



**GWILYM WILLIAMS**

# **UNDERSTANDING INSURANCE**





267875

Gwilym Williams

# Understanding Insurance



WATERLOW PUBLISHERS LIMITED

*Dedicated to my Father, L.W.*



First Edition 1983

© Gwilym Williams 1983

Waterlow Publishers Limited

Maxwell House

Worship Street

London EC2A 2EN

A member of the British Printing &  
Communication Corporation PLC

*British Library Cataloguing in Publication Data*

Williams, Gwilym

Understanding insurance.—(Waterlow's business library)

1. Insurance

I. Title

368

HG8051

ISBN 0-08-039138-9

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of Waterlow Publishers Limited.

Designed by The Graphic Partnership

Printed in Great Britain by

A Wheaton and Co Ltd

Hennock Road, Exeter EX2 8RP

# Preface

This book offers a basic introduction to the main elements of insurance, for businessmen, managers and students of commerce presented in a concise and easily digested form. It is not intended to be an exhaustive survey of all aspects of insurance.

The early chapters contain a brief analysis of the main principles which are fundamental to the effective operation of insurance for business or private purposes. The section covering the principle of 'utmost good faith' examines how the duties of an insurance policy holder extend beyond the payment of a premium. Under the heading 'indemnity' there are illustrations of how the terms of an insurance policy specify the amount of compensation which may be payable when a claim is submitted.

Subsequent chapters study the main types of insurance including fire, employers' liability, motor, marine and life assurance as well as more specialised policies covering credit and legal expenses, for example. Where relevant an introductory historical background is followed by details of, for instance, the cover available under a standard fire policy and what is intended to be useful guidance on the methods of calculating and obtaining adequate cover.

The final chapters examine the operation of insurance in practice from the completion of proposal forms to the content of policy documents and the submission and investigation of claims.

A multi-national business concern's operations may create the need for all of the types of insurance referred to in the text and a profile is given of the role of the specialist 'risk manager' who is engaged by such organisations to assess how those operations may be protected by insurance or modified with safety precautions. There is also a separate section covering 'loss prevention' and where proper advice may be obtained.

I would like to thank the many people who assisted in the preparation of this book; in particular Jen Watson for typing the manuscript; Gavin McFarlane and Kate Robertson.

Gwilym Williams  
Great Lumley 1983

# Contents

<b>Chapter 1</b>	<b>General Principles</b>	
1.1	Introduction	1
1.2	Risk Element	1
1.3	General Features	2
1.4	Classification of Insurance	2
1.5	General Benefits	3
1.6	The Contract	3
1.7	Insurable Interest	4
1.8	Utmost Good Faith	6
1.9	Indemnity	8
1.10	Subrogation	11
1.11	Proximate Cause	13
<b>Chapter 2</b>	<b>Fire and Damage Policies</b>	
2.1	Introduction	15
2.2	Standard Policy	15
2.3	Special Perils	16
2.4	Combination Policies	17
2.5	Consequential Loss Policies	17
2.6	Value Policies	18
2.7	Stock Policies	18
2.8	Rent Policies	19
<b>Chapter 3</b>	<b>Personal Insurance</b>	
3.1	Introduction	20
3.2	Accident Only	20
3.3	Accident and Sickness Policies	20
3.4	Permanent Health Policies	21
3.5	Private Medical Treatment	22

<b>Chapter 4</b>	<b>Employers' Liability</b>	
4.1	Introduction	25
4.2	Cover Required	25
4.3	Public Liability	26
<b>Chapter 5</b>	<b>Fidelity Guarantee, Bonds, Contingency Insurance</b>	
5.1	Fidelity Guarantee	29
5.2	Bonds	30
5.3	Contingency Insurance	31
<b>Chapter 6</b>	<b>Marine, Aviation and Engineering</b>	
6.1	Marine Insurance	33
6.2	Nature of the Cover	33
6.3	Types of Policy	34
6.4	Liability Insurance	35
6.5	Aviation	35
6.6	Cover Available	35
6.7	Compulsory Insurance	36
6.8	Engineering	36
6.9	Equipment Covered	36
6.10	Scope of Cover	36
<b>Chapter 7</b>	<b>Motor Insurance</b>	
7.1	Introduction	38
7.2	Compulsory Insurance	38
7.3	Types of Policy	39
7.4	Commercial Policies	41
7.5	Motor Trade	41
7.6	Foreign Motor Travel	41
7.7	Motor Insurers Bureau	42
7.8	Policy Selection	43
<b>Chapter 8</b>	<b>Life Assurance</b>	
8.1	Introduction	45
8.2	Types of Policy	46
8.3	Investment	47
8.4	General Features	49
8.5	Annuities and Pensions	51
8.6	General Features	51
<b>Chapter 9</b>	<b>Special Types of Insurance</b>	
9.1	Credit	56

