value of the goods entrusted to him which includes the owner's interest as well. What interest the assured intended to cover under the policy must be determined by construction of the policy itself. Thus, where the subject matter of insurance is described as 'Goods his own, in trust or on commission', the intention is to insure beyond his own personal interest and he will be entitled to recover the full value of the goods in case of loss.

Where it is described as 'goods held in trust for which they are responsible' by the assured wholesalers who purchased and resold parcels of tea lying in bonded warehouses, sold and received the value of some parcels of tea before a fire broke out and damaged them, it was held that the words 'goods for which they were responsible' showed that they did not intend to cover the proprietary interest of other persons in the goods insured.

Where it is described by the commercial trustee i.e., a bailee to whom goods are entrusted for safe custody as an insurance 'on goods', it would not cover the interests of others in the property. It will cover his personal insurable interest in the goods including his lien and his liability to the owner of the goods arising from his responsibility for their safety as a person entrusted with the goods.

A person without any interest at all can insure as trustee for the person having interest, provided interest in such insurance is not required by statute. He will then have to hold the claim amount received as trustee for the interested person. This is under the principle that a party to a contract can constitute himself a trustee for a third party of rights under a contract and thus confer rights on the third party.

In life policies, persons having relationship by marriage, blood or adoption, by contractual relationship and by statutory duty have been recognised as having insurable interest. It is not necessary that expectation of advantage or benefit should always be capable of pecuniary estimation.

Insurable interest under different kinds of insurance is as follows:

5.3.1 Insurable interest under Life insurance

Life insurance is not a contract of indemnity. In life insurance, insurable interest must be present only at the time of contract but not at the time of loss.

One can have insurable interest only when he would get financial benefit from the life of insured and he would suffer financial loss by the death of insured. Mere ties of blood and affection do not give rise to insurable interest. Insurable interest is thus a financial interest in the life of insured.

Presumption

Insurable interest is presumed in the following cases__

I. One's own wife.
II. Wife in the life of husband.
III. Husband in the life of wife.

No presumption

Insurable interest is not presumed and proof of evidence is required in the following cases—

a) Persons related

I. Father and son
II. Brother and sister
iii) Uncle and nephew

The amount of insurance has no limit.

b) Persons not related

i) Creditor in the life of debtor.
i) Creditor in the life of surety.
ii) Surety in the life of debtor.
iii) Partner in the life of copartner.
iv) Employer in the life of employee.
v) Employee in the life of employer.

The amount of insurance is limited to the possible financial loss.

5.3.2 Insurable interest under Fire insurance

Fire insurance is a contract of indemnity. In fire insurance, insurable interest must be present both at the time of contract as well as at the time of loss.

Presumption

Insurable interest is presumed in the following cases:-

i) The owner of goods or property – upto its full value.
ii) The insurer, mortgagee, pledgee, bailee, factor, common carrier, trustee – have only limited interest.
iii) Husband and wife have insurable interest in each other's property upto its full value because both of them have a right of common enjoyment.
iv) Creditor has no insurable interest in the debtor's property because debtor is personally liable and his property is liable only on default, through court.

5.3.3 Insurable interest under Marine insurance

Marine insurance is also a contract of indemnity. In Marine insurance, insurable interest need not be present at the time of contract but it must be present at the time of loss.

Presumption

Insurable interest is presumed in the following cases –

i) The owner of goods or property – upto its full value.
ii) The insurer, mortgagee, cargo owner, ship owner – have only limited interest.

5.3.4 Insurable interest under Liability insurance

A contract of insurance wherein the insurer undertakes to indemnify the insured against a contingent liability is called Liability insurance. There is sufficient nexus between the insured and the subject matter of insurance manifesting insurable interest.

The use or driving of a motor vehicle in a public place is sufficient insurable interest for the purpose of effecting insurance in favour of third party.

Insurance of motor vehicles against third party risks are however designed more to protect the victim of accident than the owner of vehicle against liability for compensation.

5.4 Self Assessment Questions

1. What is meant by insurable interest? Explain insurable interest in connection with life, fire and marine insurance.
2. “Insurable interest is of two types”. Elucidate giving examples.
3. Explain insurable interest giving illustrations with reference to life, fire and marine insurance.
4. How far is insurable interest the conscience of insurance? Is insurance enforceable without insurable interest.
5. “A person is having insurable interest in his own life and property”. State the exceptions to this rule.

5.5 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth’s Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. G.V. NAGI REDDY, M.Com., M.L., M.Phil.,

Lesson – 6

INDEMNITY, SUBROGATION AND CONTRIBUTION

6.0 Objective:

The meaning and importance of the principle of indemnity in insurance contracts. The terms and limitations in the insurance policy affecting the indemnity in practice. The right and remedies available to the insured when loss or damage is caused to the subject matter of insurance from an insured peril. The meaning and importance of the doctrine of subrogation. The rights of subrogation available to the insured. Exercise of the right of subrogation by the insurer. The limitations of the doctrine of subrogation. The meaning and importance of the doctrine of contribution conditions to be satisfied for the right of contribution. Methods of contribution i.e. methods of sharing loss by the insurers are discussed in this chapter.

Contents

6.1 Indemnity

- **6.1.1 Indemnity – Meaning**
- **6.1.2 Indemnity in practice**
- **6.1.3 Rights and remedies of insured**

6.2 Subrogation

- **6.2.1 Subrogation – Meaning**
- **6.2.2 Rights of subrogation**
- **6.2.3 Exercise of right of subrogation**
- **6.2.4 Limitations of subrogation**

6.3 Contribution

- **6.3.1 Contribution – Meaning**
- **6.3.2 Conditions for contribution**
- **6.3.3 Methods of Contribution**

6.4 Self Assessment Questions

6.5 References

6.1 Indemnity

6.1.1 Indemnity - Meaning

Insurance contact belongs to the category of special contracts, i.e. indemnity contracts.

U/s 124 of Contract Act, " a contract by which one party promises to save the other from loss caused to him by the conduct of promisor himself or by the conduct of any other person is called a contract of indemnity." The person who promises to make good the loss is called indemnifier and the person whose loss is to be made good is called the indemnified or indemnity holder.

Insurance contract, being by and large indemnity contract, is subject to the rules of rights and duties of indemnifier – insurer and indemnified / indemnity holder – insured / policy holder.

Indemnity means security against loss. All contracts of insurance are contracts of indemnity except life and personal accident insurance because no monetary payment can indemnify for loss of life, limbs or health.

In fire and marine insurance, the insurer undertakes to indemnify the insured against loss. In case of loss, the insured can recover from the insurer only the actual loss not exceeding the policy value. He cannot get more than the actual loss because one cannot make profit from misfortune. The object of contract of insurance is to place the insured in the same position as before the loss. It is not a contract to make a gain. It is to make the insured neither a loser nor a gainer, subject to insuring the property for its full value.

In **"Castellain Vs. Preston"**, Preston entered into a contract to sell his house which he had insured against fire. Before the sale was completed, the house was partly damaged by fire. The insurer indemnified the insured. The buyer also paid the agreed price and completed the sale, leaving the insured a gainer at the end. But the insurer came to know of this and sued the insured contending that as he received the agreed price from the buyer, he suffered no loss due to fire and so there was nothing to be indemnified by the insurer. The court upheld that contention and ordered Preston to refund the amount received from the insurer. It was held in this case, "Every contract of marine, fire insurance is a contract of indemnity and of indemnity only, the meaning of which is that the assured in case of loss is to receive full indemnity but is never to receive more. Every rule of insurance law is adapted in order to carry out this fundamental rule".

The principle of indemnity, which means that the insured can in no event make a gain out of that transaction, is a salutary rule of law to keep in check a human weakness. The insured would otherwise be tempted to destroy the property himself or connive at its destruction and claim the sum assured. Even by over insurance he cannot recover more than an indemnity from all the policies put together.

Indemnity – subrogation & Contribution

Indemnity is such a fundamental principle of insurance that the doctrines of Subrogation and Contribution are corollaries of this principle to further ensure that the insured does not make any profit out of the insurance transaction. Also, this is the reason why the insured who is indemnified for total loss must abandon the subject matter of insurance to the insurer. When an insured property is totally damaged and becomes scrap, the insurer indemnifies the insured by cash payment and takes over the scrap as salvage. It does not amount to sale transaction because the property ceases to exist.

Indemnity – insurable interest

Indemnity is linked with insurable interest because an insured cannot recover more than the insurable interest. Even the need for existence of insurable interest at the time of loss arises out of this principle, for if the insured has no insurable interest, he loses nothing and does not need to be indemnified. Thus, where he has transferred the insured property and it is lost by the insured peril thereafter, he incurs no loss and needs no indemnity.

Indemnity – Guarantee

Whether a particular document is a contract of insurance or a contract of guarantee is some times not easy to decide. Its substantial character and how it came to be effected will give a clue to it and merely calling it a policy or a guarantee is not conclusive in the mater.

6.1.2 Indemnity in practice

Although according to the principle of indemnity, assured is to be placed in the same position as if the loss has not occurred, such indemnity is not being provided in practice by the following terms and limitations in the insurance policy.

1. Average Policy

The policy may be taken for lesser value and there may be average clause in it. The actual loss may be greater than the sum assured. Then,

$$\frac{\text{Policy value}}{\text{Actual value}} \times \text{Actual loss}$$

Thus, the insured may get lesser amount than the actual loss.

2. Excess clause

The policy may be subject to excess clause, which means that the insured is himself to bear upto excess of every loss.

3. Franchise clause

The policy may be subject to a franchise clause, which means that the insured would have to bear losses within that amount, and where the claim exceeds that amount, the insurer would pay in full, as may be the case in certain 'all risks' insurance.

