

Session 8: Legal Principles and Analysis of Insurance Contracts

1. Jake borrowed \$800,000 from the Gateway Bank to purchase a fishing boat. He keeps the boat at a dock owned by the Harbor Company. He uses the boat to earn income by fishing. Jake also has a contract with the White Shark Fishing Company to transport tuna from one port to another.
 - a. Do any of the following parties have an insurable interest in Jake or his property? If an insurable interest exists, explain the extent of the interest.
 1. Gateway Bank
 2. Harbor Company
 3. White Shark Fishing Company
 - b. If Jake did not own the boat but operated it on behalf of the White Shark Fishing Company, would he have an insurable interest in the boat? Explain.
2. Ashley purchased a dining room set for \$5000 and insured the furniture on an actual cash value basis. Three years later, the set was destroyed in a fire. At the time of loss, the property had depreciated in value by 50 percent. The replacement cost of a new dining room set at the time of loss was \$6000. Ignoring any deductible, how much will Ashley collect from her insurer? Explain your answer.
3. Nicholas owns a laptop computer that was stolen. The laptop cost \$1000 when it was purchased five years ago. A similar laptop computer today can be purchased for \$500. Assuming that the laptop was 50 percent depreciated at the time the theft occurred, what is the actual cash value of the loss?
4. Megan owns an antique table that has a current market value of \$12,000. The table is specifically insured for \$12,000 under a valued policy. The table is totally destroyed when a tornado touches down and damages Megan's home. At the time of loss, the table had an estimated market value of \$10,000. How much will Megan collect for the loss? Explain your answer.
5. A drunk driver ran a red light and smashed into Kristen's car. The cost to repair the car is \$8000. She has collision insurance on her car with a \$500 deductible.
 - a. Can Kristen collect from both the negligent driver's insurer and her own insurer? Explain your answer.
 - b. Explain how subrogation supports the principle of indemnity.
6. One requirement for the formation of a valid insurance contract is that the contract must be for a legal purpose.
 - a. Identify three factors, other than the legal purpose requirement, that are essential to the formation of a binding insurance contract.
 - b. Explain how each of the three requirements in part (a) is fulfilled when the applicant applies for an auto insurance policy.
7. Nicole is applying for a health insurance policy. She has a chronic liver ailment and other health problems. She honestly disclosed the true facts concerning her medical history to the insurance agent. However, the agent did not include all the facts in the application. Instead, the agent stated that he was going to cover the material facts in a separate letter to the insurance company's underwriting department. However, the agent did not furnish the material facts to the insurer, and the contract was issued as

standard. A claim occurred shortly thereafter. After investigating the claim, the insurer denied payment. Nicole contends that the company should pay the claim because she answered honestly all questions that the agent asked.

- a. On what basis can the insurance company deny payment of the claim?
 - b. What legal doctrines can Nicole use to support her argument that the claim should be paid?
8. Michael owns a small plane that he flies on weekends. His insurance agent informs him that aircraft are excluded as personal property under his homeowners policy. As an insured, he feels that his plane should be covered just like any other personal property he owns.
- a. Explain to Michael the rationale for excluding certain types of property, such as aircraft, under the homeowners policy.
 - b. Explain some additional reasons why exclusions are present in insurance contracts.

9. A manufacturing firm incurred the following insured losses, in the order given, during the current policy year.

<i>Loss</i>	<i>Amount of Loss</i>
A	\$ 2500
B	3500
C	10,000

How much would the company's insurer pay for each loss if the policy contained the following type of deductible?

