5

FUNDAMENTALS/PRINCIPLES OF GENERAL INSURANCE

5.0 INTRODUCTION

After studying, the life insurance and its importance, the over aspect of insurance other than 'Life Insurance' would is General Insurance. In this chapter, we cover various aspect of General Insurance such as Principles of utmost Good faiths material fact Principle of Insurable Insures and Principle of Indemnity.

General Insurance comprises of insurance of property against fire, burglary etc, personal insurance such as Accident and Health Insurance, and liability insurance which covers legal liabilities. Suitable general Insurance covers are necessary for every family. It is important to protect one's property, which one might have acquired from one's hard earned income. Losses created to catastrophes such as the tsunami, earthquakes, cyclones etc. have left many homeless and penniless. Such losses can be devastating but insurance could help mitigate them. Property can be covered, so also the people against Personal Accident. A Health Insurance policy can provide financial relief to a person undergoing medical treatment whether due to a disease or an injury.

5.1 OBJECTIVES

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

- Various additional principles applicable to life insurance contract
- In case any of these principles are missing the insurance contract will become void

5.2 PRINCIPLES OF UTMOST GOOD FAITH

Both the parties to a commercial contract are by law required to observe good faith. Let us say that you go to a shop to buy an electrical appliance. You simply will not enter, pay and pick up any sample piece but will check two, three or even more pieces. You may be even ask the shopkeeper to give a demonstration to ensure that it is in working condition and also ask several questions to satisfy yourself about what you are buying. Then when you go home you find it does not work or is not what you were looking for exactly so you decide to return the item but the shopkeeper may well refuse to take it back saying that before purchasing you had satisfied yourself; and he is possibly right. The common law principle "Caveat Emptor" or let the buyer beware is applicable to commercial contracts and the buyer must satisfy himself that the contract is good because he has no legal redress later on if he has made a bad bargain. The seller cannot misrepresent the item he has sold or deceive the buyer by giving wrong or misleading information but he is under no obligation to disclose all the information to the buyer and only selective information in reply to the buyers queries is required to be given. But in Insurance contracts the principles of "Uberrima fides" i.e. of Utmost Good Faith is observed and simple good faith is not enough. Why this difference in Insurance contracts?

Firstly, in Insurance contracts the seller is the insurer and he has no knowledge about the property to be insured. The proposer on the other hand knows or is supposed to know everything about the property. The condition is reverse of ordinary commercial contracts and the seller is entirely dependent upon the buyer to provide the information about the property and hence the need for Utmost Good Faith on the part of the proposer.

It may be said here that the insurer has the option of getting the subject matter of Insurance examined before covering the risk. This is true that he can conduct an examination in the case of a property being insured for fire risk or of getting a medical examination done in the case of a health policy. But even then there will be facts which only the insured can know e.g., the history of Insurance of the property whether it has been refused earlier for Insurance by another company or whether it is also already insured with another company and the previous claim experience. Similarly a medical examination may not reveal the previous history i.e. details of past illness, accidents etc. Therefore Insurance contracts insist on the practice of Utmost Good Faith on the part of the Insured.

Secondly, Insurance is an intangible product. It cannot be seen or felt. It is simply a promise on the part of Insurer to make good the loss incurred by the Insured if and when it occurs.

Thus the Insurer is also obliged to practice Utmost Good Faith in his dealings with the Insured. He cannot and should not make false promises during negotiations.

He should not withhold information from the Insured such as the discounts available for good features e.g., fire extinguishing Appliances discount in fire policies or that Earthquake risk is not covered under the standard fire policy but can be covered on payment of additional premium.

In the recent Earthquake disaster in Gujarat a number of Insured failed to get any relief from Insurance Companies as Earthquake risk was not covered.

Utmost Good Faith can be defined as "A positive duty to voluntarily disclose, accurately and fully all facts material to the risk being proposed whether requested for or not".

In Insurance contracts Utmost Good Faith means that "each party to the proposed contract is legally obliged to disclose to the other all information which can influence the others decision to enter the contract".

The following can be inferred from the above two definitions:

(1) Each party is required to tell the other, the truth, the whole truth and nothing but the truth.

(2) Unlike normal contract such an obligation is not limited to any questions asked and

(3) Failure to reveal information even if not asked for gives the aggrieved party the right to regard the contract as void.

How is this duty of Utmost Good Faith to be practiced? And what are the facts that the proposer has to disclose? The answer to both the question is simply the proposer must disclose to the insurer all material facts in respect of the subject matter of Insurance.

5.3 WHAT IS A MATERIAL FACT?

Material fact is every circumstance or information, which would influence the judgement of a prudent insurer in assessing the risk.

Or

Those circumstances which influence the insurer decision to accept or refuse the risk or which effect the fixing of the premium or the terms and conditions of the contract must be disclosed.

