

T E X A S

P & C LICENSE
Study
GUIDE

**Property & Casualty Agents
Insurance Service Representatives**



*Independent
Insurance
Agents
of Texas*

Chapter 1

Insurance Principles & Concepts

Introduction

Chapter 1 introduces you to the insurance industry. A great many terms and concepts are presented in this chapter which will be important to an understanding of later chapters. You are encouraged to gain a thorough comprehension of this chapter before proceeding to the other topics.

Topic A An Overview of the Property/ Casualty Insurance Industry

The business of insurance in the United States is divided into three broad categories: life insurance, health insurance and property/casualty insurance. Altogether, the industry provides more than two million jobs and has responsibility for assets which total nearly \$3.9 trillion. But surely its greatest contribution to the American economy is its ability to absorb the financial consequences of loss for both individual and business risks. Without the mechanism of insurance, our economy could not exist.

The property and casualty arm of the industry alone is responsible for assets of nearly \$900 billion. **Property insurance** protects both individuals and businesses from the financial loss that arises from the destruction of property assets. For the individual or family, property insurance is needed for dwellings, the contents of dwellings and other personal property. For businesses, property insurance can be written to cover buildings (real property), equipment and machinery, furniture, inventory, business records and supplies, and other physical property. **Casualty insurance** is a general term that includes a variety of insurance coverages, such as liability, automobiles, crime insurance, bonds, aviation, boiler and machinery, and other forms of coverage.

The providers of property and casualty insurance are known as "insurers." There are several types of insurers that provide coverage for both personal and commercial risks. **Stock companies** are the dominant type of property/casualty insurers, controlling about 70% of the business. These companies are owned by stockholders. Stock companies can pay dividends to stockholders, and also to policyholders on a non-discriminatory basis. **Mutual companies** are owned by the policyholders who purchase insurance from the companies. Mutual companies can pay dividends to policyholders. Although mutual companies have the right to assess policyholders for additional funds necessary to keep the company solvent, almost all mutual companies today operate like stock companies, charging a non-assessable, fixed premium for their policies. There are other types of insurers, such as reciprocal exchanges, self-insurance plans, and lloyds syndicates, but they provide coverage for only a small segment of the market. Even the federal government and some state governments provide some forms of coverage, usually when a competitive market is not provided by standard insurers.

Insurers can also be classified by their place of origin. State laws refer to a **domestic insurer** as one organized under the laws of that particular state. A **foreign insurer** is organized under the laws of some other state within the United States. The term **alien insurer** usually refers to an insurer organized under the laws of a country other than the United States.

Regulation of the insurance business is accomplished by each individual state government. The laws governing insurance can vary significantly by state. For instance, one state may require that insurers obtain prior

approval of all rates the insurer wishes to charge for coverage. Another state may have no control over the rates charged. The federal government has only a limited role in regulating insurance. Most states require that companies meet certain minimum standards of financial strength and licensing. Companies complying with these standards are called **admitted** companies, or authorized insurers. A company choosing not to come under the regulation of a particular state can still write insurance in that state, but it does so as a **non-admitted** insurer, sometimes called an excess-surplus lines company.

Insurance companies are organized into a number of different departments that support the sale of insurance or provide services to policyholders. The **underwriting** department is responsible for selecting the risks to be insured by the company and determining an appropriate premium to charge. Underwriters usually do not deal directly with the insured, but rather accept information and applications from agents. The **sales and marketing** department promotes the company's insurance products and services, and provides support to the company's agents. **Loss control services** are provided to policyholders by a separate loss control or engineering department in most companies. The **claims** department is responsible for adjusting claims payable under the policies the company has written. There can be many other departments in a company responsible for technical support services and administrative functions. One activity that is important to all insurers today is the purchase of reinsurance. **Reinsurance** allows insurers to "sell" part of the risk they have assumed from a policyholder, and thereby write more insurance and protect the company from large losses it would not be able to handle on its own.

Most property/casualty insurance is sold by agents or brokers. **Agents** represent an insurance company and usually hold a contract with that company. **Brokers** do not represent any particular company, but act

instead on behalf of their clients in arranging insurance. Most states require that a broker work through a licensed agent in arranging for the purchase of insurance.

There are several types of agents, defined by their relationship with the insurance company. An **independent agent** usually represents several insurance companies. The independent agent works solely on a commission basis and makes the decision on which company will write an account. If the contract between the independent agent and the company is terminated, the agent retains the right to place the business with another company. A **captive agent** represents only one insurance company, and usually works on a commission basis. The captive agent has no right to the account records and usually cannot place business with another company. A **direct writer agent** is usually an employee of the company, working on a salaried basis with an additional commission or bonus. A **direct marketing insurance company** does not use agents. Rather, it sells insurance directly to the consumer.