4. Valued policy

The valued policies provide for value of property at the time of loss. The value agreed at the time of policy may be less or more than the actual value at the time of loss. Such policies are issued only in respect of articles like Jewellary, work of art etc., which are not likely to fall in value.

5. Commercial indemnity

In Marine policies, the contract is to indemnify 'in the manner and to the extent agreed', which means only a commercial indemnity rather than a strict common law indemnity.

6.1.3 Rights and remedies of insured

When loss or damage is caused to the subject matter of insurance from an insured peril, the insured has the following rights and remedies:

1. Against the insurer

   The insured has a right against the insurer to be indemnified.

2. Against the third party

   a) Under the law of contract

The insured has a right against the third party under the law of contract to make good the loss. e.g. Lessor has a right against lessee of premises insured, to get it repaired in case of damage.

   b) Under the law of Tort

The insured has a right against the third party, who caused the loss, to recover compensation for the loss caused, under the law of Tort.

The insured cannot recover from both the insurer and the third party, who caused the loss. If he proceeds against the insurer, the insurer cannot avoid liability on the ground that the insured has the right to claim against the third party. Conversely, if he proceeds against the third party, the third party cannot avoid liability on the ground that the insured has been or will be fully indemnified by the insurer.

In a suit for recovery of loan, the bank obtained an ex-parte decree without mentioning the fact that the goods were insured and pledged, and in execution of the decree, the judgement debtor has the right to get the ex-parte decree set aside by invoking inherent powers under section 151 of C.P.C. Once the suit has been decreed and the said decree having become final and put in execution, it is only within the purview of S. 47 of C. P. C. that objections could be raised.

Under the Motor Vehicles Act, the defences available to the insurer are statutorily circumscribed. In a case of an insurance under the general law of contract, given to a doctor i.e., a doctor's indemnity insurance, the insurance company cannot be restrained from agitating the grievance against the finding of negligence. Where the claimant had suffered injury on the bladder, and the doctor was found to have exercised due care, skill, diligence and had put in all efforts to save life of the patient, the claimant had not shown any lack of care on the part of doctor, he was held not entitled for compensation.

6.2 Subrogation

6.2.1 Subrogation - Meaning

The indemnifier after indemnifying the loss is subrogated to the rights of indemnified. Similarly, the insurer after indemnifying the loss is subrogated to the rights of insured.

Subrogation is the right of the insurer who has paid loss to be put in the place of the assured so that he can take advantage of any means available to the assured to extinguish or diminish the loss which the insurer has paid to the assured.

Under the doctrine of subrogation, the insurer after indemnifying the loss, steps into the shoes of the insured and is entitled to all the rights and remedies of the insured against the third parties.

Subrogation and abandonment

Abandonment is primarily a voluntary act of the assured giving up his proprietary rights over the subject matter of insurance in case of a total loss accepted by the insurer. The insurer thereafter is entitled to all the benefits flowing out of the subject matter, even exceeding the amount of indemnity paid to the assured. On being paid for a total loss, the assured is required to abandon his interest in the subject matter of the insurance to the insurer.

But in contracts of indemnity insurance, the insurer gets subrogation rights automatically on payment of indemnity whether the loss is total or partial.

6.2.2 Rights of subrogation

The doctrine of subrogation confers two specific rights on the insurer—

All the rights and remedies of the assured against third parties incidental to the subject matter of the loss, by the exercise of which the insurer may recoup the loss. The insurer can compel the insured to take proceedings against the third parties for the benefit of the insurer.

All the benefits received by the insured from third parties with a view to compensate the insured for the loss which the insurer has indemnified him. The insurer is entitled to get even the moneys received by the insured exgratia except those that are given to benefit the insured exclusively.

6.2.3 Exercise of right of subrogation

On being subrogated, the insurer can enforce the right against the third party, only in the name of the insured and can recoup the amount paid to the insured. If the insurer recovers more than that, the excess must be paid over to the insured. The insurer cannot recover anything more than he has paid. He does not also get any proprietary rights over the subject matter of insurance.

However, if the insurer obtains a legal assignment of the insured's right of action in respect of the subject matter of insurance, he may sue the third party in his own name and will also be entitled to retain the excess that may be recovered.

6.2.4 Limitations of Subrogation

The doctrine of subrogation has the following limitations:

1. The right of subrogation does not apply to life and personal accident policies, since life and personal accident policies are not governed by strict principles of indemnity. Hence, this doctrine applies only to fire, marine and other non-life policies.
2. The right of subrogation arises only when the insured's claim has been fully paid and not till then. It is from actual payment that the right springs.

   However, in practice, this common law right is modified by a condition in the policy giving subrogation rights to the insurer even before indemnifying the insured.
3. The right of subrogation arises only in respect of rights incidental to the subject matter of the loss.

   e.g. Payment for loss of the ship does not entitle the insurer, to be subrogated for the owner's right of action for the loss of freight.
4. The right of subrogation does not arise where the assured himself has no cause of action against the third party.

   e.g. There was collision between two ships, which were owned by the same owner, for the fault of one of the ships. The owner could not recover from the ship at fault, as that was also owned by him. Hence, the insurer of the ship not at fault could not sue the ship at fault, under the right of subrogation.

6.3 Contribution

6.3.1 Contribution - Meaning

Like subrogation, contribution is also a corollary to the principle of indemnity. Therefore, contribution generally arises only in property insurance.

In case of double insurance, where there are two or more insurance policies fully covering the same risks in respect of the same interests in the subject matter, the insured can select the policy from which he can recover his full indemnity. If one insurer indemnifies the insured in full, he can claim contribution from the other co-insurers to contribute their share of the loss.

The right of contribution is based not in contract but on equity that the burden should be shared by all the insurers. It would be inequitable for any of the insurers to receive the benefit of premium without being liable for their share of the loss. This is called the right of contribution.

This common law right of contribution is modified in practice by an express term in the policy, which results in the insured being required to proceed against each of the insurers and recover from them the rateable proportion of the loss, they are liable to make good and no more. The clause inserted for this purpose merely states that the insurer will pay no more than his rateable share. Sec. 60 of Marine Insurance Act provides the rule of contribution in the case of marine insurance.

6.3.2 Conditions for Contribution

The following conditions must be satisfied to give rise to a right of contribution.

1. Common subject matter

   The subject matter of insurance, in respect of which the claim to right of contribution arises must be common to all the policies, though they may include other properties.
2. Common peril

   The peril which causes the loss must be common to all the policies, though they may include other perils.
3. Common assured

   All the policies must be effected by or on behalf of the common assured. It is not enough that they all relate to the same physical object.
4. Policies in force

   All the policies must be real contracts and be in force at the time of loss.
5. Excluding clause

   The policy must not contain any stipulation by which it is excluded from contribution.
6. Excess payment

   One insurer must have paid to the insured more than his share of the loss.

6.3.3 Methods of contribution

Where the insurers have to share a loss rateably, it is done in two ways:

1. Maximum Liability basis

Contribution in proportion to the sum assured i.e. maximum liability basis, is the normal method of ascertaining the amount of contribution.

e.g. If insurer A has provided cover of Rs. 6,000 and insurer B has provided cover of Rs. 4,000 and a loss of Rs. 3,000 is sustained, then A pays Rs. 2,000 and B pays Rs. 1,000.

2. Independent liability basis

Contribution in proportion to the liability i.e. independent liability basis is another method of contribution.

In the above example,

If the loss was Rs. 3,000, each would pay Rs. 1,500 because each policy would have paid the whole amount of loss if there was no other insurance and so each contributes equally towards the loss.

If the loss was Rs. 6,000, A would be liable to pay Rs. 6,000 and B would be liable to pay Rs. 6,000, which would be more than an indemnity and hence this is to be proportionately scaled down to 6/8 and 4/8 of Rs. 6,000. Then, A would pay Rs. 3,600 and B would pay Rs. 2,400.

If the loss was Rs.12,000, then A would be liable to pay Rs. 6,000 and B would be liable to pay Rs. 4,000.

6.4 Self Assessment Questions

1. "Indemnity is the controlling principle in insurance law but all insurance contracts are not perfect contracts of indemnity" comment.
2. "Insurance is indemnity and indemnity only". Discuss.
3. "The liability of insurer depends purely on the principle of indemnity. There is no question of sentiment, sympathy or mercy". Discuss.
4. Explain that except life and accident insurance, all other insurances are contracts of indemnity.
5. Define subrogation and explain subrogation rights arise.
6. Discuss the doctrine of subrogation and mention its limitations.
7. Discuss the application of subrogation and contribution in insurance law.
8. What do you understand by subrogation in a contract of insurance? Distinguish between subrogation and contribution.
9. Write short notes on

a) subrogation and b) contribution.

6.5 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth's Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. G.V. NAGI REDDY, M.Com., M.L., M.Phil.,

Lesson –7

THE RISK

7.0 Objective :

The meaning of risk of loss in insurance contracts. The extent of the risk covered by contract of insurance. What is included and what is not included in the risk under insurance contract. Duty of the assured by way of direct act and indirect act of the assured in relation to risk, Elements or risk under different kinds of insurance viz. life, marine and property insurance, commencement of risk and duration of risk. Alteration of risk and termination of risk are discussed in this chapter.