5.4 FACTS, WHICH MUST BE DISCLOSED

i. Facts, which show that a risk represents a greater exposure than would be expected from its nature e.g., the fact that a part of the building is being used for storage of inflammable materials.

ii. External factors that make the risk greater than normal e.g. the building is located next to a warehouse storing explosive material.

iii. Facts, which would make the amount of loss greater than that normally expected e.g. there is no segregation of hazardous goods from non-hazardous goods in the storage facility.

iv. History of Insurance (a) Details of previous losses and claims (b) if any other Insurance Company has earlier declined to insure the property and the special condition imposed by the other insurers; if any.

v. The existence of other insurances

vi. Full facts relating to the description of the subject matter of Insurance

Some examples of Material facts are

(a) **In Fire Insurance:** The construction of the building, the nature of its use i.e. whether it is of concrete or Kucha having thatched roofing and whether it is being used for residential purposes or as a godown, whether fire fighting equipment is available or not.

(b) In Motor Insurance: The type of vehicle, the purpose of its use, its age (Model), Cubic capacity and the fact that the driver has a consistently bad driving record.

(c) In Marine Insurance: Type of packing, mode of carriage, name of carrier, nature of goods, the route.

(d) In Personal Accident Insurance: Age, height, weight, occupation, previous medical history if it is likely to increase the choice of an accident, Bad habits such as drinking etc.

(e) Burglary Insurance: Nature of stock, value of stock, type of security precautions taken.

As mentioned this is not an exhaustive list but only a few examples.

Details of previous losses is a material fact which is relevant to all policies.

5.5 FACTS, WHICH NEED NOT BE DISCLOSED

a. **Facts of Law:** Every one is deemed to know the law. Overloading of goods carrying vehicles is legally banned. The transporter can not take excuse that he was not aware of this provision.

b. **Facts which lessen the Risk:** The existence of a good fire fighting system in the building.

c. **Facts of Common Knowledge:** The insurer is expected to know the areas of strife and areas susceptible to riots and of the process followed in a particular trade or Industry.

d. **Facts which could be reasonably discovered:** For e.g. the previous history of claims which the Insurer is supposed to have in his record.

e. **Facts which the insurers representative fails to notice:** In burglary and fire Insurance it is often the practice of Insurance companies to depute surveyors to inspect the premises and in case the surveyor fails to notice hazardous features and provided the details are not withheld by the Insured or concealed by him them the Insured cannot be penalized.

f. **Facts covered by policy condition:** Warranties applied to Insurance polices i.e. there is a warranty that a watchman be deployed during night hours then this circumstance need not be disclosed.

Duration of Duty of Disclosure

The duty of disclosure remains in force through out the entire negotiation stage and till the contract is finalized. Once the contract is finalized than the contract is subject to ordinary simple good faith.

However when an alteration is to be made in an existing contract then this duty of full disclosure recovers in respect of the proposed alteration.

The duty of disclosure also revives at the time of renewal of contract since legally renewal is regarded as a fresh contract.

For example: a landlord at the time of proposal has disclosed that the building is rented out and is being used as an office. If during the continuation of the policy the tenants vacate the building and the landlord subsequently rents it out to a person using it as a godown then he is required to disclose this fact to the Insurer as this is a change in material facts and effects the risks.

(***Note:*** Please note that in long term Insurance Business the Insurer is obliged to accept the renewal premium if the Insured wishes to continue the contract and there is no duty of disclosure operating at the time of renewal. Normally Insurer arranges inspection on each renewal.)

5.6 BREACHES OF UTMOST GOOD FAITH

Breaches of Utmost Good Faith occur in either of 2 ways.

(1) **Misrepresentation,** which again may be either innocent or intentional. If intentional then they are fraudulent

(2) **Non-Disclosure,** which may be innocent or fraudulent. If fraudulent then it is called concealment.

It is important to distinguish between the two: Misrepresentation and Non-Disclosure

Breach of
Utmost Good Faith

Misrepresentation

Non-Disclosure

Innocent

Intentional
(Fraudulent)

Innocent

Intentional
(Concealment)

Misrepresentation :

Innocent :

This occurs when a person states a fact in the belief or expectation that it is right but it turns out to be wrong. While taking out a Marine Insurance Policy the owner states that the ship will leave on a specific date but in fact the ship leaves on a different date.

Intentional : Deliberate misrepresentation arises when the proposer intentionally distorts the known information to defraud the insurer. The selfish objective is somehow to enter the contract or to get a reduction in the premium e.g., If an applicant for motor Insurance stated that no one under 18 would drive the vehicle when in fact his 17 years old son drives frequently. Such a misrepresentation would be material as it would effect the decision of the insurer.

Non-Disclosure

Innocent : This arises when a person is not aware of the facts or when even though being aware of fact does not appreciate its significance e.g.

A proposer at the time of effecting the contract has undetected cancer therefore does not disclose it or

A proposer had suffered from Rheumatic fever in his childhood but he does not disclose this not knowing that people who have this are susceptible to heart diseases at a later age.

Deliberate : This is done with a deliberate intention to defraud the insurer entering into a contract, which he would not have done had he been aware of that fact.

A proposer for fire Insurance hides the fact knowingly by not disclosing that he has an outhouse next to his building, which is used as a store for highly inflammable material.