This brief introduction to the property and casualty insurance industry will be useful to you as you continue your study of insurance and the responsibilities of insurance agents.

Topic B Definitions of Key Terms

Risk

Central to the understanding of the insurance concept is an understanding of "risk." Risk is a major component of our environment and is a condition in which losses are possible. Individuals and business entities are constantly faced with countless risks; e.g., premature death, destruction of property, automobile accidents, catastrophic illness, bankruptcy, liability lawsuits, etc.

Risk has been defined as the chance of financial loss or the uncertainty of loss. Without risk, there would be no need for the insurance industry. There are two types of

risk: pure risk and speculative risk. **Pure risk** exists when there is only a chance for loss without a simultaneous chance for gain. **Speculative risk** involves an opportunity for gain as well as loss. An example of pure risk is the risk of damage to property by fire. Investment in the stock market is a speculative risk. The significance of this distinction is that **only pure risks are insurable**.

Insurance

Insurance is defined as a contractual device for transferring risk to an insurance company in exchange for the payment of a premium.

Not all types of pure risks are suitable subjects for insurance. The possibility of loss must be sufficiently severe so that the cost of insuring becomes practical. Some losses fall into the category of maintenance losses, or part of the normal and expected cost of owning property or conducting a business.

Elements of Insurable Risks

Some types of loss are generally considered **uninsurable**, such as losses where the subject of insurance is illegal or against public policy.

There are five prerequisites a risk must generally satisfy in order to be commercially insurable.

1. **Independence.** Many persons or organizations must be independently exposed to the same or similar risk, and must purchase insurance to cover the risk, so that there will be sufficient numbers to allow the "**law of large numbers**" to work. The greater the numbers, the more accurate the statistics will be that permit an insurer to predict the **frequency** and **severity** of losses and calculate a premium to spread the cost of risk among all policyholders.
2. **Similarity of exposures.** A large number of insured persons is not enough to allow the law of large num-

bers to work. The exposures faced by the insureds must be similar.

3. **Definiteness.** The losses that occur as a result of the risk must be definite as to cause, time, place and amount.
4. **Calculability.** The expected loss amounts must be frequent enough and in an amount sufficient to permit calculation of rates that are equitable to all policyholders.
5. **Accidental.** The loss must be a random event over which the insured has no control. Losses caused intentionally by the insured person are not insurable. In addition, the insured cannot expect a loss to occur at a particular time.

Loss

In insurance terminology, **loss** means a reduction in value of an asset and the financial consequences of a reduction in value of an asset.

This definition implies a double meaning as there are direct losses as well as indirect losses. An example of a **direct loss** is damage to property caused directly by a fire. The property has been reduced in value as a direct result of the fire. Other losses may occur as an **indirect** result of the fire. For example, if the damaged property is a residence, the family residing there will most likely incur additional living expenses before the residence can be repaired, including the cost of a motel and eating out in restaurants.

Peril

The event that causes a loss is often referred to as a **peril**, such as fire or windstorm damage. Some policies use the phrase **cause of loss** instead of the term peril.

Proximate Cause

The courts have construed direct loss to mean that a peril must be the immediate or proximate cause of the loss as distinguished

from the remote cause. A peril is said to be the **proximate cause** where there is an unbroken connection between the peril and the loss without the intervention of a new and independent cause. For example, such things as water damage, damage by chemicals, firemen breaking down the door or smoke damage are considered direct losses caused by fire.

Indemnity

The primary focus of insurance is to indemnify the insured person when a loss occurs. **Indemnity** is the "heart" of insurance, and means to place the insured in the financial position that was held immediately prior to the loss. The concept of indemnity in insurance prevents an insured person from using insurance to realize a profit when a loss occurs. An attempt is made, through various clauses in the insurance contract, to promote this concept and allow recovery for the full amount of the loss without paying more than would be required to restore the insured to the pre-loss financial position.

Insurable Interest

Another insurance concept that attempts to control the payment of losses and thus support the principle of indemnity is the concept of **insurable interest**. This means that the insured person must have a financial interest in the continued existence of the subject of insurance.

In life insurance, the general rule is that the beneficiary must have an insurable interest in the life of the insured at the time the policy is issued.

In property insurance, however, an insurable interest must exist at the time of loss. A homeowner has an insurable interest in the home, as does the mortgagee holding a note on the real estate. Two owners having joint ownership may have an insurable interest equal to 50% of the property's value.

