5. Law of Insurance

Insurance is the purchase of protection. You often take an umbrella to protect yourself against the heavy rain or sun. Insurance is something like that. The Insured or assured, protects himself against a serious risk (for example, burglary or fire) by making a payment called a premium, and securing the right to be indemnified by an insurer.

Insurance is thus an important feature of both commercial and domestic life. The institutions that provide insurance also represent a significant component of the Sri Lankan financial services sector. No business enterprise or individual engaged in business should ever forget the importance and need for insurance.

We can identify the following main benefits of insurance

- Insurance introduces security into business undertakings

Whether it be life, fire, motor vehicle, accident or marine insurance, it guarantees protection against large and uncertain losses that can occur in any business undertaking, in exchange for reasonable payments called premiums. For example, a fire can destroy the property or goods of a business but no one can with certainty forecast that such a fire will occur. Insurance provides for this uncertainty.

- Insurance increases business efficiency and enterprise

If it were not for the availability of insurance each businessman would have to establish his own financial provision and staff to safeguard his business (land, goods and motor vehicles etc.) against many possible and unforeseen accidents.

Insurance makes it possible to apportion and distribute costs of damage more equally. Everyone who insures his life or property or motor vehicles etc does not suffer so as to be compensated. Thus, that money that is saved is pooled together and invested and the collections from all the premiums plus the interest earned from the investment is then used to pay the claims of those who have suffered some loss or damage. Thus, insurance enables an equitable distribution of costs.

- Insurance serves as a basis for credit

Credit is most important to any business and insurance is a form of credit. For example, if a businessman wishes to borrow money from a bank on the security of his factory or house, the bank will insist that the factory of house be insured against fire and other damage. So also if a person imports or exports goods, marine or air-freight insurance will be required during the shipment of the goods. In both these illustrations, insurance acts as an integral part of the provision of credit to a business. Also, a life insurance policy is considered a good security by financial institutions like banks that lend money to individuals.

- Insurance is also a method of compulsory savings

This is especially so in the case of life insurance. The money you pay as an annual premium on your life policy, you will get back with interest and possible bonuses at the end of the period for which you insure your life, say at the end of 70 years. And, if you die before reaching that age, the beneficiary you have named will receive the amount for which you have insured your life.

- Prevalence of risk and desire for security

Insurance is about taking precautions against risk. A risk may be defined as the possibility of an unfortunate occurrence. While one can ignore and disregard risks with insignificant consequences, there are serious risks we must guard against. For example, the right of losing your pen or umbrella is accepted by many people but few will accept the loss of one's house by a fire or serious injury to oneself in a motor accident. Thus, the desire for security in the case of an accident or misfortune in the basis of all insurance.

Definition and explanation of insurance contracts

A contract of insurance may be defined as a contract whereby, in consideration of the payment of a premium, the insurer agrees to take upon himself a risk borne by the insured and to compensate the insured for any loss if the risk insured against does in fact occur. A stated earlier, the above definition shows that insurance is all about safeguarding possible risks. In effect, the insurance company says that in return for a payment of money, which is called a premium, it will cover the insured against loss or damage which may be cause by a specified risk. All premiums paid to the insurance company form a pool of money which the insurance company invests for further income. Thus, this money also grows or increases and from that larger pool of money the insurance company can meet any claims for loss or damage in individual cases.

Classification of Insurance

The main categories of insurance are;

i. General insurance
ii. Life insurance
iii. Marine insurance

General insurance includes all the different kinds of insurance that is available other than life and marine insurance. Hence general insurance will cover areas such as:-

a. Motor vehicle and house and contents insurance
b. Accident and sickness insurance
c. Fire and burglary (theft) insurance
d. Employees fidelity and cash in transit insurance
e. Travel insurance
f. Professional indemnity insurance.

Law relating to Insurance

As regards the common law governing insurance in Sri Lanka, life, fire and marine insurance is governed by English law: see section 2 and 3 of the Civil law Ordinance No. 5 of 1852. All other types of insurance described above is governed by the principles of Roman Dutch law.

Requirement of Insurable Interest

Before a person can obtain an insurance policy he must show that he has some "insurable interst" in the subject matter of the insurance. This requirement is an "insurable interest" is a requirement of the common law and not of statute law. An "insurable interest" means that the person seeking the insurance (the insured) will benefit from the preservation of the subject matter insured or be affected by its loss. The reason why the law insists on an "insurable interest: is to distinguish an insurance contract from a gambling or wagering contract and also to ensure that the insured will not willfully damage or destroy the subject matter of the insurance.