How To Deal With Breaches

How breaches are dealt with depends upon whether the breaches are

(1) Innocent

(2) Deliberate

(3) Material to the risk

(4) Immaterial to the risk

When Breach of Utmost Good Faith occurs the aggrieved party gets the right to avoid the contract. The contract does not become automatically void and it must decide on the course to be taken. The options available are on case-to-case basis like: -

1) The contract becomes void from the very beginning if deliberate misrepresentation or non-disclosure is resorted to with the intention of misleading the insurer to enter into a contract.

2) To consider the contract void, the bereaved party, must notify the offending party that breach has been noticed and as per the conditions of the contract he is no longer governed with the terms of the contract agreed upon in covering the risk. In case the breach is discovered at the time of claim he will refuse to honour his promise and will not pay the claim. This again occurs when there has been a deliberate breach.

3) When the breach is innocent but it is material to the fact then the insurer may impose a penalty in the form of additional Premium.

4) Where the breach is found to be innocent and is not

material the insurer can choose to ignore the breach or waive off the breach.

5.7 PRINCIPLE OF INSURABLE INTEREST

One of the essential ingredients of an Insurance contract is that the insured must have an insurable interest in the subject matter of the contract. Insurance without insurable interest would be a mere wager and as such unenforceable in the eyes of law.

The subject matter of the Insurance contract may be a property, or an event that may create a liability but it is not the property or the potential liability which is insured but it is the pecuniary interest of the insured in that property or liability which is insured.

The concept is the basis of the doctrine of insurable interest and was cleared in the case of Castellain v/s Priston in 1883 as follows.

"What is it that is insured in a fire policy? Not the bricks and materials used in building the house but the interest of the Insured in the subject matter of Insurance."

The subject matter of the contract is the name given to the financial interest, which a person has in the subject matter and it is this interest, which is insured.

Insurable Interest is defined as

"The legal right to insure arising out of a financial relationship recognized under the law between the insured and the subject matter of Insurance".

There are four essential components of Insurable Interests

1) There must be some property, right, interest, life, limb or potential liability capable of being insured.
2) Any of these above i.e. property, right, interest etc. must be the subject matter of Insurance.
3) The insured must stand in a formal or legal relationship with the subject matter of the Insurance. Whereby he benefits from its safety, well-being or freedom from liability and would be adversely affected by its loss, damage existence of liability.

4) The relationship between the insured and the subject matter must be recognized by law.

5.8 HOW IS INSURABLE INTEREST CREATED

There are a number of ways by which Insurable Interest arises or is restricted.

(a) By Common Law: Cases where the essential elements are automatically present can be described as Insurable Interest having arisen by common law. Ownership of a building, car etc, gives the owner the right to insure the property.

(b) By Contract: In some cases a person will agree to be liable for something which he would not be ordinarily for. A lease deed for a house for example may make the tenant responsible for the repair and maintenance of the building. Such a contract places the tenant in a legally recognized relationship with the house or the potential liability and this gives him the insurable interest.

(c) By Statute: Sometimes an Act of the Parliament may create an insurable interest by granting some benefit or imposing a duty and at times removing a liability may restrict the Insurable Interest.

Insurable Interest is applicable in the Insurance of property, life and liability.

In case of property Insurance, insurable interest arises out of ownership where the owner is the insured but it can arise due to other situations & financial interests which gives a person who is not an owner, insurable interest in the property and some of the situations are listed below.

(i) Mortgagee and Mortgagers:

The practice of Mortgage is common in the area of house & vehicle purchase. The mortgagee is the lender normally a bank or a financial institution, and the mortgager is the purchaser. Both have an insurable interest; The mortgager because he is the owner and the mortgagee as a creditor with insurable interest limited to the extent of the loan.

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(ii) Bailee:

Bailee is person legally holding the goods of another, may be for payment or other reason. Motors garages and watch repairers have a responsibility to take care of the items in their custody and this gives them an insurable interest even though he is not owner.

(iii) Trustees:

They are legally responsible for the property under their charge and it is this responsibility which gives rise to insurable interest.

(iv) Part Ownership:

Even though a person may have only part interest in a property he can insure the entire property. He shall be treated as a trustee or the co-owners; and in the event of a claim he will hold the money received by him in excess of his financial interest in trust for the others.

(v) Agents:

When the principal has an insurable interest then his agent can insure the property.

(vi) Husband & Wife:

Each has unlimited interest in each others life and hence they have an insurable interest in each others property.

These parties can insure each others lives as they stand to lose in the event of death of any of them.

(vii) Creditor:

Similarly a creditor may lose financially if a debtor dies before paying the loan so the creditor gets an Insurable Interest in the life of the debtor to the extent of the loan amount.

(viii) Liability:

In Liability Insurance a person has insurable interest to the extent of any potential liability which may be incurred due to damages and other costs. It is not possible to foretell how much liability or how often a person may incur liability and in what form or shape it arises. In this way Insurable Interest in Liability Insurance is different than

Insurable Interest in life & property - where it is possible to predetermine the extent of Insurable Interest.