Contents :

7.1 The risk
7.2 Coverage of Risk
7.2.1 Extent of Risk covered
7.2.2 The risk includes
7.2.3 The risk not includes
7.2.4 The risk and the duty of the assured
7.3 Elements of risk
7.3.1 Life insurance
7.3.2 Marine insurance
7.3.3 Property insurance
7.4 Commencement and Duration of risk
7.4.1 Commencement of risk
7.4.2 Duration of risk
7.5 Alteration and Termination of risk
7.5.1 Alteration of risk
7.5.2 Termination of risk

7.1 The Risk

The very object and purpose of insurance is coverage of risk which is very natural to human life. We always try to avoid or reduce risk by taking insurance.

A contract of insurance is a contract under which the insurer undertakes to protect the insured from a specified loss if it occurs. The insured is afraid of loss which is called risk of loss, and the insurer undertakes to indemnify him from the apprehended loss, if it occurs, for a consideration called premium. The insurer calculates the premium according to the probability, nature and extent of risk from which the insured desires to be protected. The risk of loss is coextensive with the value of the insurable interest, the insured has. The law does not compel a man to insure, but if he so desires he may like to be covered in respect of all or certain risks. So, he must describe in his proposal form the risk, which he wants to be covered by the insurer. The insurer calculates the premium according to the nature, quantity, quality and probability of the risk desired to be covered by the policy. The risk remains to be the risk until the happening

of the contingency. Once the contingency happens, it becomes a definite loss and it is against this loss, the insurer undertakes to indemnify the assured. Thus, the life blood of insurance contract is the risk it deals with.

7.2 Coverage of Risk

7.2.1 Extent of risk covered

The determination of the dimensions and extent of the risk, covered by the contract of insurance, is important to both parties:

- It is important to the assured because from that he can know the exact extent of the risk covered by the contract so that he may adjust his economic affairs, and
- It is important to the insurer because he has to calculate the exact premium required to cover it.

The insurer indemnifies the insured only against the loss caused during the period insured, for which the direct and proximate cause is the peril insured against. In Xantho's case the scope of the risk is neatly described as: "It is open to both the parties by agreement to extend or limit the liability of the insurer in respect of the operation of the risk".

7.2.2 The risk includes

Unless the policy otherwise provides, the risk includes –

1. The loss caused, i.e. the risk brought about by the negligence not only of the insured but even by his servants or strangers, as protecting the insured against consequences of negligence is also one of the objects of insurance.
2. The risk brought about wilfully or maliciously by the insured's servants or strangers.

7.2.3 The risk not includes

Unless the policy otherwise provides, the risk does not include –

1. The loss caused by the wilful misconduct of the insured or caused with his connivance, whether it amounts to a crime or not.
2. The loss due to ordinary wear and tear, and inherent vice of the subject matter insured, as insurance is against the risks that may happen and not those that must happen.

7.2.4 The risk and the duty of the assured

Insured's direct act

In a contract of insurance, the insurer undertakes to indemnify the insured in respect of loss caused by the perils insured against. The object of insurance is to afford protection against losses caused by fortuitous or accidental occurrences. Hence it is an implied term of the contract that the risk should not be brought about by the willful act of the insured or others with his privity or consent. For example, one who has insured his house cannot himself set fire to it and claim indemnity under the policy. Similarly, if he has insured his ship against marine risks, he cannot himself scuttle the ship or connive with his servants to scuttle it and claim indemnity under the policy. It may be noted that these acts are not crimes. In the same way, a person

who has insured his life cannot by committing suicide while he is sane, cause the sum insured to become payable. As Lord Atkin observed: " On ordinary principles of insurance law, an assured cannot by his own deliberate act cause the event upon which the insurance money is payable. The insurers have not agreed to pay on that happening". This does not flow from any rule of public policy; it is to be presumed that the insurers have not agreed to pay in that case. Where the insured's act amounts to a crime, it is all the more so that the risk is impliedly excluded. Additional ground is that, it is a rule founded on a principle of public policy that a court will not assist a criminal to recover any kind of benefit from or an indemnity for his crime.

In " **Amicable Insurance Vs. Boland",** a person who had insured his life, committed forgery, became a bankrupt and was also executed for his crime. His assignees in bankruptcy claimed the life insurance amount. But the court negatived the claim, the reason being that death at the hands of the Justice is considered as the natural consequence of his crime.

The absolute rule is that courts will not recognise a benefit accruing to a criminal from his crime. It is a principle of public policy that a person guilty of murder or manslaughter or any one claiming through him, for instance, his personal representatives or assignees cannot claim a benefit under a policy on the life of the victim.

The rule of public policy that bars a criminal from claiming or enforcing rights resulting to him from his own crime is not confined in its application to insurance cases. This is a general statement of principle.

Insured's indirect act

According to Porter, "If the insured accelerates happening of the risks or if when it occurs refrains from doing what ought to be done to minimize the damage consequent thereon, hazards the chance of recovering nothing on the contract".

It is the duty of the assured not to contribute anything which will cause the happening of the risk. Not only should he refrain from accelerating the risk but also there is a positive duty on the assured to prevent the happening of the risk, if possible. Once the risk happens, it is the duty of the assured to minimize the loss or damage. He must act as a reasonable man not having an insurance policy. The duty to mitigate damages is a general principle applicable to all branches of law and it is applied to the law of insurance especially in view of the fact that insurance is a contract of indemnity. Sometimes the insurance companies encourage the insured to take all possible steps to minimize the loss and to save the property by inserting a clause in the policy to the effect that the insurance company will be ready to pay all such expenses. e.g. Marine insurance policies contain 'the sue and labour clause'

No person is entitled to look on and let his property be lost just because it is insured. He is bound to take all reasonable steps to prevent the damage. If the assured does any act which causes the happening of the risk prematurely or if he is indifferent if the risk happens, he cannot recover on the policy. This is sometimes regarded as the application of the maxim '***Causa proxima',*** because if the maxim is strictly applied, the loss may be treated as the act of the assured himself.

In "**Beresford Vs. Royal Assurance Company"**, it was observed that a fire assured cannot recover if he intentionally burns his own house, nor the marine assured if he deliberately scuttles the ship, nor the nominee of the life assured if the latter deliberately ends his own life.

In **“ Gray Vs. Barr”,** Mrs. Barr took a policy under which the insurer agreed to indemnify the insured and any member of her family which such person ‘shall become legally liable to pay as damages in respect of bodily injury caused by accidents’. Her husband Mr. Barr went on the night armed with a loaded shotgun to Mr. Gray’s farm in search of her. She had been committing adultery with Mr. Gray. Gray prevented him from seeing for himself if she was there. Barr fired a shot into the ceiling to frighten Gray. In the scuffle that followed, Barr fell backwards and another shot involuntarily went off and killed Gray. Barr was acquitted of murder and manslaughter. But the widow and father of Gray claimed damages against Barr for unlawfully and negligently causing the death of Gray. Barr claimed indemnity under his wife’s policy which covered him also. It was held that the effective and dominant cause of Gray’s death amounted to an unlawful assault with violence and it was against public policy to indemnify him of the consequence of his deliberate crime.

In **“ Currie Vs. Bombay Native Insurance Company”,** the insurance policy was on a cargo of timber. The ship ran aground and became a wreck. The master of the ship abandoned the ship as well as the cargo. It was in evidence that if the help of the other ship had been taken, the cargo could have been saved. It was held that the omission to take steps to save the cargo from loss, prevented the assured from recovery under the policy.

In **“Devlin Vs. Queen Insurance Company”,** the following propositions were laid down –

i) Because an insurance contract is a contract of indemnity, the person to be protected shall neither wilfully cause the loss nor purposely increase by wilfully refraining from easy and ordinary exertion as may be reasonably expected from a person acting honestly.
ii) If he wilfully prevents the interference of others to save the property or prevents the working of the fire brigade, he commits fraud on the insurer.
iii) If he wilfully refrains and neglects to save the property having no reasonable excuse, he cannot recover.
iv) If a person has insurance on valuable Jewellary kept in a box of light weight which can easily be carried and if during a fire he intentionally leaves the box to be consumed by fire, it amounts to dishonest act.
v) Mere negligence will not affect the recovery under the policy.

7.3 Elements of risk

The risk depends upon the various elements of the event insured against in its happening sooner or later. These circumstances must be disclosed by the insured and the insurer generally calculates the premium with reference to these elements.

7.3.1 Life insurance

In Life insurance, the risk depends upon:
i) Habits in life or mode of living,
ii) Occupation,
iii) Environment,
iv) Position and status in life,
v) Character,
vi) Heredity,
vii) Previous illness, and
viii) Opportunities for exposure to special dangers.

7.3.2 Marine insurance

In Marine insurance, the risk depends upon:
i) Voyage and its nature,
ii) The route of voyage,
iii) Usage of trade,
iv) Loss occasioned on inland waters,
v) Perils due to winds and storms in the locality,
vi) The danger of war, capture and seizure,
vii) Pirates,
viii) Mutiny of the crew, and
ix) Insurrection of natives and dangerous coasts.

7.3.3 Property insurance

In property insurance, the risk depends upon:
i) The nature of property like moveable or immoveable, perishable or non-perishable,
ii) Character and constitution,
iii) Area,
iv) Life,
v) Situation and locality,
vi) Exposure to outside dangers,
vii) Inherent defects,
viii) Use and habits of the assured,
ix) Title of the property,
x) Acts of God like heavy rainfall, floods or natural calamities, and
xi) Fire, riot or civil commotion.