Underwriting

Insurance companies underwrite applications submitted by producers in order to accept or reject the application. **Underwriting** is defined as the process of hazard recognition and evaluation, risk selection, pricing, and determination of policy terms and conditions. The function of an underwriter, then, is to underwrite applications and accept those deemed to be capable of producing a profit for the insurance company. The company realizes a profit when the overall loss ratio of the company's book of business, when combined with the company's expenses for producing and servicing the business, is less than 100 percent. The **loss ratio** is determined by dividing the amount of money paid out in losses and loss adjustment expenses by the amount of premiums earned during a specific period of time.

The process of risk selection in insurance underwriting is critical to an insurance company's ability to make a profit. The term **adverse selection** in insurance underwriting refers to a situation when applicants for insurance are largely those most likely to suffer a loss. It is more prevalent with some exposures to loss, such as the flood peril, than others. Where flood insurance is available, only those persons most susceptible to flooding are likely to desire the coverage. Because of the risk of adverse selection, an insurance company must "select or be selected against." If the insurance company does not select its customers carefully, the customers may adversely select against the company. The fundamental purpose of underwriting, then, is to protect the insurance company against the consequences of adverse selection.

The underwriter is also concerned with proper pricing of the insurance policy by charging rates that are adequate to produce an overall profit but not so excessive that potential customers look elsewhere for their insurance needs. The process of **rate-making** is fundamental to insurance. The rate-making process attempts to obtain data concerning losses and, through the use of statis-

tics and basic concepts of probability, rates are promulgated. There are three basic rating-making systems. **Class or manual rates** are average rates applied to all members of a group. These rates are developed by grouping together insureds having similar characteristics in a single "class," such as all single male operators under age 25 in personal auto insurance. **Individual rates** take into account relative differences in insured subjects and allow insureds within a "class" of insureds to be charged different rates which reflect hazard differences, such as applying surcharges to individuals in the single male operator class based on the number of moving violations and accidents attributable to each. **Judgment rates** are developed when there are no distinguishable classes or individual rate systems that can be used, such as physical damage insurance on an unusual "classic" automobile, or when there are important and distinctive hazard differentials for an individual within a class.

Rate-Making In Texas

In Texas, rates for personal lines of insurance (personal auto and homeowners) and commercial auto are approved by the Insurance Commissioner in the form of "**benchmark**" rates, following an annual public hearing where competing interests (companies and consumer groups) present their rate recommendations based on actuarial studies. Insurance companies may file and use their own rates within 30 percent above or below the benchmark rate, or file rates outside that range subject to the Commissioner's approval. In commercial lines of insurance except commercial auto, insurance companies develop their own rates and rating plans which then must be filed with the Texas Department of Insurance. TDI may disapprove the filing for good cause. In reality, the companies usually file only "loss cost factors" which are applied to **loss costs** which have been previously filed with and approved by TDI. Loss costs are developed by insurance advisory organizations such as Insurance Services Office

(ISO) and Insurance Council of Texas (ICT).

Risk Management

Insurance is not the only method available to individuals and businesses to take care of the risks they face. A related concept has arisen out of the desire to manage risks rather than simply pay premium to an insurance company. This concept is called **risk management**.

Risk management is defined as "a process designed to systematically manage the pure risks of an organization or individual." Although the process can be quite complex, people have practiced the fundamentals of risk management for ages. Only recently, however, have risk management principles been identified and organized into a formal process with identified steps and systems. The steps in the risk management process include:

1. **Identifying and analyzing exposures.** In order to manage a risk, it is first necessary to identify the exposures that might cause a loss to the organization. There are several tools the risk manager can use to identify exposures, including **exposure survey forms and checklists**, **flow charts** depicting the business activity graphically, **financial statements** to identify assets and income exposed to loss, and **personal inspection** of the business locations and operations. Once identified, the exposures can be analyzed to determine potential loss frequency and severity.
2. **Formulating alternatives for dealing with each exposure.** There may be several alternatives the risk manager can consider to deal with each identified exposure. **Avoidance** eliminates the risk entirely by disposing of an existing exposure or not assuming a new one. This alternative is generally impractical and often impossible to accomplish. **Retention** means absorbing all or part of the risk involved with a particular exposure. This alter-

native works best when potential losses are small and/or frequent. The use of deductibles is one example of the retention alternative. **Sharing** as a risk management alternative refers to sharing the exposure to loss with another person or organization, such as would occur with a partnership or joint venture. **Reduction** is an exposure control technique that is designed to reduce the severity of losses that do occur. An automatic sprinkler system in a building, for example, will not eliminate the risk of fire, but it will control the fire and reduce the amount of loss. **Transfer** means to transfer the financial impact of losses to another party by contract, either through a hold-harmless clause in a business contract, or through an insurance contract written by an insurance company.