Therefore in liability assurance the insured is asked to choose the amount of sum insured as the maximum figure that he estimates is ever likely to be required to settle the liability claims.

5.9 WHEN SHOULD INSURABLE INTEREST EXIST

(i) **In Life Insurance** Insurable Interest must exist at the time of inception of Insurance and it is not required at the time of claim

(ii) **In Marine Insurance** Insurable Interest must exist at the time of loss / claim and it is not required at the time of inception.

(iii) **In Property and other Insurance** Insurable Interest must exist at the time of inception as well as at the time of loss/ claims.

Other Salient Features of Insurable Interest

(i) **Insurable Interest of Insurers** Once the Insurers have accepted the liability they derive an insurable interest, which arises from that liability thus they are free to insure a part or whole of the risk with another insurer. This is done by reinsurance.

(ii) **Legally Enforceable** The Insurable Interest must be legally enforceable. The mere expectation that one may acquire insurable interest in the future is not sufficient to create insurable interest.

(iii) **Possession** Lawful possession of property together with its responsibility creates an insurable interest

(iv) **Criminal Acts** A person cannot avail benefits from Insurance to cover penalties because of a criminal act but Insurance to take care of civil consequences arising out of his criminal act can be done. This is applicable in the case of motor Insurance where a driver found guilty of an offence which is involved in an accident receives the claim for damage to his own car and also liability incurred due to damage to another's property but he shall not be insured for the amount of penalty that was imposed for his offense.

(v) **Financial Value** Insurable interest must be capable of financial evaluation. In the case of property and liability incurred it is easily evaluated but in life it is difficult to put a value on the life of a person or his spouse and this depends on the amount of premium the individual can bear. However in cases where lives of others is involved a value on life can be placed i.e. creditor can put a value on the life of debtor restricted to the extent of the loan.

Employers have an insurable interest in the lives of their employees because if the employee dies there will be cost on training of the replacement and in the case of death of a key employee there may be loss of income as well. The amount of insurable interest cannot be exactly determined but it should be reasonable and proportionally related with salary of an employee; contribution level of a key personal or equity contribution in case of partners.

Assignment of policies is possible but normally not without the permission of the Insurer because it can mean a change in the underwriting consideration as the new policyholder may not have the same insurable interest.

Fire and other Misc. policies are not freely assignable as the Insurer at the time of underwriting has satisfied himself about the Insureds attitude or treatment of the subject matter and its loss causing capability. This would however change in the case of an assignee and it is reasonable to give the insurer a chance to consider the credentials of the new proposer. **When the Insurer gives his consent to the assignment of the policy a new contract is in fact being entered into and this is called NOVATION.**

Marine cargo policies are however freely assignable without the knowledge or the consent of the Insurer the reason being that the ownership of the goods insured frequently change when the goods are still in transit and it is necessary that the benefit of the policy passes to the new owner.

In some cases only the proceeds of the policy are assigned. There is normally no objection to such assignments as the assured is still a party to the contract with the insurer and he has to continue to comply with all the terms and conditions of the policy with the only difference being that in event of a claim the insurer is directed to pay the amount to the Assignee.

Insurers protect themselves by taking a receipt from the person receiving the amount discharging the Insurer from any further liability. This condition arises often in motor claims when bills of repair are directly paid to the garage and not the owner of the vehicle. In these cases the garage owners obtain a letter of satisfaction from the owner and submit his bills to the Insurer directly for payment.

INTEXT QUESTION 5.1

1. Can you insure you house under residential building where you are storing fire works item without disclosing it to insurance company?

2. Can you take insurance policy of Red Fort situated at Delhi?

5.10 PRINCIPLE OF INDEMNITY

Indemnity according to the Cambridge International Dictionary is "Protection against possible damage or loss" and the Collins Thesaurus suggests the words "Guarantee", "Protection", "Security", "Compensation", "Restitution" and "Re-imbursement" amongst others as suitable substitute for the word "Indemnity". The words protection, security, compensation etc. are all suited to the subject of Insurance but the dictionary meaning or the alternate words suggested do not convey the exact meaning of Indemnity as applicable in Insurance Contracts.

In Insurance the word indemnity is defined as **"financial compensation sufficient to place the insured in the same financial position after a loss as he enjoyed immediately before the loss occurred."**

Indemnity thus prevents the insured from recovering more than the amount of his pecuniary loss. It is undesirable that an insured should make a profit out of an event like a fire or a motor accident because if he was able to make a profit there might well be more fires and more vehicle accidents.

As in the case of Insurable Interest, the principle of indemnity also relies heavily on the financial evaluation of the loss but in the case of life and disablement it is not possible to be precise in terms of money.

An Insurance may be for less than a complete indemnity but it may not be for more than it. To illustrate let us take the example of a person who insures his car for Rs.4 lacs and it meets with an accident and is a total loss. It is not certain that he will get Rs.4 lacs. He may have over valued the car or may be the prices of cars have fallen since the policy was taken. The Insurer will only pay an amount equal to the value of the car at the time of loss. If he finds that a car of the same make and model is available in the market for Rs.3 lac then he is not liable to pay more than this sum and payment of Rs.3 lacs will indemnify the Insured.