9.2	Glass	57
9.3	Weather	57
9.4	Animals	58
9.5	Licence	60
9.6	Nuclear Risks	61
9.7	Satellites and Space	61
9.8	Kidnap, Ransom, Hijack	61
9.9	Environmental Damage	61
9.10	Legal Expenses	62
9.11	Business Acquisitions and Disposals	63
9.12	Driving	64
9.13	Household Policies	65
9.14	Libel	71
9.15	Contractors	71
9.16	Freezer	71
9.17	Sportsmen	72
<b>Chapter 10</b>	<b>Insurance Documents</b>	
10.1	Proposal Forms	73
10.2	Policy Documents	75
10.3	Premiums	77
10.4	Claims	80
10.5	Risk Management	84
10.6	Loss Prevention	85
10.7	Policy Selection	85
<b>Appendix A</b>	<b>Glossary of Terms</b>	87
<b>Appendix B</b>	<b>Useful Addresses</b>	91
<b>Appendix C</b>	<b>Further Reading</b>	92
	<b>Index</b>	93

# Chapter 1 General Principles

## 1.1. Introduction

Modern living and business activities in general involve the risk of sustaining losses of varying type and degree. At its most basic a policy of insurance provides for the payment of monetary compensation for losses sustained on the occurrence of an insured event.

Individuals and business managers are faced not only with the uncertainty of when losses may occur but also with the uncertainty as to the level of replacement costs. In the business community, where risks are great and the level of potential losses is high, a degree of security and certainty can be provided for managers by taking out insurance policies. By paying a premium based on assessed risk a commercial firm minimises its potential loss burden and its managers are free to concentrate financial resources and their own abilities on normal areas of operation.

From the insurers' point of view they hold a fund which has been pooled by contributors. The largest contributions are paid by those who are likely to make substantial or more frequent claims. However, the greater risks those contributors face are spread across all members of the fund.

The expertise of the insurer lies in fixing equitable contributions amongst members of the fund, setting competitive premium levels and maintaining a secure and profitable fund.

## 1.2 The Risk Element

Risk is capable of many definitions but it is the central basis of the contract of insurance. Essentially risk is the element of uncertainty as to whether losses may or may not be sustained. There are three basic types of risk:

- (a) *Pure risks* — involve either loss or preservation of the status quo. A warehouse may be covered against fire damage but no claims may ever be made on the policy;
- (b) *Speculative risks* — involve the prospect of gain as well as loss or the status quo position. Because of the element of speculation and the



prospect of gain such risks cannot normally be insured. For instance marketing a new product involves the risks of financial losses. However, market research conducted before the product is launched gives the entrepreneur a reasonably accurate assessment of demand for the product. He has an element of personal control over the risk involved; indeed he is unlikely to proceed if the research is unfavourable.

(c) *Fundamental risks* — are generally uninsurable as they can involve wide-ranging losses for businesses, individuals and society as a whole. They involve losses following occurrences such as war, and insurers are extremely selective if they agree to cover a risk of this sort.