3. **Selecting best alternatives.** Once the exposures have been identified and analyzed and the various alternatives for dealing with them determined, the risk manager must select the best alternative, or combination of alternatives, to deal with each exposure.
4. **Implementing chosen techniques.** The risk manager must then decide how to implement the techniques that have been selected and delegate responsibility for each phase of the risk management program.
5. **Monitoring results.** The risk management program must be monitored on an ongoing basis to determine its effectiveness in dealing with new or changing exposures. If there is a problem, the risk manager reevaluates the program, essentially by going back to step #1.

Topic C Contract Law

Insurance Agreements as Contracts

The insurance policy is a document containing the contract between the insurance company and the insured and is subject to the legal conformity of the law of contracts. The essential elements of an insurance contract are:

- Agreement (offer and acceptance)
- Competent parties
- Legal object
- Consideration

Each should be examined carefully since all four elements must be present to form a valid contract, or in this instance, a valid insurance policy.

An **agreement** is the result of an offer by one party and the acceptance by the other. When an application is submitted to the company or agent, this is usually considered an offer. To become an agreement (contract) binding on both parties, the company must expressly accept the offer. The agreement may take the form of an oral binder by the agent who has authority to bind the business. In the property/casualty area, the agent usually has binding authority, and so the acceptance of the contract is validated by issuance of the binder.

Both parties must have the **legal capacity** to make a contract. The incompetency of either makes the contract voidable. Such incompetency may result from mental inability to comprehend the policy or because the applicant is a minor.

Those who are mentally ill may not be held to any contract consummated after they are considered mentally incompetent. The general rule is that one should be able to understand the nature of the transaction.

The purpose of the contract must be **legal**. Insurance may not be used to insure an illegal activity or for immoral purposes. Fur-

thermore, insurance requires the existence of an insurable interest.

Finally, there must be **consideration**. Both parties must give value or assume a responsibility. It's not necessary that the actual premium be tendered before coverage incepts. The mere promise to pay is construed to be proper consideration. The promise to pay must be evidenced in the form of a legally prescribed promissory note, partial premium or any settlement acceptable to the insurer.

Unique Features of Insurance Contract

The insurance policy has certain characteristics not found in the typical legal contract. Because of this uniqueness, we will consider the unusual aspects, some of which may also be found in non-insurance contracts.

Aleatory—Equal value is not paid by each party. The premium of the policy is not equal to the recovery amount that could be obtained in the event of a covered loss.

Adhesion—This term is descriptive of a standard form printed contract prepared by one party and submitted to the other party on a take-it-or-leave-it basis where there is no bargaining power on the part of one party. In the event of ambiguity in the wording, the doubts are resolved in favor of the insured because the company draws up the original contract and the insured has little or no control over the content.

Doctrine of Reasonable Expectations—This doctrine permits the reasonable and objective expectations of insureds regarding the terms of the insurance contract to be considered even though painstaking study of the policy provisions would negate those expectations. As the courts see it, the doctrine is necessary to protect individuals with little knowledge of insurance who buy standard policies. For example, there has been some application of the doctrine to an insurer's advertising brochures where the brochures seem to indicate broad coverage that the policy exclusions substantially nar-

rowed. Particularly with personal insurance coverages, certain courts have been sympathetic to insureds who have relied solely on brochures for an understanding of their coverage.

Executory—This describes a contract that promises action in the event of a future occurrence, where something is to be done in the future, as opposed to an executed contract where all things are simultaneously completed.

Unilateral—This is a contract in which only one party to the contract makes an enforceable promise. The insured exchanges the premium dollar for a future promise on the part of the insurance company to pay insured losses.

Conditional—In the event of loss, both sides must still perform certain acts to make the contract legally enforceable.

Utmost Good Faith—Since insurance is partly an abstract thing (i.e., the promise to pay in the future) and the insurance company is unable to completely control the causes of loss, both parties must bargain in good faith.

Personal Aspect—In the business of insurance, both the insurer and the policyholder consider the character, credit and conduct of each other. Contrary to popular belief, the insurance carrier insures the insurable interest of the insured and the property represents the object of this interest. Since the coverage does not attach to the property but to a person's interest in it, the policy does not pass with the house to the new purchaser. The insurance company wants to deal with each person on his or her own merits and must give written consent for an insured to assign a policy before a loss.