Similarly in the case of partial loss if some part of the car needs to be replaced the Insurer will not pay the full value of the new part. He shall assess how much the old part had run and after deduction of a proportionate sum he shall pay the balance amount. An insured is not entitled to new for old as otherwise he would be making a profit from the accident.

However there are two modern types of policy where there is a deviation from the application of this principle.

One is the agreed value policy where the insurer agrees at the outset that they will accept the value of the insured property stated in the policy (sum insured) as the true value and will indemnify the insured to this extent in case of total loss. Such policies are obtained on valuable pieces of Art, Curious, Jewellery, Antiques, Vintage cars etc.

The other type of policy where the principle of strict indemnity is not applied is the Reinstatement policy issued in Fire Insurance. Here the Insured is required to insure the property for its current replacement value and the Insurer agrees that in the event of a total loss he shall replace the damaged property with a new one or shall pay for the replacement in full.

Other than these there are Life and Personal Accident policies where no financial evaluation can be made. All other Insurance policies are subjected to the principle of strict Indemnity. In most policy documents the word indemnity may not be used but the courts will follows this principle in case of any dispute coming before them.

5.10.1 HOW IS INDEMNITY PROVIDED?

The Insurers normally provide indemnity in the following manner and the choice is entirely of the insurer

1) Cash Payment
2) Repairs
3) Replacement
4) Reinstatement

1. Cash Payment

In majority of the cases the claims will be settled by cash payment (through cheques) to the assured. In liability claims the cheques are made directly in the name of the third party thus avoiding the cumbersome process of the Insurer first paying the Insured and he in turn paying to the third party.

2. Repair

This is a method of Indemnity used frequently by insurer to settle claims. Motor Insurance is the best example of this where garages are authorized to carry out the repairs of damaged vehicles. In some countries Insurance companies even own garages and Insurance companies spend a lot on Research on motor repair to arrive at better methods of repair to bring down the costs.

3. Replacement

This method of Indemnity is normally not preferred by Insurance companies and is mostly used in glass Insurance where the insurers get the glass replaced by firms with whom they have arrangements and because of the volume of business they get considerable discounts. In some cases of Jewellery loss, this system is used specially when there is no agreement on the true value of the lost item.

4. Reinstatement

This method of Indemnity applies to Property Insurance where an insurer undertakes to restore the building or the machinery damaged substantially to the same condition as before the loss. Sometimes the policy specifically gives the right to the insurer to pay money instead of restoration of building or machinery.

Reinstatement as a method of Indemnity is rarely used because of its inherent difficulties e.g., if the property after restoration fails to meet the specifications of the original in any material way or performance level then the Insurer will be liable to pay damages. Secondly, the expenditure involved in restoration may be much more than the sum Insured as once they have agreed to reinstate they have to do so irrespective of the cost.

Limitations on Insurers Liability

1. The **maximum** amount recoverable under any policy **is the sum insured,** which is mentioned on the policy. The amount is not the agreed value of the property (except in Valued policies) nor is it the amount, which will be paid automatically on occurrence of loss. What will be paid is the actual loss or sum insured whichever is less.

2. Property Insurance is subjected to the **Condition of Average.** The underlying principle behind this condition is that Insurers are the trustees of a pool of premiums from which they meet the losses of the few who suffer damage, so it is reasonable to conclude that every Insured should bring a proper contribution to the pool by way of premium. Therefore if an insured deliberately or otherwise underinsures his property thus making a lower contribution to the pool, he is not entitled to receive the full benefits.

The application of this principle makes the insured his own Insurer to the extent of under-insurance i.e. the pro-rata difference between the Actual Value and the sum insured. The amount of loss will be shared between the Insurer and the insured in the proportion of sum insured and the amount underinsured. The formula applicable for arriving at the amount to be paid by the Insurance Co. is

Claim = Loss X (Sum Insured / Market Value)

Example

Mr. Sudhir Kumar has insured his house for Rs.5 lacs and suffers a loss of Rs.1 lac due to fire. At the time of loss the surveyor finds that the actual market value of the house is Rs.10 lacs. In this case applying the above formula the claim will be as under:

Loss = 1 lac sum insured = 5 lacs Market Value = 10 lacs

Therefore, 1 lac X 5 lacs / 10 lacs = 50,000/-

Claim = Rs 50,000/-

5.11 COROLLARIES OF INDEMNITY

There are two corollaries to the principle of Indemnity and these are Subrogation and Contribution.

1. Subrogation

It has already been established that the purpose of Indemnity is to ensure that the Insured does not make a profit or gain in any way as a consequence of an accident. He is placed in the same financial position, which he had occupied immediately before the loss occurred.

As an off shoot of the above it is also fair that the insurer having indemnified the insured for damage caused by another (A Third Party) should have the right to recover from that party the amount of damages or part of the amount he has paid as indemnity.