7.4 Commencement and duration of risk

7.4.1 Commencement of risk

The risk must happen during the subsistence of the policy. The peril insured against must happen during the period of insurance though the full effect of the peril is manifested or the extent of loss is discovered after the period of insurance. But, where the event happens at or before the beginning of insurance and only the loss is manifested during the operation of the policy, the loss is not recoverable. Similarly, if the operation of the peril begins partly before commencement of the policy and partly afterwards and if the loss is apportionable, so much loss referable only to events which occurred after the commencement of the policy and before the expiration of the policy are recoverable. Again, where the loss is wholly attributable to the operation of the peril, after the policy ceases to be in operation, the loss is not recoverable. But, all this is subject to a contract to the contrary. These difficulties are avoided in practice by resorting to the insertion of express terms in the policy like" 'The policy covers all losses disclosed during its currency irrespective of the time when they were actually sustained'.

It is not a requirement of law that the risk should commence at any particular time. The date or time of commencement of risk under a policy is also a matter of agreement between the insurer and the insured. In each case, it has to be ascertained by a construction of the terms of the preliminary agreement or of the policy.

7.4.2 Duration of risk

Some of the ways in which the duration of the risk is expressed in policies are as follows:
a) "from" a particular date until the corresponding day in the following month or year.
b) 'for 15 days from the commencement date of risk',
c) 12 months from…………. to 4 .m. on ………,
d) from ………..to …………both days inclusive,
e) from ………….a.m./p.m. on………..to noon on………

In the absence of anything in the context to indicate a contrary intention, the word 'from' a specified day has been interpreted to mean exclusive of the specified day.

However, in India the Supreme Court has held that, the effectiveness of a policy taken on a particular date commences from the commencement of the day, i.e. from the previous midnight. This view is preferable because the insurer can ascertain whether there was any accident or not since the commencement of the date.

S. 147 of Motor Vehicles Act, 1766 requires the issue of a certificate of insurance in the prescribed form containing the prescribed particulars. The certificate must contain, apart from the particulars to identify the vehicle, 'the effective date and time of commencement of insurance' and 'the date of expiry of insurance'. Hence, to that extent the uncertainty as to commencement of risk has been removed.

In **"New India Assurance Company Vs. Ram Dayal",** a motor insurance policy was taken on 26-7-1764 and the vehicle met with an accident on the same day. The insurer repudiated liability contending that the policy had been taken after the accident. But, the High court held 'the policy obtained on the date of accident became operative from the commencement of the date of insurance, i.e. from the previous midnight and since the accident took place on the date of the policy, the insurer became liable'. The Supreme Court agreed with the view and observed 'when a policy is taken on a particular date, its effectiveness is from the commencement of the date'.

In **"United India Insurance Company Vs. Master Bunty" and "United India Insurance Company Vs. Gulaichi Devi",** a motor insurance policy was expired on 20-12-1770. It was renewed on 27-12-1770 at about 4 .m. The car has met with an accident at about 8 a.m. that day and so the insurer contended that it was not liable. But the court held that the insurer was liable relying on the Supreme Court decision above.

7.5 Alteration and Termination of risk

7.5.1 Alteration of risk

The liability of the insurer under a contract of insurance is confined only to the particular risk insured against in the policy. He would not be liable for any change or alteration which has either increased the original risk or has brought out a new and substantially different risk. Where the alteration does not affect the description in the policy, even though it increases the danger of loss, it does not vitiate the policy so long as the risk as defined in the policy remains the same.

In **"Baxendale Vs. Harvey"**, Pollock observed: " This is a mere increase in danger. It is like the case of a person who has an oven in his premises and instead of using it for baking

bread, he uses it for some other purpose. If a person, who insures for life goes up in a balloon, that does not vitiate his policy. The society having had notice of the nature of the risk, were not entitled to any notice by reason of the increase of the danger. A person who insures may light as many candles as he pleases in his house though each additional candle increases the danger of setting the house on fire. So, it cannot be said that everything that increases the risk vitiates the policy".

The effect of an alteration on the policy further depends on the fact whether the policy contains any express prohibition on alteration. Where there is no express condition against alterations, the effect of any alteration in the risk depends upon the fact whether the statement in terms referring to the future is a mere representation of the existing situation or it is a contractual condition. If it is of the first type an alteration does not affect the policy. On the other hand, if the representation is construed as a contractual condition, any alteration in the subject matter vitiates the policy.

In some policies, there may be express conditions relating to the alteration of the risk. Those conditions may prohibit alterations –

a) Absolutely,
b) Without prior notice,
c) Without prior sanction, or
d) Increasing the risk.

Where there is an express absolute prohibition of alteration, any alteration even if trivial would render the policy void. If the prohibition is in regard to alterations increasing the risk, the alterations which do not increase the risk will not void the policy. Whether alteration increases or decreases the risk is a question of fact. This must be proved by the insurance company.

There may be conditions prohibiting alterations without notice and in such a case, mere giving of prior notice is sufficient. On the other hand, there may be a prohibition from alteration not only without giving mere notice but without obtaining prior sanction. Then, for the continued validity of the policy, the alteration must be made with prior sanction. Simply because the insurer sanctioned an alteration increasing the risk on a prior occasion, he is not bound to sanction another alteration which increases the original risk though it does not go in excess of the prior sanctioned alteration. Such an increase in risk caused by an alteration also requires a fresh sanction.

Once there is an alteration, the insurance company can avoid the policy even though the loss was not caused by the alteration.

In **"Pim Vs. Reid",** certain premises were insured which were used for paper manufacture. Subsequently large quantities of cotton waste were brought into the building. The building was destroyed by fire. The insured company argued that the cotton waste increased the risk and so they were not liable. But the court rejected the contention and held that in the absence of fraud, such an alteration will not affect the policy unless there is a condition in the policy.

In **"Exchange Theatre Vs. Iron Traders Mutual Insurance",** a bingo hall was insured against fire. The assured without informing the insurer installed a petrol generator in the hall. The hall was destroyed by fire. The insurer denied liability on the ground, inter alia, that installation of petrol generator amounted to an unauthorized alteration, as it increased risk. But, the court rejected the contention and upheld the claim of the assured.

Again in **"Pennsylvania Company for Insurance on Lives and Granting Annuities Vs. Mumford",** the following propositions were laid down: the insurer is not liable under a policy if the risk is altered –

a) in breach of an express or implied condition or warranty against the alteration,

b) if the change is made by the fraud of the assured, or

c) if there is a complete change of risk or subject matter of insurance e.g., a change of voyage.

7.5.2 Termination of risk

Ordinarily, the risk terminates on the expiry of the time fixed for the duration of the risk in the policy, i.e., according to the terms of the policy, the agreement between the insurer and the insured. The termination may also be brought about unilaterally by the insurer or the insured in exercise of their right under the policy to terminate the policy.

Where the insured is guilty of breach of warranty, the insurer may elect to terminate the policy by notifying the insured to that effect. Both the insurer and the insured may agree to terminate the policy and substitute a new one in its place.

Where the insurer is liable only upto a particular amount, a loss or successive losses in excess of the sum stated in the policy, will in effect terminate the policy.

If the premium was not paid within due date, the insurer ought to have enforced the guarantee and recovered the premium. If there is any lapse on the part of the insurer in enforcing the bank guarantee for recovery of the premium, that would not endure to the benefit of the insurer to repudiate the policy.

7.6. Self Assessment Questions:

1. What is meant by the risk of loss in insurance? What is covered and not covered under the risk?
2. Explain the duty of the assured in relation to the risk.
3. What are the elements of risk under different insurances.
4. Explain commencement and duration of the risk under an insurance policy.
5. What is the effect of alteration of risk on the insurance policy. When does risk terminates.

7.7 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
5. Insurance Law by Brij Nandan Singh
6. Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
7. Murth's Lecturers on Law of Insurance by KVS Sarma
8. Law of Contracts by Avtar Singh

Sri. G.V. NAGI REDDY, M.Com., M.L., M.Phil.,

Lesson – 8

PROXIMATE CAUSE, REINSURANCE AND AGENCY

8.0 Objective :

The meaning and importance of the doctrine of proximate cause. Determination of proximate cause where perils are acting consecutively in unbroken sequence, where perils are acting consecutively in broken sequence and where perils are acting simultaneously. The meaning of reinsurance. The general principles of reinsurance. The meaning of agents, The position of agents in the insurance field. Authority of agents. Licensing of agents. The meaning and position of the insurance brokers are discussed in this chapter.

Contents :

8.1 Proximate cause
- **8.1.1 Doctrine of Proximate cause**
- **8.1.2 Determination of Proximate cause**

8.2 Reinsurance
- **8.2.1 Reinsurance – Meaning**
- **8.2.2 General principles of Reinsurance**

8.3 Agency
- **8.3.1 Agents**
- **8.3.2 Agents in insurance field**
- **8.3.3 Authority of agents**
- **8.3.4 Licensing of agents**

Insurance Brokers
Glossary
Self Assessement Questions
References

8.1 Proximate cause

8.1.1 Doctrine of Proximate cause

The insurer’s liability under the policy arises only if the cause of the loss is a peril insured against and not an expressly excluded or other perils. The insurer is not liable for any loss caused by remote or indirect cause. There is no difficulty if a single peril acts and causes the loss. Often, these perils do not act in isolation, but act in succession or simultaneously and it will be difficult to assess the relative effect of each peril as the actual cause of the loss.

The doctrine of proximate cause is based on the legal maxim ***“Causa proxima non remota spectator”,*** which means that proximate and not the remote cause shall be taken as the cause of the loss.

It is “ the cause which is truly proximate in efficiency” and “ effective or predominant cause”, that is taken into consideration for determining the liability of the insurer. The insurer is not liable for remote causes and remote consequences even if they belong to the category of insured perils.