### 1.3 General Features

A number of conditions must be satisfied before a policy of insurance can be considered. They are:

(a) insurance provides only monetary compensation when losses have occurred based, for instance, on the assessed value of goods at the date of loss. No allowance can be given for sentimental value of property;

(b) a specific loss must be unexpected, otherwise it is not usual for insurance cover to be given. Generally a person with a terminal illness is not likely to be accepted for life assurance and because shoplifting is a prevalent crime it will be excluded by insurers from the businessman's theft policy;

(c) losses which may be sustained as a result of a general disaster are normally excluded from cover. Insurers are unwilling to accept the responsibility for substantial claims by policy holders which might well exhaust the insurance fund. State funds may be made available on the occurrence of these events;

(d) normally it must also be possible to calculate the degree of risk attached to the insured event. Reference to statistical information enables insurers to offer a commercially reasonable premium.

These conditions may be fixed and subsequently varied by public policy, statute or commercial profitability, so far as insurers are concerned.

### 1.4 Classification of Insurance

A number of different classifications are used in the insurance world and vary from company to company. There is a basic division, however, between private and commercial business. A classification, introduced by the Insurance Companies Act 1974, divided work into (a) *general business*: property, personal, liability, motor vehicles; (b) *long term business*: life assurance and annuities.

## 1.5 General Benefits of Insurance

Although the main function of an insurance fund is to spread losses equitably among subscribers and to compensate claimants there are a number of subsidiary benefits. They are:

(a) *Security* Adequate insurance protection transfers the risk of unexpected losses from the business operator to the insurer and gives him a degree of confidence to enable him to concentrate his own skills on affairs in hand.

Even the smallest business enterprise may be at risk so far as losses to premises, machinery and stock are concerned. Modern machinery may bring with it risks which have to be carefully assessed. New legislation and developing case law concerning employee liability and in the product liabilities field present areas of risk and potentially crippling claims.

(b) *Efficiency* It is perfectly feasible for a profitable firm to guard against the risks of losses by setting aside special reserves. Insurance removes the need for such reserves, enabling such funds to be invested in production thereby putting profits to most effective use. Plainly, even the largest reserves could be exhausted by a series of substantial claims. Inflation, too, has a damaging effect by reducing the value of reserves while at the same time increasing the potential size of losses. The uncertainty these factors create can indirectly result in, or require increases in, operating charges. The firm whose insurance premiums are a known quantity can operate more cost effectively and need only pass on a smaller percentage of the risk premium to the customer.

(c) *Loss prevention* The benefits of diligent attention to potential loss assessment and prevention are twofold. First the risk of losses occurring can be reduced, and generally uninterrupted business operations are of more importance than monetary compensation. Secondly the more obvious benefit is in reduced premium ratings. Specialist surveyors and investigators engaged by insurers, will advise on installation of alarms, sprinkler systems and so on. Large firms will themselves employ a risk manager to study all aspects of their business activities. His functions are considered in more detail later.

## 1.6 The Contract of Insurance

A simple contract is an agreement between parties which they intend to be legally binding. Any party to the agreement may seek legal redress to have terms of the contract enforced or the payment of damages for non-performance of those terms. A contract of insurance falls within this definition and is generally evidenced in writing in the form of a policy document.

There are several factors which are essential elements to the contract of insurance. They are:

(a) *The Offer* Generally the person seeking insurance offers business to the insurer by submitting a proposal form. This form should contain, for the benefit of both parties, the fullest particulars of the proposer and the nature of the risk.

(b) *Acceptance* Having studied carefully the proposal form and assessed the risk the insurers may notify the proposer in writing or orally that they are prepared to give him cover from payment of the first premium. Unless conditions are introduced by the insurers, which require reconsideration by the proposer, the agreement becomes legally binding. It is, of course, essential for the person insured to verify that the insurers have in fact agreed to take on all the risks he proposed.

(c) *Consideration* Any party seeking to enforce a contract must show that consideration has passed from themselves to the other party: that is to say that they have performed some act — assumed some responsibility for the benefit of the other party. In the context of insurance, consideration passes from the insured to the insurer on payment of the premium. The consideration given by the insurer is his acceptance of the risk.

(d) *Validity* A contract of insurance may be unenforceable or rendered unenforceable because of actions of the insured. For instance trading activities in breach of government sanctions, or operating vehicles in breach of Road Traffic Regulations may invalidate the contract.

