

# Contract Law: Insurance Applications

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## SPECIAL CHARACTERISTICS OF INSURANCE CONTRACTS

Insurance contracts must contain all the necessary elements of a legally enforceable contract and are in many ways similar to other contracts. However, insurance contracts have distinctive features and their own body of law.

In addition to having the four essential elements of all contracts, insurance contracts have certain special characteristics:

- A conditional contract
- A contract involving fortuitous events and the exchange of unequal amounts
- A contract of utmost good faith
- A contract of adhesion
- A contract of indemnity
- A nontransferable contract

### Conditional Contract

An insurance policy, in addition to having the four essential elements of all contracts, is a **conditional contract**. Whether the insurer pays a claim depends on whether a covered loss has occurred. Additionally, the insured must fulfill certain duties before a claim is paid, such as giving prompt notice to the insurer after a loss has occurred.

#### Conditional contract

A contract that one or more parties must perform only under certain conditions.

#### Elements of a Contract

A contract must have each of these elements to be legally enforceable:

- Agreement
- Capacity to contract
- Consideration
- Legal purpose

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A covered loss might not occur during a particular policy period, but that fact does not mean the insurance policy for that period has been worthless. In buying an insurance policy, the insured acquires a valuable promise—the promise of the insurer to make payments if a covered loss occurs. The promise exists, even if the insurer’s performance is not required during the policy period.

### **Contract Involving Fortuitous Events and the Exchange of Unequal Amounts**

While noninsurance contracts involve an exchange of money for a certain event, such as the provision of goods or services, insurance contracts involve an exchange of money for protection upon the occurrence of uncertain, or fortuitous, events. Insurance contracts involve an exchange of unequal amounts. Often, there are few or no losses, and the premium paid by the insured for a particular policy is more than the amount paid by the insurer to, or on behalf of, the insured. If a large loss occurs, however, the insurer’s claim payment might be much more than the premium paid by the insured. The possibility that the insurer’s obligation may be much greater than the insured’s makes the insurance transaction a fair trade.

For example, suppose an insurer charges a \$1,000 annual premium to provide auto physical damage coverage on a car valued at \$20,000. Three situations may occur:

- If the car is not damaged while the policy is in force, the insurer pays nothing.
- If the car is partially damaged, the insurer pays the cost of repairs, after subtracting a deductible.
- If the car is a total loss, the insurer pays \$20,000 (minus any deductible).

Unless, by chance, the insurer’s obligations in a minor accident come to exactly \$1,000, unequal amounts are involved in all three of these cases. However, it does not follow that insureds who have no losses—or only very minor losses—do not get their money’s worth or that insureds involved in major accidents profit from the insurance.

The premium for a particular policy should reflect the insured’s share of estimated losses that the insurer must pay. Many insureds have no losses, but some have very large losses. The policy premium reflects the insured’s proportionate share of the total amount the insurer expects to pay to honor its agreements with all insureds having similar policies.

### **Contract of Utmost Good Faith**

Because insurance involves a promise, it requires complete honesty and disclosure of all relevant facts from both parties. For this reason, insurance contracts are considered contracts of utmost good faith. Both parties to an



insurance contract—the insurer and the insured—are expected to be honest and forthcoming in their dealings with each other.

The insured has a right to rely on the insurer to fulfill its promises. Therefore, the insurer is expected to treat the insured with **utmost good faith**. An insurer that acts in bad faith, such as denying coverage for a claim that it knows is clearly covered, could face serious penalties under the law.

#### Utmost good faith

An obligation to act in complete honesty and to disclose all relevant facts.

The insurer also has a right to expect that the insured will act in good faith. An insurance buyer who intentionally conceals certain information or misrepresents certain facts does not act in good faith. Because an insurance contract requires utmost good faith from both parties, an insurer could be released from a contract because of concealment or misrepresentation by the insured.

Concealment is an intentional failure to disclose a material fact. Courts have held that the insurer must prove two things to establish that concealment has occurred. First, it must establish that the failure to disclose information was intentional, which is often difficult. The insurer must usually show that the insured knew that the information should have been given and then intentionally withheld it. Second, the insurer must establish that the information withheld was a **material fact**. In the case of an auto insurance applicant, for example, material facts include the use of the applicant's autos, the identity of the drivers, and the ages and driving records of the drivers. If an insured intentionally conceals the material fact that her sixteen-year-old son lives in the household and is the principal driver of one of her cars, the insurer could avoid (reject) the policy based on that concealment.

#### Material fact

In insurance, a fact that would affect the insurer's decision to provide or maintain insurance or to settle a claim.

Insurers carefully design applications for insurance to include questions regarding facts material to the underwriting process. The application includes questions on specific subjects, which the applicant must answer. These questions are designed to encourage the applicant to reveal all pertinent information.

In normal usage, a misrepresentation is a false statement. As used in insurance, a **misrepresentation** is a false statement of a material fact on which the insurer relies. The insurer does not have to prove that the misrepresentation is intentional.

#### Misrepresentation

A false statement of a material fact on which a party relies.

For example, assume an applicant for auto insurance has had two speeding tickets during the eighteen months immediately before he submitted his application for insurance. When asked whether any driving violations have occurred within the past three years (a question found on most auto insurance application forms), an applicant giving either of these answers would be making a misrepresentation:

- “I remember having one speeding ticket about two years ago.”
- “I’ve never been cited for a moving violation—only a few parking tickets.”