In **“Pink Vs. Fleming”**, in a marine insurance policy, the peril insured against was collision with another ship. The cargo was a shipment of oranges. There was collision during the voyage. The oranges were taken on lighter for repairing the ship and subsequently reloaded. This caused delay resulting in damage to the oranges due to the perishable nature of goods. The question was whether or not this damage to the cargo was consequence of or caused by the collision within the meaning of the policy. It was held that the loss was due to mishandling of cargo and delay, and not due to collision, which was a remote cause, though mishandling and delay were the result of collision. As such, the insurer was held not liable.

In **“ Hamilton Fraser and company Vs. Pandrof and company”,** the cargo was insured against damage by seawater. During the voyage, rats made a hole in a pipe which connected the bathroom with the sea and as a result the seawater got through the hole and

damaged the cargo. It was held that the proximate cause of damage was seawater, the rats being a remote cause, and thus the insurer was held liable.

Thus, where there is a succession of causes which must have existed in order to produce a particular result, the direct and proximate cause, i.e. the last cause must be looked into and the other cause rejected although the result would not have been produced without their occurrence.

8.1.2 Determination of proximate cause

The determination of proximate cause, where perils are acting consecutively or concurrently, must be made by applying common sense standards. Causation is to be understood as the man in the street, but not either the scientist or the metaphysician would understand it.

A. Where perils are acting consecutively in unbroken sequence, i.e., one peril is caused by and follows from another peril:

1. If there is one insured peril, but no excepted peril, i.e. uninsured peril, the insurer is liable for the loss caused by insured peril.
2. (i) If the excepted peril precedes an insured peril, the insurer is not liable.

e.g. Where an earthquake fire, an excepted peril, is spread by natural means and burnt the insured premises, the insurer was not liable as the loss was proximately caused by the excepted peril.

(ii) If the excepted peril follows the insured peril, the insurer is not liable if the loss caused by each peril is distinguishable; the insurer is liable for the loss caused by the insured peril up to the happening of excepted peril.

e.g. Where fire causes an explosion and explosion is an excepted peril, the insurer will be liable for fire damage up to the time of explosion.

B. Where perils are acting consecutively in broken sequence, i.e. each peril is independent of the other:

1. If there is one insured peril, but no excepted peril, the insurer is liable for the loss caused by insured peril.
2. (i) If the excepted peril precedes an insured peril, the insurer is liable for the loss caused by the insured peril.

e.g. A plate glass insurance policy covered breakage from any risk except fire. A fire occurred in a neighbouring premises and taking advantage of it a mob broke the insured plate glass to commit theft. It was held that the mob action was the cause of the loss and not the fire and so the insurer was liable.

(ii) If the excepted peril follows the insured peril, as an independent cause, the insurer is liable for the loss caused by the insured peril up to the happening of excepted peril.

C. Where the perils are acting concurrently i.e. simultaneously:

1. If there is one insured peril, but no excepted peril, the insurer is liable for the loss caused by the insured peril.
2. (i) If the losses caused by insured and excepted perils can be distinguished, the insurer is liable.

(ii) If the losses caused by insured and excepted perils cannot be distinguished, the insurer is not liable.

8.2 Reinsurance

8.2.1 Reinsurance - meaning

An insurer assuming larger risk from the insured may arrange with another insurer to offload the excess of undertaken risk. Such arrangement between two insurers is called reinsurance. Thus, by the device of reinsurance, the original insurer transfers a part of the risk to the reinsurer. Payment made by the ceding insurer (called original insurer or 'reinsured') to accepting insurer (called 'reinsurer') for the assumption of the risk by the latter is termed 'reinsurance premium'.

Reinsurance is resorted to for the purpose of distributing risks over a number of insurers, so that in the event of loss, the insured claims against the original insurer who in turn claims against the reinsurer. Thus, the doctrine of reinsurance is based on the principle that every insurance company has a limit of undertaking the risk.

e.g. A gets his property insured with B for Rs. 2,00,000. B may shift half of the risk by reinsurance with C for Rs. 1,00,000. Thus, in case of loss, A can claim from B and B, in turn, can claim from C.

Reinsurance applies to all kinds of insurance contracts.

Reinsurance is also effected by way of treaties i.e., arrangements are made by means of treaties with other insurance companies or underwriters, which provide for automatic reinsurance of a fixed percentage of the risk.

Another feature of reinsurance is that the insurer can make a profit out of the second insurance, i.e., accepting an insurance with a higher premium and transferring the risk to the reinsurer with a lesser premium.

The contract of reinsurance is always subject to the contract of original insurance. If the original contract is altered without the knowledge or consent of the reinsurer, the reinsurer is discharged. Again, if the original contract expires or is cancelled, the reinsurance contract gets automatically cancelled. Hence, a policy of reinsurance is coextensive with the original policy.

The contract of reinsurance is between the insurer and the reinsurer. The original insured is not a party to the reinsurance contract. Hence, a reinsurance contract does not affect the insurer's contractual obligation to the insured under the original contract of insurance. Thus, in an action between the assured and the insurer, the reinsurer is not a necessary party, nor can the assured sue the reinsurer if he cannot get indemnity from the insurer.

8.2.2 General principles of reinsurance

The general principles of reinsurance are common to all branches in insurance subject to minor variation in individual classes. The reinsurance policy is also a contract of insurance governed by the same doctrines as follows:

1. Insurable interest

The insurer's liability under the original policy is enough insurable interest to support the reinsurance policy.

For instance, S. 11(1) of Marine Insurance Act states, " the insurer under a contract of marine insurance has an insurable interest in his risk and may reinsure in respect of it."

2. Utmost good faith

Utmost good faith has to be observed at all times by the parties to the reinsurance contract also and the insurer has a duty to disclose material facts to the reinsurers.

Thus, in **" London General Insurance Company Vs. General Marine Underwriters Association",** the reinsurer was held entitled to avoid a contract as the insurer who reinsured a cargo 'lost or not lost' had failed to disclose that the insured cargo was damaged by fire, as news of that calamity was posted at Lloyds' a few hours before the reinsurance, and the insurer was also informed of it in the post by then.

3. Indemnity

Reinsurance contracts are contracts of indemnity though even the original policy may not be one of indemnity such as a life or personal accident policy. Since, a contract of

reinsurance is also a contract of indemnity the reinsurer, before paying the money, must make sure that the sum originally insured has been paid by the original insurer.

The reinsurer is liable in respect of claims for which the insurer is legally liable and for which the reinsurer is liable under the reinsurance policy. Thus, the reinsurer is not liable where the insurer has made ex-gratia payment to his insured.

4. Subrogation

After paying the money in proportion to the risk transferred to him, a reinsurer becomes entitled to the benefits of subrogation to all the rights and remedies of the insurer in respect of the subject matter of insurance.

8.3 Agency

8.3.1 Agents

S. 162 of the contract act defines an agent as “a person employed to do an act for or to represent another, who is called principal in dealings with third persons”.

Any person who has the capacity to make a contract can appoint another person as his agent. No consideration is necessary to create an agency. Contracts and acts done through an agent have the same legal consequences as if done by the principal in person. Thus, by appointing agents, the principal is enabled virtually to be in many places and to perform many acts at the same time.

As between the principal and third persons, any person may become an agent, even though the agent has no capacity, as a minor has only limited capacity. For instance, though an insurance agent cannot be a minor, he can complete contracts for insurers in the general insurance field. An agent may also be more capable than the principal himself, as where solicitors, architects, brokers etc., are employed in view of their professional skill.

Principle of agency

The principal is made available to third parties for the acts of the agents on the principle ***”qui facit per alium, facit per se”,*** which means that he who does through another, does it himself. His position is that he brings the principal and the third party face to face, and drops himself down. Generally, the third party cannot make the agent personally liable and he is treated as a mere conduit pipe through which rights and liabilities pass through from the principal to the third parties and vice versa.

Master and servant relationship

The relationship between the principal and agent differs from that of a master and servant relationship, in its nature and scope. An agent represents his principal and acts not only for him but also in his place. But the employee merely works for the employer and performs his duties according to the employer’s directions, but cannot commit him in any contractual way.

“ A servant acts under the direct control and supervision of his master, and is bound to conform to all reasonable orders given by him in the course of his work; an independent contractor, on the other hand, is entirely independent of any control or interference and merely undertakes to produce a specified result, employing his own means to produce that result. An agent, though bound to exercise his authority in accordance with all lawful instructions which may be given to him from time to time by his principal, is not subject in its exercise to the direct control or supervision of the principal. An agent, as such, is not a servant but a servant is generally for some purposes his master’s agent, the extent of the agency depending upon the duties or position of the servant, and in some cases an independent contractor may also be an agent.”

8.3.2 Agents in insurance field

Insurers at present are invariably corporate bodies. Being artificial persons their powers are fixed by their memorandum and articles of association, and their statute of incorporation.

They have to transact their business only through agents, whether they be directors at the highest level or other employees and field agents who solicit proposals for insurance.

In the Life insurance branch, the insurance agent is only an agent in the limited sense. In India, he has no authority to complete the contract in the name and on behalf of the insurer. He can only canvass for proposals and submit them for consideration to the insurer. The insurer may also impose other limitations on the agent, but they must be made known to the persons with whom the agents have to deal with.

Agents of the LIC of India are not authorized to collect moneys, accept risks or bind the insurer in any way other than collect deposits towards first premium and initial expenses. LIC (Agents) Rules, 1761 and LIC Act, 1756 prohibit agents from collecting premiums on behalf of LIC. They are not authorized or allowed to advance premiums on behalf of policy holders not to collect or pass receipts for money paid towards premiums. In respect of any unauthorized collections they are told that they will be acting as agents of the party concerned and not of the insurer, and warned that they alone will be answerable to the party for the consequences of such unauthorized action. But where the insurer allows the agent to collect the moneys and issue receipts for the amounts collected, the insurer must be deemed to have held out the agent as a person authorized to collect.