### 1.7 Insurable Interest

When a person insures his motor car or any of his property, that property is termed the subject matter of the insurance. However, the money he stands to lose, or more properly *the financial interest protected*, is termed the subject matter of *the contract of insurance*.

Before a binding policy of insurance can be effected there must be an insurable interest, that is, a legally recognised relationship between the subject of the insurance and the financial interest to be protected.

This principle is illustrated by the example of a sole shareholder in a private company who took out fire assurance in his own name to cover timber which he had sold previously to the company. When the timber was damaged he was unable to enforce the contract of insurance because the company owned the timber. He and the company were separate legal entities and his only interest in the company was the value of his shares. Without the requirement of insurable interest, insurance would assume the form of wagering contracts which are themselves unenforceable in law. Particular cases include:

(a) *Life Assurance* An individual has a clear financial interest in his own life. The same remarks apply to sickness insurance. Strictly there are no limits to the cover he may obtain but the size of premiums in relation to disposable income is a restricting factor.

In keeping with the insurable interest principle, where a person has a financial interest in another's life it is lawful for that person to effect insurance. A husband has a common law duty to maintain his wife, she is a dependant and her right to insure his life has been recognised by statute in the Married Women's Property Act 1882.

Consider too, the position of a person with a partnership interest in a business. The sudden death of this key member of a firm could have damaging repercussions for the firm's business. Losses might arise through delay and failure to meet completion or delivery dates; loans guaranteed personally by the deceased partner could be called in. Customers of the firm might suspend dealings with the firm until satisfied as to its continuing financial viability or existence. Partners are therefore permitted to insure the lives of each other. Another problem which can be solved by insurance is the purchase of the deceased partner's share in the business by the continuing partner.

Creditors may also lawfully insure the lives of their debtors but only for the amount of the debt outstanding at the date the policy is put into force.

(b) *Property Insurance* Another area where the principle of insurable interest can be more readily distinguished is property insurance. The owner of property has an obvious financial interest in it but there may be others who have similar financial and insurable interests in the property. For instance:

(i) *OWNERSHIP* Property may be part or jointly owned by several people. One of the joint owners may insure the property up to the value of his share or up to the value of the entire property. In the latter case if a successful claim were made on the policy, the excess above the value of the insured's own interest would be held on trust for the other co-owners.

(ii) *PROPERTY LOANS* Where property is mortgaged or charged as security for a loan, the lender is entitled to insure his security up to the value of the loan. It is important that the borrower appreciates this limitation particularly where under the terms of the loan agreement the lender effects the policy. The borrower should ensure that full reinstatement costs are covered and not simply the amount borrowed.

(iii) *BAILEES* Persons in lawful possession of goods belonging to others may be responsible for loss or damage. Garages, pawnbrokers and

repairers, for example, generally have a duty to take reasonable care of goods in their possession and therefore have the right to insure.

(iv) **AGENT** An agent can insure his principal's property provided the principal has an insurable interest to protect. For instance a company may insure employees' property against loss or damage whilst on company premises. The company acts as agent for its employees and the same agency principle exists where a motor vehicle policy covers other drivers using the vehicle with the owner's consent.

(v) **ADMINISTRATORS** Administrators are empowered under Grants of Administration to deal with property comprising deceased's estates. They owe a responsibility to the beneficiaries of the estate and therefore have the right to insure.

(c) **Liability Insurance** A business concern has a clear interest to protect in seeking to cover itself against potential claims arising out of breach of contract, negligence, or nuisance. There are qualifications in that, for instance, fines for breach of the Factories Act could not be covered but a civil claim by an employee for damages arising out of the same breach could be met by insurance.

### **1.8 Utmost Good Faith**

When parties enter into a normal commercial agreement they do so on an equal footing. For instance the purchaser of merchandise may ask for samples, state specifications or carry out durability tests. The more extensive his enquiries the more certain he will be about the bargain he is about to strike. Because the purchaser may make extensive enquiries at his own discretion, there is no obligation on the vendor to volunteer information that is not requested. What the vendor does say about his goods must not amount to misrepresentation or fraud but the law imposes no higher obligation.