This requirement of an insurable interest has an important bearing on life insurance. In the case of life insurance, an insurable interest means that the person taking the insurance will sustain pecuniary loss on the death of the person whose life is insured. The insurable interest need only subsist when the insurance policy is taken. The policy is not affected if the insurable interest ceases to exist after the policy is taken and before the death of the insured.

The following are case law illustrating insurable interest in life insurance

i. A person always has an insurable interest in his own life and one spouse has an insurable interest in the life of the other spouse. *Griffiths v Fleming* [1909] 1 KB 805
ii. A parent normally, has no insurable interest in his child's life unless the parent is supporting the child. *Howard v Refuge Friendly Society* (1886) 54 LT 644
iii. Similarly, a child has no insurable interest in the parents' lives unless the child is being supported by the parents.
iv. Sisters have no insurable interest in each other's lives. *Evanson v Crooks* (1911) LT 264
v. A creditore has an insurable interest in the life of the debtor to the extent of the amount of the debt. *Dalby v Indian and London Life Assurance Co* (1854) 15 CB 365
vi. A surety (guarantor) of a debt, has an insurable interest in the life of the principal debtor and so have joint debtors in each others lives to the extent of half the debt. *Banford v Saunders* (1877) 25 WR 650
vii. An employee engaged for a term of ears has an insurable interest in the life of his employer for that period for which he is employed because if the employer dires the employee may lose his employment and therefore his wages. A manager of a theatre where artists and actors perform has an insurable interest in the life of anactor engaged by him to perform at his theatre *Habden v West* (1863) 3 B&S 597

The requirement of an "insurable interest" in general insurance, other than life insurance, is illustrated in the well-known English case of *Macaura v Nothern Assurance Co Ltd* (1925) AC 619.

> In that case, Macaura had sold his business to a company in which he was the major shareholder. The property which was also transferred to the company had been insured in Macaura's name. After the transfer to the company, the property was destroyed by a fire and when Macaura claimed under his insurance policy, the insurer refused to pay arguing that after the transfer Macaura had no insurable interest in the property because it now belonged to the company. This argument was based on well-known principles of company law that a company is a separate and distinct legal entity from its shareholders – however large the shareholding. The English House of Lords upheld this argument and held that when the fire occurred it was not Macuara but the company that had an insurable interest in the property and since the insurance policy was not in the company's name, the insurer was not liable to pay for the loss.

The duty of utmost good faith in insurance

Contracts of insurance are considered as special types of contracts which impose a duty of utmost good faith on the person applying for the insurance cover. The requirement of utmost good faith is normally referred to by the Latin *uberrimae fidei*. Utmost good faith is higher than good faith for which the Latin term is *bona fidei*.

Utmost good faith means that the person seeking the insurance owes a duty to disclose to the insurer every material fact which he knows or ought to know about the insurance so that the insurer can properly evaluate the risk he is undertaking. If a material fact is not disclosed by the person seeking insurance, the insurer has a right at any time to reject payment on the policy.

The cost of the insurance policy or the premium that has to be paid will normally depend on the risk undertaken. The insurer can only evaluate the risk and decide on the premium etc. on the basis of what is disclosed to him in the application. Normally, only the person seeking the insurance and not the insurance company will know the true facts about the subject of the insurance. For example, if a person who is asking for a life policy is suffering from a serious illness he must disclose that fact in his application form. If he does not do so any life policy that is issued to him can be later invalidated.

Only material facts need be disclosed

A fact is material if it would influence the judgment of a prudent insurer in deciding whether to accept the risk and if so, in fixing the amount of the premium. As an illustration *London Assurance v Mansel* (1879) 11 ChD 363, where Mansel applied for a life insurance policy, he was asked if he had applied to other insurance companies for such a policy. He said that he had insurance policies with two other companies but he did not reveal the fact that his application for life insurance had been rejected by several other companies. The court held that mansel had failed in his duty of utmost good faith to disclose a material fact and therefore his policy could be set aside.

In *Looker v Law Union Insurance Company* [1928] 1 KB 554, Looker, who applied for a life policy was badly ill from an attack of pneumonia, but he did not disclose this fact to the insurance company. After the policy was issued to him he died because of the illness. The court held that the insurance company could refuse to honour the policy because of non-disclosure of a material fact.

On the other hand, in *Mutual Life Insurnace Co. v Ontario Metal Product Company* [1925] AC 344, an applicant for life insurance was asked whether he had consulted a doctor during the past five years. He answered "none" when in fact he had consulted a doctor for influenza and had received some tonic but he had not kept away from work because of that illness. The doctor for the insurance company conceded that even if he had known these facts he would have still recommended the life policy. On these facts, the court held that the non-disclosure by the applicant was not a material non-disclosure and did not affect the validity of the policy.