LIC Act, 1756 and LIC of India (Agent) Regulations, 1772 regulate the method of recruiting agents of LIC and the terms and conditions of their employment and work, such as their qualifications for appointment, functions, amount of business to be secured, payment of remuneration by way of commission, gratuity etc., including that on discontinuance of agency, termination of agency and other matters.

An agent in the fire or motor insurance branch has the authority to complete a binding contract by issuing a cover note, subject to its being cancelled by the insurer after underwriting review within a stated period.

8.3.3 Authority of agents

The power of the agent to bind the principal may consist of three kinds of authority as follows:

1. Express authority

Express authority is the actual authority given to the agent whether orally or in writing, and which the principal intends to give. When the agent's act is within his express authority, the principal is bound by it.

e.g., The Life insurance agent's authority to solicit proposal and to collect initial premium is an express authority.

2. Implied authority

Implied authority is to be inferred from the circumstances of the case and things spoken or written. Thus, the agent is said to have implied authority to transact in accordance with the general customs of the business.

If an insurer gives his agent blank cover notes, he impliedly authorizes him to make temporary insurance contracts.

3. Apparent or ostensible authority

When an agent has without authority, done acts or incurred obligations to third persons on behalf of his principal, the principal is bound by such acts or obligations, if he has by his words or conduct induced such third persons to believe that such acts and obligations were within the scope of the agents authority. The principal is then estopped from denying the agent's authority.

An agent gave a temporary cover note for a property. The insurer refused to accept the insurance. In the meantime, fire occurred and claim was made. The insurer urged that the agent had no authority to give cover note for the particular class of business involved in the case. But, the claimant showed that the insurer had confirmed similar cover notes given by the

agent in the past. It was, therefore, held that the insurer had to meet the claim as the agent had implied authority to issue such cover notes. **(Murfitt Vs. Royal Insurance Company)**

8.3.4 Licensing of agents

S. 40 of the Insurance Act, 1736 stipulates that only authorized agents are entitled to solicit business for insurance companies. S. 42 provides for issuing licenses to the insurance agents. A license is issued by the Insurance Regulatory and Development Authority (IRDA) to a person who applies for an agency on payment of prescribed fee. He must have the minimum educational qualifications and must not suffer from any disqualifications mentioned. The license will be valid for 3 years subject to renewal under the regulation. Practical training is also prescribed. The regulation also prescribes a code of conduct. Acting as agent without holding license is made an offence punishable with fine of Rs. 500 and if an insurer appoints a person having no license, he is punishable with a fine of Rs. 1,000.

The agent is not entitled to make any alteration in the policy unless the agent has express or implied authority. Payment of premium to the agent amounts to payment to the insurer, but the agent has no power to receive a renewal premium unless authorized by the insurer.

Minimum business required to be done by an agent in a year is prescribed and the commission rates and rebates are regulated. The act also provided the grounds for termination of agency. An appeal is also provided for unreasonable termination.

8.4 Insurance Brokers

Insurance brokers are another class of agents – not in India – who are professional technical experts, who can be procured by the insured, to give advice and professional assistance and act for them in arranging insurance at the best terms possible. Because of their professional skill and responsibilities brokerage i.e. the remuneration paid to them, is on a higher scale than that for ordinary insurance agents.

Being a skilled agent, he is always bound to act with reasonable diligence and competent skill. He is also liable to make compensation to his principal in respect of the direct consequence of his negligence, want of skill or misconduct. Thus, where the broker failed to see that the usual clauses are inserted in a marine policy and in consequence of the omission, nothing could be recovered by the insured from the underwriters; the broker has to make good the loss to the owner.

A factory manager employed an insurance broker to secure adequate employer's liability insurance cover from a reputed insurer, against claims made by employees injured at work owing to any breach of duty by the employer. Miss, Frazer, an employee sustained injuries in the factory due to the breach of their statutory duty. She obtained damages from the employer. But insurer could not be called upon to indemnify the employer, as the policy was defective. The employer took out third party proceedings against the broker and obtained decree for damages against the broker for breach of contract. **[Frazer Vs. Furman (productions) Ltd.]**

Insurance brokers in India are agents of the insured, but are remunerated by the insurer. Insurance agents are not expected to be technical experts. But insurance brokers must have professional competence.

In England, insurance brokers must be registered after satisfying the requirements of the Insurance Brokers Registration council, which include professional and financial criteria as well as professional liability insurance cover.

8.5 GLOSSARY

ccident: An event or occurrence which is unforeseen or unintended.

gent: A licensed insurance company representative who solicits, negotiates or effects contracts of insurance and provides service to the policy holder for the insurer.

ll risks policy: Coverage by an insurance contract that promises to cover all losses except those losses specifically excluded in the policy. Also known as open peril coverage.

eneficiary: An individual designated in a will to receive an inheritance, or the individual designated to receive the proceeds of an insurance policy.

enefits: The amount payable by the insurance company to a claimant, assignee or beneficiary under each coverage.

roker: One who represents an insured in the solicitation, negotiation or procurement of contracts of insurance and who may render services incidental to those functions. By law, the broker may also be an agent of insurance for certain purposes such as delivery of the policy or collection of premium.

ontract: A binding agreement between two or more parties for doing or not doing of certain things. A contact of insurance is embodied in a written document called the policy.

ontribution: It is the principle of insurance of which the insured is prevented from recovering more than his loss, despite his having several policies.

ouble insurance: If the insurance policy is taken from more than one insurance company where period of insurance, subject matter of insurance and sum assured are same, then this is called double insurance.

ıdemnity : Legal principle that specifies that an insured should not collect more than the actual cash value of a loss, but should be restored to approximately the same financial position as existed before the loss.

ısurable interest: It gives the owner the right to insure the property, to protect himself against financial loss. Without insurable interest, the contract of insurance will be gambling and void.

ısured: A person or organisation covered by an insurance policy.

ısurer: Any corporation engaged primarily in the business of furnishing insurance to the public.

iability insurance : Insurance covering the policyholder's, legal liability resulting from injuries to other persons or damage to their property. It provides protection for the insured against loss arising out of legal liability to third panties.

oss: The happening of the event for which insurance company pays.

ominee: Nominee is the person who is nominated to receive the amount under a policy and to give a valid discharge to the insurance on settlement of claim under a life insurance policy.

eril: The cause of a possible loss, such as fire, windstorm, theft, explosion or riot.

olicy: The printed legal document stating the terms and conditions of the insurance contract, that is issued to the policyholder by the insurance company.

olicy holder: A person who pays premium to an insurance company in exchange for the insurance protection provided by a policy of insurance.

remium: The sum paid by a policy holder to secure an insurance policy.

roposal: A person interested in taking out insurance has to make an offer by means of a proposal. This is an application for the cover required or for obtaining quotations of the premium chargeable. It may be made verbally, in writing or by completing the company's proposal form.

roximate cause: The dominating cause of loss or damage, an unbroken chain of events between the occurrence and damage.

roperty insurance: Insurance providing financial protection against the loss of, or damage to, real and personal property caused by such perils as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicle, vandalism, malicious mischief, riot, civil commotion and smoke.

isk: It can be potential source of loss or the subject matter of insurance itself.

ubrogation: It means the transfer of rights and remedies of the insured to insurer who has indemnified the insured in respect of loss.

um assured: It is the amount an insurer agrees to pay on the occurrence of an event.

Surrender value: It is the amount payable to the policyholder on his surrendering his rights under a policy and terminating the contract of insurance.

Third party: The claimant under a liability policy. He is not one of the two parties i.e. insured and insurer.

8.6 Self Assessment Questions

1. Explain and illustrate the doctrine of proximate cause in the law of insurance.
2. Explain the maxim "causa proxima non remota spectator".
3. What is meant by reinsurance? What are the general principles of reinsurance?
4. Explain the position of agents in insurance field.
5. Write short notes on
   a) Agents
   b) Brokers
6. Write short notes on
   a) Reinsurance
   b) Double insurance

8.7 References :

Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
Law of Insurance by Dr. MN Mishra
Principles of Insurance Law by MN Srinivasan
Law relating to Insurance by RM Vats
Insurance Law by Brij Nandan Singh
Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
Murth's Lecturers on Law of Insurance by KVS Sarma
Law of Contracts by Avtar Singh

Sri. G.V. NAGI REDDY,
M.Com., M.L., M.Phil.,

Lesson – 8

PROXIMATE CAUSE, REINSURANCE AND AGENCY

8.0 Objective :

The meaning and importance of the doctrine of proximate cause. Determination of proximate cause where perils are acting consecutively in unbroken sequence, where perils are acting consecutively in broken sequence and where perils are acting simultaneously. The meaning of reinsurance. The general principles of reinsurance. The meaning of agents, The position of agents in the insurance field. Authority of agents. Licensing of agents. The meaning and position of the insurance brokers are discussed in this chapter.

Contents :

8.1 Proximate cause
- **8.1.1 Doctrine of Proximate cause**
- **8.1.2 Determination of Proximate cause**

8.2 Reinsurance
- **8.2.1 Reinsurance – Meaning**
- **8.2.2 General principles of Reinsurance**

8.3 Agency
- **8.3.1 Agents**
- **8.3.2 Agents in insurance field**
- **8.3.3 Authority of agents**
- **8.3.4 Licensing of agents**

8.4 Insurance Brokers
8.5 Glossary
8.6 Self Assessement Questions
8.7 References

8.1 Proximate cause

8.1.1 Doctrine of Proximate cause

The insurer's liability under the policy arises only if the cause of the loss is a peril insured against and not an expressly excluded or other perils. The insurer is not liable for any loss caused by remote or indirect cause. There is no difficulty if a single peril acts and causes the loss. Often, these perils do not act in isolation, but act in succession or simultaneously and it will be difficult to assess the relative effect of each peril as the actual cause of the loss.

