3

ESSENTIALS OF INSURANCE CONTRACT

3.0 INTRODUCTION

The fundamental principle of Insurance is mathematical; its application is financial; and its interpretation is legal. For the layman to understand the Insurance principle he should be an actuary (who design and price the insurance products); to understand its application to financial problems, he need not be a financial; and to understand its legal concepts, he need not be a lawyer. The subject of Insurance covers a vast array of topics. This and the following chapters are concerned with these topics.

Insurance may be defined as a contract between two parties whereby one party called insurer undertakes in exchange for a fixed sum called premium to pay the other party called insured a fixed amount of money after happening of a certain event.

Insurance policy is a legal contract & its formation is subject to the fulfillment of the requisites of a contract defined under Indian Contract Act 1872.

According to the Act **"A Contract may be defined as an agreement between two or more parties to do or to abstain from doing an act, with an intention to create a legally binding relationship."**

Since Insurance is a contract, certain sections of Indian Contract Act are applicable.

3.1 OBJECTIVES

At the end of this lesson you will be able to know;

- Features of commercial contract
- Principles of contracts for insurance

3.2 ESSENTIALS OF COMMERCIAL CONTRACT

A. Elements of General Contract

1. Offer & Acceptance
2. Consideration
3. Legal capacity to contract or competency
4. Consensus "ad idem"
5. Legality of object

B. Elements of Special Contract relating to Insurance

1. Life Insurance
    - a. Utmost Good Faith (Uberrima Fides)
    - b. Insurable Interest
2. General Insurance
    - a. Utmost Good Faith (Uberrima Fides)
    - b. Insurable Interest
    - c. Indemnity
    - d. Subrogation
    - e. Proximate Cause

The essentials of any Insurance Contract are discussed as under with reference to the life Insurance only.

1. Offer & Acceptance:

In Life Insurance an offer can be made either by the Insurance company or the applicant (proposer) & the acceptance will follow. e.g., subsequently

(a) An offer made by the Insurance company to proposer that the premium amount will be Rs.100/- per annum for the Insurance amount of Rs.1000/-. It is for the proposer to accept the offer or not.

(b) An advertisement in the newspaper about the availability of different life Insurance policies is an invitation for an offer. If a proposer makes an application then it will be offer from the applicant and the Insurance company may or may not accept it.

(c) An offer may be considered accepted either when the Insurance company issues the policy or the first premium is paid by the applicant.

As stated above in example **(a)** if the applicant pays the first premium of Rs.100/- to the Insurance company then the contract is completed as both the parties have accepted the offer.

Similarly, if the company issues the policy in above stated example **(b)** then the offer is accepted by the Insurance company & the contract is completed. In fact, in life Insurance contract the effective date of the policy is very important; when the premium is paid with the application but no conditional receipt is issued the contract is not in force until the policy is delivered to the applicant. The payment of the premium with the application constitutes the offer and the delivery of policy is its acceptance.

Further, if the premium is paid with the application & conditional receipt is issued, the effective date of the contract depends upon the provisions of the conditional receipt. There are three types of conditions as follows:

(a) The condition may be that the Insurance becomes effective as of the date of the application or medical examination whichever is later. A claim arising after this date will be paid even if the application papers have not reached the competent / Approving Authority, provided of course, that the facts on the application & the results of the medical examination are such that the company would have accepted the application had the applicant lived.

(b) The second type of conditional receipt used by a company is the **approval form**, which provides coverage beginning with the date the application is approved by the company. This form does not offer the insured protection for the period from the date of the application until it is approved by the company.

(c) A third type of receipt is the **unconditional binding receipt**. According to this receipt the company binds the Insurance from the date of the application until the policy is issued or the application is rejected. The companies using this type of receipt place a time limit usually from 30 to 60 days. This binding receipt is beneficial to the prospects because he becomes insured from the time the application is filed. This form of receipt is not widely used.

The offer or proposal and its acceptance may be verbal or in writing but in Insurance contracts these are in writing. In General Insurance the Insured offers to purchase an insurance from the Insurer and this offer is in the form of a proposal form and the Insurer after studying the proposal can either reject the proposal or accept it. In case he accepts he issues a cover note or a letter of acceptance. In the latter event the acceptance letter becomes a counter offer or proposal, which is accepted on payment of premium by the insured.