Why it is important to declare material facts to insurer

It is only by the disclosure of material facts that the insurance company can evaluate the risk they are undertaking and fix an appropriate premium to be paid for the insurance policy. For example, in the case of a motor vehicle insurance, if the person seeking the insurance has been earlier convicted on several occasions for dangerous driving or driving under the influence of liquor, then obviously such a person is prone to motor accidents. In such a case, the insurance company must be told of these prior convictions. Then they may decide to refuse the insurance or to demand the payment of a higher premium or limit the risks to a specified amount, for example, not exceeding Rs. 1 million for any injury or damage to the car, the driver and/or passengers.

In the Australian case of *Khoury v General Insurance Office* (1984) 165 CLR 622, Khoury applied for an insurance to protect his goods and valuables in his household. At that time, Khoury had a suspicion that his own children and robbed him of money kept in his house, but he did not disclose this fact to the insurance company when he applied for the household insurance. Subsequently, goods were stolen from his house and he claimed the loss on the insurance policy. The Court held that the insurance company was not liable because Khoury has not disclosed a material fact to them.

Effect of misrepresentation in Insurance

While non-disclosure of a material fact may entitle the insurance company to refuse the payment of a claim, misrepresentation of a material fact, can also have a similar effect. It does not matter whether the misrepresentation was fraudulent (deliberate) or innocent. In both cases the insurance company can refuse to pay the insurance claim. As an illustration in the case of *O'Connor v BDB Kirby & Company* [1971] 2 WLR 1233, in an insurance application form to be filled up, O' Connor mistakenly stated that the car that was to be insured was normally parked at night in the street outside O'Connor's house. Subsequently, the car was damaged when it was parked on the street. The court held that even though the misrepresentation was not deliberate, the insurance company was entitled to reject the claim.

Concept of 'indemnity' and 'subrogation' in insurance

Most insurance contracts (other than life insurance) are indemnity contracts. The words "indemnity" or "to indemnify" means to make good or compensate for loss or damage suffered or to give security against any anticipated loss or damage. The basis of the indemnity is that the insured is contractually entitled to have a loss compensated. In insurance contracts, the insurer indemnifies the insured to pay the amount of the insured's actual loss upto the amount covered by the insurance policy. Also, if the insurer pays on the insurance policy, he is *subrogated* to any right of action which the insured may have against anyone who may be legally liable for the loss that was compensated. Under this doctrine of subrogation when the insurer honours the claim of the insured under the insurance policy, the insurer is placed in the position of the insured.

For example, if goods insured by Mr. Silva with an insurance company are damaged by a fire negligently caused by Perera, and the insurance company pays Silva under the policy, then the insurance company can sue Perera for the damage caused to Silva which the insurance company settled with Silva. Under the principle of subrogation Silva's rights to sue Perera pass to the insurance company.

The indemnity feature in insurance also means that the insured is only allowed to recover from the insurer his loss, and must not make a profit out of the insurance. As an illustration in the English case of *Castellain v Preston* (1883) a house was insured against fire risk. The insured sold the house, but before completion of the sale, that is, before the vendor conveyed the house to the purchaser, the house was damaged by fire. The insurer paid for the damage, for pending conveyance, the vendor was, of course, still the owner. Later the purchaser paid the full price for the house and when the insurers heard of this they claimed the return of their payment under the policy. It was held that the action should succeed for otherwise the assured would have made a profit on the insurance.

Special Feature of Life insurance

Uncertainty is a common feature in all insurance but uncertainty in life insurance is different from that in other types of insurance. This is because death unlike any other event is certain; no one can ultimately avoid it. The only uncertainty about death is as to when it will occur. In the case of non-life insurance, property insured against loss by fire may never catch fire and a motor vehicle insured against accidents may never be involved in an accident.

Accordingly, some classify life insurance as a type of contingency insurance, that is, a contract to pay a sum of money when the event insures against (namely, death) occurs. And, because death is ultimately assured, it is argued that life insurance should be called death assurance.

Duration of insurance cover

The duration of the insurance cover depends on the period of time for which the policy has been taken. In a general insurance policy (for example, motor, fire and household contents insurance) the duration is usually for one year. Accordingly, it is always wise for the insured to give standing instructions to the insurance company to renew the policy at the end of each year and to send the invoice to the insured for the payment of the annual premium. If this is not done the insured may forget to renew the policy and the subject matter of the insurance will not be protected.

In a life insurance policy the duration can be for a specified term, for example 10 years or for the insured person’s lifetime, or as in the case of an endowment policy, upto a certain age.