1. \$1000 straight deductible
 2. \$15,000 annual aggregate deductible
10. Stephanie owns a small warehouse that is insured for \$200,000 under a commercial property insurance policy. The policy contains an 80 percent coinsurance clause. The warehouse sustained a \$50,000 loss because of a fire in a storage area. The replacement cost of the warehouse at the time of loss is \$500,000.
- a. What is the insurer's liability, if any, for this loss? Show your calculations.
 - b. Assume that Stephanie carried \$500,000 of property insurance on the warehouse at the time of loss. If the amount of loss is \$10,000, how much will she collect?
 - c. Explain the theory or rationale of coinsurance in a property insurance contract.
11. Andrew owns a commercial office building that is insured under three property insurance contracts. He has \$100,000 of insurance from Company A, \$200,000 from Company B, and \$200,000 from Company C.
- a. Assume that the pro rata liability provision appears in each contract. If a \$100,000 loss occurs, how much will Andrew collect from each insurer? Explain your answer.
 - b. What is the purpose of the other-insurance provisions that are frequently found in insurance contracts?

12. Assume that a \$300,000 liability claim is covered under two liability insurance contracts. Policy A has a \$500,000 limit of liability for the claim, while Policy B has a \$125,000 limit of liability. Both contracts provide for contribution by equal shares.
 - a. How much will each insurer contribute toward this claim? Explain your answer.
 - b. If the claim were only \$50,000, how much would each insurer pay?

13. Ashley has an individual medical expense insurance policy with a \$1000 calendar-year deductible and a 20 percent coinsurance clause. Ashley had outpatient surgery to remove a bunion on her foot and incurred medical bills of \$10,000. How much will Ashley's insurer pay? How much will Ashley have to pay?

14. The Lincoln Saltdogs is a professional minor league baseball team in the American Association league. The clubhouse is insured for \$600,000 under a commercial property insurance policy with an 80 percent coinsurance clause. The current replacement cost of the clubhouse is \$1 million. After a playoff game for the league championship, a whirlpool tub for the players shorted out, and a fire ensued. The clubhouse sustained a \$100,000 fire loss. Ignoring any deductible, how much will the team's insurer pay for the loss?

Answer 1:

- (a) (1) The Gateway Bank has an insurable interest in the boat because it serves as collateral for the loan. Thus the Gateway Bank has an insurable interest in the amount of \$800,000.
- (2) The Harbor Company also has an insurable interest in the property. The Harbor Company is a bailee, and there may be possible legal liability if Jake is negligent while docking the boat and using the facilities. Also, the Harbor Company would lose rental income if the boat is damaged. The loss of rental income will support an insurable interest.
- (3) The White Shark Fishing Company also has an insurable interest in the property. Jake is acting as the company's agent, and his negligence can be imputed to the White Shark Fishing Company. Thus, potential legal liability for a negligent act by Jake would support an insurable interest.
- (b) Yes. Jake is using the boat and has a potential legal liability as a bailee if he should damage the boat. In addition, if the boat is damaged there may be a business income loss and the loss of earnings, which would also support an insurable interest.

Answer 2:

Actual cash value (ACV) is replacement cost less depreciation. Replacement cost is \$6000. Depreciation is \$3000 because the dining room set is 50 percent depreciated. Ashley would collect \$3000 as shown by the following:

$$\begin{aligned} \text{ACV} &= \text{Replacement cost} - \text{depreciation} \\ &= \$6000 - \$3000 \\ &= \$3000 \end{aligned}$$

Answer 3:

ACV is replacement cost less depreciation. Replacement cost of a new computer is \$500. Depreciation is \$250 because the laptop is 50 percent depreciated. Nicholas would collect \$250.

Answer 4:

Under a valued policy, the face amount of insurance is paid if a total loss occurs. Megan would collect \$12,000.

Answer 5:

- (a) No. If Kristen collects from her own insurer, she gives her insurer the right to subrogate against the negligent driver who caused the accident. Her insurer then has the legal right to collect damages from the negligent driver or negligent driver's insurance company.
- (b) Subrogation supports the principle of indemnity since the insured does not profit from the loss. By giving up subrogation rights, the insured does not collect twice for the same loss, which supports the principle of indemnity.