The doctrine of proximate cause is based on the legal maxim ***"Causa proxima non remota spectator"***, which means that proximate and not the remote cause shall be taken as the cause of the loss.

It is " the cause which is truly proximate in efficiency" and " effective or predominant cause", that is taken into consideration for determining the liability of the insurer. The insurer is

not liable for remote causes and remote consequences even if they belong to the category of insured perils.

In **"Pink Vs. Fleming"**, in a marine insurance policy, the peril insured against was collision with another ship. The cargo was a shipment of oranges. There was collision during the voyage. The oranges were taken on lighter for repairing the ship and subsequently reloaded. This caused delay resulting in damage to the oranges due to the perishable nature of goods. The question was whether or not this damage to the cargo was consequence of or caused by the collision within the meaning of the policy. It was held that the loss was due to mishandling of cargo and delay, and not due to collision, which was a remote cause, though mishandling and delay were the result of collision. As such, the insurer was held not liable.

In **" Hamilton Fraser and company Vs. Pandrof and company",** the cargo was insured against damage by seawater. During the voyage, rats made a hole in a pipe which connected the bathroom with the sea and as a result the seawater got through the hole and damaged the cargo. It was held that the proximate cause of damage was seawater, the rats being a remote cause, and thus the insurer was held liable.

Thus, where there is a succession of causes which must have existed in order to produce a particular result, the direct and proximate cause, i.e. the last cause must be looked into and the other cause rejected although the result would not have been produced without their occurrence.

8.1.2 Determination of proximate cause

The determination of proximate cause, where perils are acting consecutively or concurrently, must be made by applying common sense standards. Causation is to be understood as the man in the street, but not either the scientist or the metaphysician would understand it.

A. Where perils are acting consecutively in unbroken sequence, i.e., one peril is caused by and follows from another peril:

1. If there is one insured peril, but no excepted peril, i.e. uninsured peril, the insurer is liable for the loss caused by insured peril.

2. (i) If the excepted peril precedes an insured peril, the insurer is not liable.

e.g. Where an earthquake fire, an excepted peril, is spread by natural means and burnt the insured premises, the insurer was not liable as the loss was proximately caused by the excepted peril.

(ii) If the excepted peril follows the insured peril, the insurer is not liable if the loss caused by each peril is distinguishable; the insurer is liable for the loss caused by the insured peril up to the happening of excepted peril.

e.g. Where fire causes an explosion and explosion is an excepted peril, the insurer will be liable for fire damage up to the time of explosion.

B. Where perils are acting consecutively in broken sequence, i.e. each peril is independent of the other:

1. If there is one insured peril, but no excepted peril, the insurer is liable for the loss caused by insured peril.

2. (i) If the excepted peril precedes an insured peril, the insurer is liable for the loss caused by the insured peril.

e.g. A plate glass insurance policy covered breakage from any risk except fire. A fire occurred in a neighbouring premises and taking advantage of it a mob broke the insured plate glass to commit theft. It was held that the mob action was the cause of the loss and not the fire and so the insurer was liable.

(ii) If the excepted peril follows the insured peril, as an independent cause, the insurer is liable for the loss caused by the insured peril up to the happening of excepted peril.

C. Where the perils are acting concurrently i.e. simultaneously:

1. If there is one insured peril, but no excepted peril, the insurer is liable for the loss caused by the insured peril.

2. (i) If the losses caused by insured and excepted perils can be distinguished, the insurer is liable.

(ii) If the losses caused by insured and excepted perils cannot be distinguished, the insurer is not liable.

8.2 Reinsurance

8.2.1 Reinsurance – meaning

An insurer assuming larger risk from the insured may arrange with another insurer to offload the excess of undertaken risk. Such arrangement between two insurers is called reinsurance. Thus, by the device of reinsurance, the original insurer transfers a part of the risk to the reinsurer. Payment made by the ceding insurer (called original insurer or ‘reinsured’) to accepting insurer (called ‘reinsurer’) for the assumption of the risk by the latter is termed ‘reinsurance premium’.

Reinsurance is resorted to for the purpose of distributing risks over a number of insurers, so that in the event of loss, the insured claims against the original insurer who in turn claims against the reinsurer. Thus, the doctrine of reinsurance is based on the principle that every insurance company has a limit of undertaking the risk.

e.g. A gets his property insured with B for Rs. 2,00,000. B may shift half of the risk by reinsurance with C for Rs. 1,00,000. Thus, in case of loss, A can claim from B and B, in turn, can claim from C.

Reinsurance applies to all kinds of insurance contracts.

Reinsurance is also effected by way of treaties i.e., arrangements are made by means of treaties with other insurance companies or underwriters, which provide for automatic reinsurance of a fixed percentage of the risk.

Another feature of reinsurance is that the insurer can make a profit out of the second insurance, i.e., accepting an insurance with a higher premium and transferring the risk to the reinsurer with a lesser premium.

The contract of reinsurance is always subject to the contract of original insurance. If the original contract is altered without the knowledge or consent of the reinsurer, the reinsurer is discharged. Again, if the original contract expires or is cancelled, the reinsurance contract gets automatically cancelled. Hence, a policy of reinsurance is coextensive with the original policy.

The contract of reinsurance is between the insurer and the reinsurer. The original insured is not a party to the reinsurance contract. Hence, a reinsurance contract does not affect the insurer's contractual obligation to the insured under the original contract of insurance. Thus, in an action between the assured and the insurer, the reinsurer is not a necessary party, nor can the assured sue the reinsurer if he cannot get indemnity from the insurer.

8.2.2 General principles of reinsurance

The general principles of reinsurance are common to all branches in insurance subject to minor variation in individual classes. The reinsurance policy is also a contract of insurance governed by the same doctrines as follows:

1. Insurable interest

The insurer's liability under the original policy is enough insurable interest to support the reinsurance policy.

For instance, S. 11(1) of Marine Insurance Act states, " the insurer under a contract of marine insurance has an insurable interest in his risk and may reinsure in respect of it."

2. Utmost good faith

Utmost good faith has to be observed at all times by the parties to the reinsurance contract also and the insurer has a duty to disclose material facts to the reinsurers.

Thus, in **" London General Insurance Company Vs. General Marine Underwriters Association",** the reinsurer was held entitled to avoid a contract as the insurer who reinsured a cargo 'lost or not lost' had failed to disclose that the insured cargo was damaged by fire, as news of that calamity was posted at Lloyds' a few hours before the reinsurance, and the insurer was also informed of it in the post by then.

3. Indemnity

Reinsurance contracts are contracts of indemnity though even the original policy may not be one of indemnity such as a life or personal accident policy. Since, a contract of reinsurance is also a contract of indemnity the reinsurer, before paying the money, must make sure that the sum originally insured has been paid by the original insurer.

The reinsurer is liable in respect of claims for which the insurer is legally liable and for which the reinsurer is liable under the reinsurance policy. Thus, the reinsurer is not liable where the insurer has made ex-gratia payment to his insured.

4. Subrogation

After paying the money in proportion to the risk transferred to him, a reinsurer becomes entitled to the benefits of subrogation to all the rights and remedies of the insurer in respect of the subject matter of insurance.

8.3 Agency
8.3.1 Agents

S. 162 of the contract act defines an agent as “a person employed to do an act for or to represent another, who is called principal in dealings with third persons”.

Any person who has the capacity to make a contract can appoint another person as his agent. No consideration is necessary to create an agency. Contracts and acts done through an agent have the same legal consequences as if done by the principal in person. Thus, by appointing agents, the principal is enabled virtually to be in many places and to perform many acts at the same time.

As between the principal and third persons, any person may become an agent, even though the agent has no capacity, as a minor has only limited capacity. For instance, though an insurance agent cannot be a minor, he can complete contracts for insurers in the general insurance field. An agent may also be more capable than the principal himself, as where solicitors, architects, brokers etc., are employed in view of their professional skill.

Principle of agency

The principal is made available to third parties for the acts of the agents on the principle ***”qui facit per alium, facit per se”,*** which means that he who does through another, does it himself. His position is that he brings the principal and the third party face to face, and drops himself down. Generally, the third party cannot make the agent personally liable and he is treated as a mere conduit pipe through which rights and liabilities pass through from the principal to the third parties and vice versa.

Master and servant relationship

The relationship between the principal and agent differs from that of a master and servant relationship, in its nature and scope. An agent represents his principal and acts not only for him but also in his place. But the employee merely works for the employer and performs his duties according to the employer’s directions, but cannot commit him in any contractual way.

“ A servant acts under the direct control and supervision of his master, and is bound to conform to all reasonable orders given by him in the course of his work; an independent contractor, on the other hand, is entirely independent of any control or interference and merely undertakes to produce a specified result, employing his own means to produce that result. An agent, though bound to exercise his authority in accordance with all lawful instructions which may be given to him from time to time by his principal, is not subject in its exercise to the direct control or supervision of the principal. An agent, as such, is not a servant but a servant is generally for some purposes his master’s agent, the extent of the agency depending upon the duties or position of the servant, and in some cases an independent contractor may also be an agent.”

8.3.2 Agents in insurance field

Insurers at present are invariably corporate bodies. Being artificial persons their powers are fixed by their memorandum and articles of association, and their statute of incorporation.