This right to recover damages usually lies with the bereaved or injured party but the law recognises that if another has already paid the bereaved or injured party then the person who has paid the compensation has the right to recover damages.

In case the insured after having received indemnity also recovers losses from another then he shall be in a position of gain which is not correct and this amount recovered from another shall be held in trust for the insurer who have already given indemnity. Subrogation may be defined as **the transfer of legal rights of the insured to recover, to the Insurer.**

CASE STUDY -

Why Subrogation is called a corollary of Indemnity and not treated as a separate basic Principle of Insurance can be traced to the judgement given in the case of Casletlan V Preston (1883) in U.K.

"That doctrine (Subrogation) does not arise upon any terms of the contract of Insurance, it is only the other proposition, which has been adopted for the purpose of carrying out the fundamental rule i.e. indemnity. Which I (Judge) have

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mentioned “it is a doctrine in favour of the underwriters or insurers, in order to prevent the insured from recovering more than a full indemnity; it has been adopted solely for that reason.”

Subrogation does not apply to life and personal accidents as these are not contracts of Indemnity. In case death of a person is caused by the negligence of another than the legal heirs of the deceased can initiate proceedings to recover from the guilty party in addition to the policy proceeds.

If the insured is not allowed to make profit the insurer is also not allowed to make a profit and he can only recover to the extent he has indemnified the Insured.

Subrogation – How?

Subrogation can arise in 4 ways

(i) Tort

(ii) Contract

(iii) Statute

(iv) Subject matter of Insurance

(i) Tort: When an insured has suffered a loss due to a negligent act of another then the Insurer having indemnified the loss is entitled to recover the amount of indemnity paid from the wrongdoer.

The Insured has a right in Tort to recover the damages from the individuals involved. The Insurers assume these rights and take action in the name of the insured and take his permission before starting legal proceedings.

Another reason for seeking permission of the insured is that the Insured may be having another claim which was not insured arising from the same incident which he may wish to include because the law allows one to sue a person only once for any single event.

(ii) Contract: This can arise when a person has a contractual right to compensation regardless of a fault then the Insurer will assume the benefits of this right.

(iii) Statute: Where the Act or Law permits, the insurer can recover the damages from Government agencies like the

Risk (Damage) Act 1886 (UK) gives the right to insurers to recover damages from the District Police Authorities in respect of the property damaged in Riots which has been indemnified by them.

(iv) Subject Matter of Insurance: When the Insured has been indemnified and the property treated as lost he cannot claim salvage as this would give him more than indemnity. Therefore when Insurers sell the salvage as in the case of damaged cars it can be said that they are exercising their right of subrogation.

Subrogation – When?

According to common law the right of subrogation arises once the Insurers have admitted the claim and paid it. This can create problems for the Insurers as delay in taking action could at times hamper their chance of recovering the damages from the wrongdoer or it could be adversely effected due to any action taken by the Insured. To safeguard their rights and to ensure that they are in control of the situation from the beginning Insurers place a condition in the policy giving themselves subrogation rights before the claim is paid. The limitation is that they cannot recover from the third party unless they have indemnified the insured but this express condition allows the insurer to hold the third party liable pending indemnity being granted.

Many individuals having received indemnity from the Insurer lose interest in pursuing the recovery rights they may have. Subrogation ensures that the negligent do not get away scot free because there is Insurance. The rights which subrogation gives to the Insurers are the rights of the Insured and it places certain obligations on the Insured to assist the Insurers in enforcing their claims and not to do anything which would harm the Insurers chances to recover losses.

2. Contribution

Contribution is the second corollary of Indemnity.

An individual may have more than one policy on the same property and in case there was a loss and he were to claim from all the Insurers then he would be obviously making a profit out of the loss which is against the principle of Indemnity. To prevent such a situation the principle of contribution has been evolved under common law.

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Contribution may be defined as the "**right of Insurers who have paid a loss to recover a proportionate amount from other Insurers who are also liable for the same loss".** The common law allows the insured to recover his full loss within the sum insured from any of the insurers.

Condition of Contribution will only arise if all the following conditions are met:

1) Two or more policies of Indemnity should exist
2) The policies must cover a common interest
3) The policies must cover a common peril which is the cause of loss
4) The policies must cover a common subject matter
5) The policies must be in operation at the time of loss

It is not necessary that the policies be identical to one another. What is important is that there should be an overlap between policies, i.e. the subject matter should be common and the peril causing loss should be common & covered by both.

As said earlier common law gives the right to the insured to recover the loss from any one insurer who will than have to effect proportionate recoveries from other insurers, who were also liable to pay the loss. To avoid this the Insurers modify the common law condition of contribution by inserting a clause in the policy that in the event of a loss they shall be liable to pay only their "Rate-able proportion" of the loss. It means that they will pay only their share and if the Insured wants full indemnity he should lodge a claim with the other Insurers also.