Answer 6:

- (a) Three additional factors are (1) offer and acceptance, (2) consideration, and (3) competent parties.
- (b) The applicant for an auto insurance policy fills out the application for insurance. This constitutes the offer. The insurer then accepts or rejects the offer. Consideration by the applicant is payment of the premium or a promise to pay the premium plus an agreement to abide by the conditions specified in the policy. The insurer's consideration is the promise to do certain things as specified in the contract, which can include payment of a loss from an insured peril, providing certain services,

or defending the insured. Each party must be legally competent and have legal capacity to enter into a binding contract. The applicant for auto liability insurance must not be a minor, insane, or intoxicated when he or she applies for insurance. Also, the liability insurer must have legal authorization to sell auto liability insurance.

Answer 7:

- (a) The insurer could attempt to deny payment of the claim on the basis of a material concealment.
- (b) The principal is responsible for all acts of the agents when they are acting within the scope of their authority. Also, knowledge of the agent is presumed to be knowledge of the principal with respect to matters within the scope of the agency. In this case, the agent knew that Nicole had a health problem and deliberately omitted this information from the application. This knowledge is imputed to the insurer. Thus, if the insurer issues the policy, it cannot later attack the validity of the policy on the grounds that Nicole concealed a material fact. Based on the doctrine of estoppel, the company could not deny liability for the claim. The agent told Nicole the health information would be given to the underwriters. Nicole relied on the agent's statement and believed she had coverage. Since the insurer is responsible for the acts of agents, including acts of omission and fraud, the company cannot deny liability for the claim.

Answer 8:

- (a) The homeowners policy excludes certain types of property such as aircraft because the protection is not needed by the typical insured. To cover aircraft under the homeowners policy as personal property would be grossly unfair to other insureds who would then be required to pay substantially higher premiums for coverage they do not need.
- (b) Other reasons for exclusions include the following: (1) the peril may be considered uninsurable by commercial insurers; (2) extraordinary hazards are present; (3) coverage is provided by other contracts, (4) moral hazard is present; and (5) the loss may be difficult to determine and measure.

Answer 9:

- (1) Loss A \$1500
Loss B \$2500
Loss C \$9000
- (2) Loss A \$0
Loss B \$0
Loss C \$1000. The three losses total \$16,000. Since the annual aggregate deductible is \$15,000, the amount paid after the occurrence of loss C is \$1000.

Answer 10:

- (a) \$25,000

$$\frac{\$200,000}{80\% \times \$500,000} \times \$50,000 = \$25,000$$

- (b) \$10,000
- (c) The fundamental purpose of coinsurance is to attain equity in rating. Most property insurance losses are partial and not total. If everyone in the insured group insures only for the partial loss rather than for the total loss, the premium rate for each \$100 of insurance would be higher. To promote rate equity, the insured who meets the coinsurance requirement is given a rate discount, while insureds who do not meet the coinsurance requirement at the time of loss are penalized according to the coinsurance formula.

Answer 11:

- (a) Company A has one-fifth of the total amount of insurance. Thus, based on the pro-rata liability clause, it will pay one-fifth of the \$100,000 loss or \$20,000. Company B and Company C will each pay \$40,000.
- (b) The purpose is to reduce profiting from insurance and violation of the principle of indemnity.

Answer 12:

- (a) Based on contribution by equal shares, each company shares equally in the loss until the share of each insurer equals the lowest limit of liability under any policy, or until the full amount of the loss is paid. Company A and Company B will each contribute \$125,000 toward the loss. At that point, the limit of liability under Company B's policy is exhausted. Therefore, Company A will pay the remaining \$50,000. Thus Company A pays a total of \$175,000 and Company B pays \$125,000.
- (b) \$25,000

Answer 13:

Ashley must first satisfy the \$1000 deductible. The insurer pays 80 percent of the remaining \$9000 of medical expenses, or \$7200. Ashley pays 20 percent of the remaining \$9000, or \$1800. Including the deductible, Ashley must pay a total of \$2800.

Answer 14:

The 80 percent coinsurance clause requires the insured to carry at least \$800,000 of property insurance to avoid a coinsurance penalty ($80\% \times \$1,000,000$). The clubhouse, however, is insured for only \$600,000, or three-fourths of the required amount. Thus only three-fourths of the \$100,000 loss will be paid, or \$75,000.