They have to transact their business only through agents, whether they be directors at the highest level or other employees and field agents who solicit proposals for insurance.

In the Life insurance branch, the insurance agent is only an agent in the limited sense. In India, he has no authority to complete the contract in the name and on behalf of the insurer. He can only canvass for proposals and submit them for consideration to the insurer. The insurer may also impose other limitations on the agent, but they must be made known to the persons with whom the agents have to deal with.

Agents of the LIC of India are not authorized to collect moneys, accept risks or bind the insurer in any way other than collect deposits towards first premium and initial expenses. LIC (Agents) Rules, 1761 and LIC Act, 1756 prohibit agents from collecting premiums on behalf of LIC. They are not authorized or allowed to advance premiums on behalf of policy holders not to collect or pass receipts for money paid towards premiums. In respect of any unauthorized collections they are told that they will be acting as agents of the party concerned and not of the insurer, and warned that they alone will be answerable to the party for the consequences of such unauthorized action. But where the insurer allows the agent to collect the moneys and issue receipts for the amounts collected, the insurer must be deemed to have held out the agent as a person authorized to collect.

LIC Act, 1756 and LIC of India (Agent) Regulations, 1772 regulate the method of recruiting agents of LIC and the terms and conditions of their employment and work, such as their qualifications for appointment, functions, amount of business to be secured, payment of remuneration by way of commission, gratuity etc., including that on discontinuance of agency, termination of agency and other matters.

An agent in the fire or motor insurance branch has the authority to complete a binding contract by issuing a cover note, subject to its being cancelled by the insurer after underwriting review within a stated period.

8.3.3 Authority of agents

The power of the agent to bind the principal may consist of three kinds of authority as follows:

1. Express authority

Express authority is the actual authority given to the agent whether orally or in writing, and which the principal intends to give. When the agent's act is within his express authority, the principal is bound by it.
e.g., The Life insurance agent's authority to solicit proposal and to collect initial premium is an express authority.

2. Implied authority

Implied authority is to be inferred from the circumstances of the case and things spoken or written. Thus, the agent is said to have implied authority to transact in accordance with the general customs of the business.

If an insurer gives his agent blank cover notes, he impliedly authorizes him to make temporary insurance contracts.

3. Apparent or ostensible authority

When an agent has without authority, done acts or incurred obligations to third persons on behalf of his principal, the principal is bound by such acts or obligations, if he has by his words or conduct induced such third persons to believe that such acts and obligations were

within the scope of the agents authority. The principal is then estopped from denying the agent's authority.

An agent gave a temporary cover note for a property. The insurer refused to accept the insurance. In the meantime, fire occurred and claim was made. The insurer urged that the agent had no authority to give cover note for the particular class of business involved in the case. But, the claimant showed that the insurer had confirmed similar cover notes given by the agent in the past. It was, therefore, held that the insurer had to meet the claim as the agent had implied authority to issue such cover notes. **(Murfitt Vs. Royal Insurance Company)**

8.3.4 Licensing of agents

S. 40 of the Insurance Act, 1736 stipulates that only authorized agents are entitled to solicit business for insurance companies. S. 42 provides for issuing licenses to the insurance agents. A license is issued by the Insurance Regulatory and Development Authority (IRDA) to a person who applies for an agency on payment of prescribed fee. He must have the minimum educational qualifications and must not suffer from any disqualifications mentioned. The license will be valid for 3 years subject to renewal under the regulation. Practical training is also prescribed. The regulation also prescribes a code of conduct. Acting as agent without holding license is made an offence punishable with fine of Rs. 500 and if an insurer appoints a person having no license, he is punishable with a fine of Rs. 1,000.

The agent is not entitled to make any alteration in the policy unless the agent has express or implied authority. Payment of premium to the agent amounts to payment to the insurer, but the agent has no power to receive a renewal premium unless authorized by the insurer.

Minimum business required to be done by an agent in a year is prescribed and the commission rates and rebates are regulated. The act also provided the grounds for termination of agency. An appeal is also provided for unreasonable termination.

8.4 Insurance Brokers

Insurance brokers are another class of agents – not in India – who are professional technical experts, who can be procured by the insured, to give advice and professional assistance and act for them in arranging insurance at the best terms possible. Because of their professional skill and responsibilities brokerage i.e. the remuneration paid to them, is on a higher scale than that for ordinary insurance agents.

Being a skilled agent, he is always bound to act with reasonable diligence and competent skill. He is also liable to make compensation to his principal in respect of the direct consequence of his negligence, want of skill or misconduct. Thus, where the broker failed to see that the usual clauses are inserted in a marine policy and in consequence of the omission, nothing could be recovered by the insured from the underwriters; the broker has to make good the loss to the owner.

A factory manager employed an insurance broker to secure adequate employer's liability insurance cover from a reputed insurer, against claims made by employees injured at work owing to any breach of duty by the employer. Miss, Frazer, an employee sustained injuries in

the factory due to the breach of their statutory duty. She obtained damages from the employer. But insurer could not be called upon to indemnify the employer, as the policy was defective. The employer took out third party proceedings against the broker and obtained decree for damages against the broker for breach of contract. **[Frazer Vs. Furman (productions) Ltd.]**

Insurance brokers in India are agents of the insured, but are remunerated by the insurer. Insurance agents are not expected to be technical experts. But insurance brokers must have professional competence.

In England, insurance brokers must be registered after satisfying the requirements of the Insurance Brokers Registration council, which include professional and financial criteria as well as professional liability insurance cover.

8.5 GLOSSARY

Accident: An event or occurrence which is unforeseen or unintended.

Agent: A licensed insurance company representative who solicits, negotiates or effects contracts of insurance and provides service to the policy holder for the insurer.

All risks policy: Coverage by an insurance contract that promises to cover all losses except those losses specifically excluded in the policy. Also known as open peril coverage.

Beneficiary: An individual designated in a will to receive an inheritance, or the individual designated to receive the proceeds of an insurance policy.

Benefits: The amount payable by the insurance company to a claimant, assignee or beneficiary under each coverage.

Broker: One who represents an insured in the solicitation, negotiation or procurement of contracts of insurance and who may render services incidental to those functions. By law, the broker may also be an agent of insurance for certain purposes such as delivery of the policy or collection of premium.

Contract: A binding agreement between two or more parties for doing or not doing of certain things. A contact of insurance is embodied in a written document called the policy.

Contribution: It is the principle of insurance of which the insured is prevented from recovering more than his loss, despite his having several policies.

Double insurance: If the insurance policy is taken from more than one insurance company where period of insurance, subject matter of insurance and sum assured are same, then this is called double insurance.

Indemnity : Legal principle that specifies that an insured should not collect more than the actual cash value of a loss, but should be restored to approximately the same financial position as existed before the loss.

Insurable interest: It gives the owner the right to insure the property, to protect himself against financial loss. Without insurable interest, the contract of insurance will be gambling and void.

Insured: A person or organisation covered by an insurance policy.

Insurer: Any corporation engaged primarily in the business of furnishing insurance to the public.

Liability insurance : Insurance covering the policyholder's, legal liability resulting from injuries to other persons or damage to their property. It provides protection for the insured against loss arising out of legal liability to third panties.

Loss: The happening of the event for which insurance company pays.

Nominee: Nominee is the person who is nominated to receive the amount under a policy and to give a valid discharge to the insurance on settlement of claim under a life insurance policy.

Peril: The cause of a possible loss, such as fire, windstorm, theft, explosion or riot.

Policy: The printed legal document stating the terms and conditions of the insurance contract, that is issued to the policyholder by the insurance company.

Policy holder: A person who pays premium to an insurance company in exchange for the insurance protection provided by a policy of insurance.

Premium: The sum paid by a policy holder to secure an insurance policy.

Proposal: A person interested in taking out insurance has to make an offer by means of a proposal. This is an application for the cover required or for obtaining quotations of the premium chargeable. It may be made verbally, in writing or by completing the company's proposal form.

Proximate cause: The dominating cause of loss or damage, an unbroken chain of events between the occurrence and damage.

Property insurance: Insurance providing financial protection against the loss of, or damage to, real and personal property caused by such perils as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicle, vandalism, malicious mischief, riot, civil commotion and smoke.

Risk: It can be potential source of loss or the subject matter of insurance itself.

Subrogation: It means the transfer of rights and remedies of the insured to insurer who has indemnified the insured in respect of loss.

Sum assured: It is the amount an insurer agrees to pay on the occurrence of an event.

Surrender value: It is the amount payable to the policyholder on his surrendering his rights under a policy and terminating the contract of insurance.

Third party: The claimant under a liability policy. He is not one of the two parties i.e. insured and insurer.

8.6 Self Assessment Questions

1. Explain and illustrate the doctrine of proximate cause in the law of insurance.
2. Explain the maxim “causa proxima non remota spectator”.
3. What is meant by reinsurance? What are the general principles of reinsurance?
4. Explain the position of agents in insurance field.
5. Write short notes on
   a. Agents
   b. Brokers
6. Write short notes on
   a. Reinsurance
   b. Double insurance

8.7 References :

1. Modern Law of Insurance in India by Prof. KSN Murthy and KVN Sarma
2. Law of Insurance by Dr. MN Mishra
3. Principles of Insurance Law by MN Srinivasan
4. Law relating to Insurance by RM Vats
   Insurance Law by Brij Nandan Singh
   Hand book of Insurance Laws published by Law Publishers (India) Pvt. Ltd.
   Murth’s Lecturers on Law of Insurance by KVS Sarma
   Law of Contracts by Avtar Singh

Sri. G.V. NAGI REDDY, M.Com., M.L., M.Phil.,