Rateable Proportion

The accepted way to interpret the term Rate-able Proportion is exhibited. First being that the Insurers should pay in the proportion to the sum insured for example

Sum Insured Policy A	=	10,000/-
Sum Insured Policy B	=	20,000/-
Sum Insured Policy C	=	30,000/-
Total	=	60,000/-

Notes

In case of a claim of Rs.6000/- the three insurers would be liable to pay in the proportion 1:2:3 i.e. 'A' pays Rs.1000/- 'B' pays Rs.2000/- and 'C' pays Rs.3000/-.

However, the draw back of this simplistic method is that the terms and conditions of the policies may be different and it would not be prudent to ignore these terms and conditions. For example, the condition of average may apply to one or more policies or there may be an excess clause in one policy which may effect their share of contribution to the loss. It would therefore be correct to assess the loss as per the terms and conditions of the individual policy and pay the claims accordingly. If by following this method the total sum of the liability of the Insurers is more than the claim amount then the Insurers shall pay in proportion to the amount of liability of each.

5.12 PROXIMATE CAUSE

There are three types of perils related to a claim under an Insurance policy

(1) **Insured Perils:** These are the perils mentioned in the policy as being insured e.g. Fire, lightening, storm etc. in the case of a fire policy

(2) **Excepted Perils:** These are the perils mentioned in the policy as being excepted perils **or excluded perils** e.g. Riot strike, flood etc. which may have been excluded and discount in premium availed.

(3) **Uninsured Perils:** Those not mentioned in the policy at all either in Insured or excepted perils e.g. snow, smoke or water as perils may not be mentioned in the policy.

Insurers are liable to pay claims arising out of losses caused by Insured Perils and not those losses caused by excepted or Uninsured perils.

Example: If stocks are burnt then the cause of loss is fire which is an Insured Peril under a fire policy and claim is payable. If the stocks are stolen the loss would not be payable as Burglary is not an Insured peril covered in fire policy Burglary policy is needed to take care of 'theft'.

It is therefore important to identify the cause of loss and to see if it is an Insured peril or not before admitting a claim.

Need to Identify Proximate Cause

If the loss is brought about by only one event then there is no problem in settlement of liability but more often than not the loss is a result of two or more causes acting together or in tandem i.e. one after another. In such cases it is necessary to choose the most important, most effective and the most powerful cause which has brought about the loss. This cause is termed the Proximate Cause and all other causes being considered as "remote". The proximate cause has to be an insured peril for the claim to be payable.

The following illustration may help in distinguishing between the proximate cause and the remote cause.

I. "A person was injured in an accident and was unable to walk and while lying on the ground he contracted a cold which developed into pneumonia and died as result of this. The court ruled that the proximate cause of death was the accident and Pneumonia (which was not covered) was a remote cause and hence claim was payable under the Personal Accident Policy."

II. "A person injured in an accident was taken to a hospital where he contracted an infection and died as a result of this infection. Here the court ruled that infection was the proximate cause of death and the accident was a remote cause and hence no claim was payable under the Personal Accident Policy.

The Meaning of Proximate Cause

The doctrine of proximate cause is based on the principle of cause and effect, which states that having proved the effect and traced the cause it is not necessary to go any further i.e. cause of cause. The law provided the rule "Cause Proxmia non Remote spectator". The **immediate cause and not the remote one** should be taken into consideration.

Therefore the **proximate cause should be the immediate cause. Immediate does not mean the nearest to the loss in point of time but the one most effective or efficient.** Thus if there are a number of causes and the proximate cause has to be chosen the choice should be of **the most predominant and efficient cause i.e. the cause which effectively caused the result.**

Proximate cause has been defined as **"The active efficient cause that sets in motion a train of events which bring about a result without the intervention of any force started and working actively from a new and independent source".** (This definition comes from the ruling given in the case Pawsey v/s Scottish Union and National Insurance Co. (1907).

It is important to note that in **Insurance Proximate has got nothing to do with time even** though the Dictionary defines Proximity as 'The state of being near in time or space' (period or physical) and the Thesaurus given the alternate words as "adjacency of" "closeness", "nearness" "vicinity" etc. **But in Insurance Proximate cause is that which is Proximate in efficiency. It is not the latest but the direct, dominant, operative and efficient cause.**

Losses can occur in the following manners:

i. Loss due to a single cause.

ii. A series or chain of events one following and resulting from the other causing the loss

iii. A series or chain of events which is broken by a new event independently from a different source causing the loss – Broken sequence and

iv. A contribution of two or more events occurring simultaneously and resulting in loss

1) In the case of a single cause being the cause of loss then if that peril is covered the claim is payable and if not covered claim is not payable.

2) Loss due to a series or chain of events. This can be illustrated by the following example event.

a) A driver of a car meets with an accident

b) As a result of the accident he suffers from concussion (shock)

c) Because of the concussion he strayed around not aware where he was going

d) While straying he fell into a stream

e) He died of drowning in the stream

It is clear that the above is a chain of events one leading to the other. The proximate cause would be accident (covered under PA Policy) which resulted in concussion (Disease – not covered) and hence the claim would be payable.