2. Consideration:

There is no validity of a contract if there is no consideration, which is the act or promise offered by one party and accepted by the other as the price of his promise. In Insurance contracts the consideration is the premium that the Insured pays to the Insurer as the price of the promise that the Insurer has made that he shall indemnify the insured. Hence premium payment is the consideration on part of the insured and the promise to Indemnify is the consideration on part of the Insurer.

INTEXT QUESTIONS 3.1

1. When is the insurance contract considered to be completed?

2. What is consideration in any insurance contract?

3. Legal Capacity to Contract or Competency:

For an agreement to be binding on all parties, the parties involved must have the legal capacity to enter into a contract.

With respect to the insurer, if the company is formed as per laws of the country & empowered to solicit insurance then the insurer is capable of entering into an agreement.

Notes

With respect to the insured, the person should be of legal age i.e. 18 years and of sound mind.

If a contract is made with an underage the application may be held unenforceable if the minor decides to repudiate it at a later date. In Insurance contract the insurer is bound by the contract as long as the underage wishes to continue it. If the minor repudiates his contract, the law will allow him a refund of all premium paid.

Insanity or mental incompetence precludes the making of a valid Insurance contract.

4. Consensus "ad idem" (Same mind):

The understanding between the insurer & insured person should be of same thinking or mind. The reasons for taking the Insurance policy should be understandable to both the parties.

Both parties to the contract should be of the same mind and there must be consent arising out of common intention. Both parties should be clear about what the other is saying. The Insurer should know what the insured wants and the insured should know what the insurer is offering and both should be agreed on this. For example, if an Insured seeking a fire policy is issued a burglary policy there is no consent arising out of common intention.

5. Legality of Object:

To be a valid, a contract must be for a legal purpose & not contrary to public policy. Insurance is legal business therefore it cannot be illegal on the part of the insurer. An individual can take the life Insurance of his own life or his/her family members. If an individual takes a policy on the life of an unknown person it will not be a valid contract as it will amount to gambling.

Another example is that the contract will not be legal if it has anything to do with stolen property or if it is in respect of any unlawful activity. Hence Insurance of stolen goods or the Insurance of smuggling operation shall not stand scrutiny in the court of law and such contracts will be void.

Notes

3.3 SUMMARY

In addition to the above features which are common to commercial contracts as well as contracts of Insurance, Insurance contracts are subject to certain special principles evolved under common law in UK and are followed by the Indian courts. These principles are known as the **fundamental principles of the law of Insurance** and these are discussed in the following chapters.

3.4 TERMINAL QUESTIONS:

1. Explain the various features of any commercial contract.

3.5 OBJECTIVE TYPE QUESTIONS

1. Choose the correct option
   a. In an insurance contract an insurer makes an offer and the prospect accepts it.
   b. In an insurance contract a prospect makes an offer and an insurer accepts it.
   c. In an insurance contract an offer and acceptance is not a requirement.
   d. In an insurance contract no principles of contact are applicable.
2. The consideration for the insurer under an insurance contract is a______(premium/sum insured)
3. The consideration for an insured under an insurance contract is a_________________(compensation/premium).
4. Choose the correct options

   Statement A: The minor can enter in to an insurance contract.

   Statement B: The person with unsound mind cannot enter into an insurance contract.

   a. Both statements are correct
   b. Both statements are wrong
   c. Statement A is correct
   d. Statement B is correct

5. Choose the correct options

   Statement A: Insurance is lawful business.

   Statement B: The insurance is not a gambling.

   a. Both statements are correct

   b. Both statements are wrong

   c. Statement A is correct

   d. Statement B is correct

3.6 ANSWERS TO INTEXT QUESTIONS

3.1

1. On accepting the proposal by the insurance company the insurance contract is completed.
2. Premium paid by the person to the insurance company and any compensation paid by the insurance company.

3.7 ANSWERS TO OBJECTIVE TYPE QUESTIONS

3.5

1. b
2. premium
3. compensation
4. d
5. a