Different considerations apply to a contract of insurance. When the insurer is assessing a proposal he makes many enquiries and evaluations but he cannot make a complete assessment of the risk proposed without the fullest co-operation of the proposer. To ensure that both parties are on an equal footing at the inception of the contract the law requires them to act in the utmost good faith.

So far as the proposer is concerned he must supply all material facts to the insurer, including details which the insurer may not have requested but which may have a bearing on the risk.

Similarly if the insurer has any information about the risk proposed which might affect the terms of the contract it must be disclosed. If either party fails to act with the utmost good faith the contract may be rendered null and void.

### (1) *Material Facts*

Facts which are material are legally defined as those which would influence a prudent insurer in fixing the risk premium. The test is an objective one and the views of the parties themselves on the importance of the facts are discounted.

Examples of facts which must be disclosed include: (a) *life assurance* — known present and past medical conditions; (b) *fire insurance* — construction materials of buildings; (c) *motor insurance* — driving convictions.

Facts which need not be disclosed include: (a) *facts of law* — insurers are deemed to have knowledge of the law; (b) *facts which reduce the risk* — such as the existence of a security system in premises insured against burglary; (c) *facts not within proposer's knowledge* — unless it can be shown that the facts could have been established by a reasonable man; (d) *facts of common knowledge* — which the insurer is presumed to know such as a state of war.

Although the above facts need not be disclosed, in practice the proposer is well-advised if he does disclose facts which clearly lessen the risk.

### (2) *Duty of Disclosure*

Common law imposes the duty whilst negotiations are taking place prior to the contract. Once the contract comes into force the insured is under no obligation to disclose changes occurring during the term of the contract.

In practice the common law position will be varied by conditions in the policy, reserving the insurer's right to terminate cover if changes in the risk are not disclosed.

Generally when contracts are about to be renewed there is a revival of the duty of disclosure. The exceptions are policies which were originally intended to be long-term, such as life policies.

Alteration of the terms of the policy imposes a duty on the insured to disclose all material facts relating to the proposed alteration.

### (3) *Breaches of the Duty*

Proposers may be in breach of their duty to act with utmost good faith by acts of commission or omission; that is to say, by making false declarations or failing to disclose material facts. Some breaches may be due to innocent errors on the proposer's part but other breaches may be deliberate fraud.

However the breach of duty may have arisen the offended party has several options: (a) to repudiate the contract entirely or to disclaim liability for a particular risk; (b) to sue for damages where fraud is

involved as well as repudiating the contract; (c) to waive the above rights and allow the policy to continue. Failure to exercise the above rights within a reasonable time might be interpreted as a waiver.

It should be noted that statutes, such as the Road Traffic Acts, which make insurance cover compulsory also prohibit insurers from disclaiming liability to third parties even though breaches of the duty have occurred. This ensures that insurance funds are kept available for third party claims, which is the whole object of compulsory insurance.

#### (4) *Current Trends*

For many years insurance contracts have been largely exempt from the general trend of legislation towards greater protection for the consumer. For example the Unfair Contract Terms Act 1977 which provides that any contractual terms may be subjected to the test of reasonableness, does not apply to insurance contracts. In their Fifth Report of 1957 only a minority of the Law Reform Committee recommended that the test of whether or not a material fact ought to be disclosed should be changed from the view of the reasonable insurer to the view of a reasonable man in the position of the proposer. At that time the Committee found no evidence to suggest that insurers abused the advantage given to them under Common Law but the case for implementing the above recommendations remains strong.

### 1.9 *Indemnity*

It has been seen from general principles that the prime functions of insurance are to provide security and compensation for loss, injury or damage.

How much compensation is payable when an insured event happens is governed by the long established indemnity rule. The insured's finances are to be restored to the position they were in before the loss or damage occurred, but no further. It would be against the public interest for a policy holder to make profit out of a claim as there would be a temptation to bring about the loss himself.

The indemnity principle cannot strictly apply to life assurance or personal injury claims because life and limb have no accurate measure in money terms. In these cases therefore the 'indemnity only' limit to compensation does not apply but in practice the sum assured is limited by the level of premium that the insured can afford. The insurers will also restrict the sum assured to be in keeping with the policy holder's current financial status. Thus, for example, only a successful actress or dancer may be able to insure her legs for a substantial sum.