Irrespective of the fact that subsequent causes are covered or not if it is established that the event starting the chain is a covered peril then claim is payable.

However if reverse were the case and the chain was started by an excepted or excluded peril then the claim would not be payable.

For e.g. A person suffers a stroke and falls down the steps resulting in his death. He will not be entitled to any claim under his personal accident policy as the chain was started by a stroke which is an excepted peril.

3. In case of the Broken sequence or Interrupted chain of events if the chain of events is started by an Insured peril but interrupted by an excepted or excluded peril then the claim is paid after deducting the damage caused by the excluded peril. For example, the burglars enter the house and leave the gas stove on leading to a fire and the house is damaged in the fire. The “burglary Insurance” will only pay for the loss due to theft but exclude loss due to fire, which is accepted peril under the burglary policy.

   In case the sequence of events started by an excluded peril is broken by an Insured peril, as a new and independent cause then there is a valid claim for even the damage caused by exempted peril. The burglars enter the house and after carrying out thefts put the house on fire. The fire policy will pay for the damages due to theft as well (which is an excluded peril).

4. In the case of loss due to concurrent causes or two or more causes occurring simultaneously then all the causes will have to be Insured perils only then the claim would be payable but even if one of the causes is an excluded peril the claim will not be payable.

Example: A house collapses due to an earthquake, which results in fire. Under the fire policy earthquake is not a covered risk, hence the claim will not be payable.

To really understand the complexities of Proximate cause and its proper identification one must go through the case studies and a few are being given hereunder.

Case Studies:

Example I

An army officer insured under a personal accident policy, which excluded accident directly or indirectly due to war during war time went to the railway line to inspect the sentries. While on the visit he was hit by a train and he died as a result of the accident. It was ruled that the policy did not cover as he was there on the line because of the war and the policy did not cover accident due to war.

Example II

A surveyor on surveying a factory damaged in a fire came to the conclusion after detailed investigation that the fire was caused by negligence as well as defective design and both these causes worked together to cause the damage. While the Insurance policy covered negligence it did not cover Defective Design and hence claim was denied.

Example III

In an incident where stocks of potatoes kept in a cold storage got damaged due to leakage of ammonia gas. The stock was insured against contamination / Deterioration / putrefaction due to rise in temperature in the refrigeration chamber caused by any loss or damage due to an accident. The Insurance company did not pay the claim saying that the leakage of gas was not accidental and hence the risk was not covered. The aggrieved approached the consumer forum which held that the leakage of gas was not foreseen or premeditated or anticipated and loosening of the nuts and bolts of the flanges. The consequential escape of gas was within the meaning of the word accident and hence ordered the Insurance Co. to pay the claim.

5.13 SUMMARY

Basically the principle of indemnity and their corollaries and proximate cause has been formulated so that any person does not make profit out of the insurance transaction. The basic purpose of insurance is that the insured is put in same financial position as he was before the loss.

5.14 TERMINAL QUESTIONS

1. Explain the relationship between the doctrine of indemnity and the principle of insurable interest.
2. How does the principle of subrogation suplement the doctrine of indemnity?
3. Explain the presence of insurable interest in various general insurance contracts.

5.15 OBJECTIVE TYPE QUESTIONS

1. When there is a fraudulent non disclosure of material facts the insurance contracts becomes:

   a. voidable b. illegal

   c. unenforceable d. Void

2. The legal right to insure means

   a. Competence to enter into contract

   b. Insurable interest

   c. Utmost good faith

   d. Consideration

3. The principle of indemnity is applied in practice through

   a. Franchise deduction b. Deduction & depreciation

   c. Extra premium d. Excess clause deduction

4. Methods of providing indemnity are

   a. cash payment b. repair

   c. Replacement d. All

5. Statement A: The proposer need not to disclose facts which considers as not material

   Statement B: Facts which are common knowledge which the insurer is expected to need not be disclosed.

   a. Only A is true b. Only B is true

   c. Both are true d. Neither of two

6. Which of the following principles of law prevents an insured from making a profit out of his loss

   a. Insurable interest b. Caveat emptor

   c. Utmost good faith d. Indemnity

7. Statement A: The existence of other insurance must be disclosed.

   Statement B: Facts of law need not be disclosed.

   a. Only A is true b. Only B is true

   c. Both are true d. Neither of two

8. Insurable interest can be created

   a. by common law b. by statute

   c. by contract d. all of the above

5.16 ANSWERS TO INTEXT QUESTION

5.1

1. No you cannot insure your house under residential building because you are storing fire hazard material and if any claim arises then no claim will be payable.

2. No, you are not the owner of Red Fort.

   a. Only A is true b. Only B is true

   c. Both are true d. Neither of two

3. Insurers are liable to pay claims arising out of losses caused by

   a. insured perils b. uninsured perils

   c. excluded perils d. All

5.17 ANSWERS TO OBJECTIVE TYPE QUESTION

5.15

1. d	2. b
3 b	4. d
5. b	6. d
7. a	8. d