#### (1) *Policy Limitations*

Full indemnity may be restricted by terms contained in the policy



document in the following ways:

- (a) the sum assured by the policy may be insufficient to provide complete indemnity. The insurers are obliged to pay only the sum assured even though the loss may exceed it;
- (b) an excess clause may require the policy holder to meet the first £25 of any claim. The insured therefore does not obtain full indemnity but in agreeing to pay an excess he may have obtained a premium reduction;
- (c) failure to insure property up to its full value may result in the operation of an average clause. In effect the insured has paid a reduced premium and the insurers reserve their right to compensate on the basis that they have only accepted a proportion of the risk;
- (d) a large commercial firm may agree to bear a substantial part of a potential loss if satisfied that they have adequate control over risks. A large excess of this sort is termed a deductible and results in premium reductions.

## (2) *Provision of Indemnity*

How an insurer provides indemnity generally depends upon the terms of the policy or the wishes of the policy holder. There are four basic means of providing indemnity. They are:

- (a) a cash settlement is often the most expedient, particularly where liability to a third party is involved;
- (b) where an item of property is capable of satisfactory repair the insurer will pay the repair bill. Restoring property to original condition amounts to an indemnity;
- (c) in many instances insurers may reduce costs by purchasing replacements at a discount, rather than making a full value cash settlement with the insured. As an example some insurers deal exclusively with one firm for replacement of shattered car windscreens. Their policyholders are supplied with an emergency telephone number for the firm concerned. Similarly it is often cheaper for an insurer to replace an almost new motor car with a brand new model purchased at a discount;
- (d) where property has been damaged by fire an insurer may agree to compensate by reinstating or rebuilding it.

## (3) *Assessment of Indemnity*

Policy terms and conditions may again dictate how the level of indemnity is to be assessed. There are, however, 'general rules' which are:

- (a) *Property* The market value of the goods at the date of loss is established and, where relevant, deductions are made for wear and tear.



Where loss or damage is only partial the cost of repairs is adequate indemnity. Sentimental value does not enter into the indemnity calculations as it is impossible to quantify in financial terms. Where business stock is concerned the value will be assessed as the actual purchase cost to the claimant (wholesaler or retailer) at the time of loss. As the subject matter of the insurance is the stock alone no account can be taken of loss of potential profits.

(b) *Pecuniary policies* Here a guarantee is made for cash compensation up to an agreed limit. A Building Society may effect a mortgage guarantee policy as additional security for a particular mortgage. If the society is forced to sell the mortgaged property to recover its loan a claim may be made on the guarantee policy to make good any short-fall between the sale price and the amount of loan outstanding. The indemnity under this type of policy is the actual cash loss incurred by the insured.

(c) *Personal Policies* These policies, such as personal accident or life policies, as previously discussed, do not strictly, indemnify. But the benefits payable will never exceed an amount which the insurers considered reasonable compensation in relation to the proposer's existing financial status.

(d) *Liability Policies* Indemnify the insured up to the level of damages and legal costs ordered by Court or negotiated.

Where property is not totally lost but is beyond economic repair it may well have a salvage or scrap value. In assessing indemnity the insurers may agree to pay the insured compensation for total loss and sell the salvage themselves. Alternatively the insured may wish to retain the salvage in which case its agreed value will be deducted from the total loss payment. Marine policies may also enable an insured to claim an immediate total loss payment even though total loss has not occurred at the time of the claim. A vessel may be grounded on rocks being gradually broken up but the insured may abandon the ship to the insurer and claim for total loss.

(4) *Special Policies*

(a) *New for Old Policies* Generally cover house contents and the insurer agrees to pay replacement costs without deductions for wear and tear. It is essential that the items are insured for full replacement costs otherwise the policy may revert to indemnity only.

(b) *Reinstatement Policies* Extend the 'new for old' principle of replacement or reinstatement of buildings and machinery. The insured does not receive a cash settlement; the insurer simply pays the reinstatement costs. Inflation and rising replacement costs mean that the sums insured