Representation, Fraud, Warranty and Concealment—These common-law concepts spring from the doctrine that the insurance contract is one of "utmost good faith." In insurance, the doctrine of warranties and representations are expressed in statutes and judicial decisions that gener-

ally favor the insurance carrier. Statements made by the prospective insured at the time of application for insurance are important. They may take the form of a representations or warranties.

Representations are not part of the insurance contract but are statements made by the applicant to the insurance company in the process of obtaining the policy. They may be in the written application or given orally. There is no presumption that they are material to the risk unless the company can prove that had the truth been known, it would not have issued a policy on the terms quoted. Representations usually concern facts of the past or present and rarely relate to future events. Generally, the courts have modified the common-law impact of representations and are reluctant to void a policy for a misrepresentation unless it placed the insurer at a serious disadvantage.

Fraud is an intentional perversion of truth for the purpose of inducing an insurer to accept an application or pay a claim. It is closely related to the concept of misrepresentation. If there is evidence of actual fraud, the insurer may void the contract.

Warranties are stipulations in the policy relating to the nature of the risk insured which conditions the liability of the insurance company. A warranty takes on a more serious impact and is presumed to be material to the contract, and if it is breached by the insured, the carrier may void the contract. Warranties often become part of the contract itself and represent an insured's promise that something is true at the present time or that he will do or refrain from doing something in the future. A common type of warranty is a promise by the insured to maintain a fire extinguishing system in working order.

Concealment is the failure to disclose known facts. Since insurance requires the applicant to tell the whole truth and nothing but the truth, it is incumbent upon him to reveal every fact material to the contract. When the applicant tells an untruth, he may

be guilty of **misrepresentation** but when he fails to speak and disclose pertinent facts, he may be guilty of **concealment**. The courts generally favor the insured rather than the insurer when the issue of concealment is a matter of litigation. The insurer must prove that the insured was fully aware that the fact concealed was material, that the insurer had no knowledge of the fact and, finally, that the insured's silence was motivated by an intent to defraud.

Application; Binding Authority

The **application** gives information regarding the insured and the identification of the insurance to be purchased. It is the basis for underwriting and rating of the policy. When presented by the agent, it is an invitation to make an offer (to purchase insurance). When completed by the insured, it becomes an offer. If the agent has **binding authority** and the risk falls within the classifications permitted by the company, he may bind the insurance company to the risk immediately. In effect, he accepts the offer made by the insured. The premium need not be paid at that time as the insured's "promise to pay" is construed as the consideration.

Binders are written evidence that coverage is in effect. While oral binders are accepted by courts, it is more prudent to always make a written record, including all pertinent data. In this fashion, all parties are aware of what is covered, and any special clauses that may apply. The binder should always include the name of the company that will underwrite the risk so any loss under the binder can be assigned to the correct company.

When binding authority is given to an agent by the insurance company, it represents a trust. The agent's word may place his carrier on the risk, and he must be careful not to exceed his binding authority. If he does so, and a loss occurs, the insurance company will be forced to pay the claim, but if the agent has exceeded his binding authority, the company may sue the agent for recovery.

Binder data should immediately be reported to the company. In no event should binders be backdated or used to provide gratuitous short-term coverage.

Waiver and Estoppel

Waiver is the intentional or voluntary relinquishment of a known legal right. **Estoppel** is the legal result of a waiver. These terms usually arise in claims handling situations. For example, a policy requires the insured to do certain things before a claim can be paid, such as promptly report the claim, furnish an inventory of damaged property, submit to examination under oath and furnish a signed sworn proof of loss. If the insurance company waives its right to require the insured to meet these conditions, then it is estopped from later using that breach of policy condition to void the coverage.

Topic D Common Policy Provisions

Topic D will develop certain principles of insurance policy construction in order to provide a basis for the analysis of specific policies in succeeding chapters.

Insurance Policy Construction

Any insurance policy may be divided into five basic parts:

- Declarations
- Insuring Agreement
- Exclusions
- Conditions and Miscellaneous Provisions
- Definitions

In many cases, policies do not use these specific labels. Still, every clause or provision of an insurance contract fits into one of these categories.

Declarations

The Declarations section identifies the parties to the contract (insured and insurer) and customizes the policy as to various aspects of the insurance being purchased.

Specifically, the Declarations specify:

- insured's name and address
- insurer's name and address
- policy period (inception and expiration)
- amounts of insurance
- premium
- list of coverage and other special information

Insuring Agreement

The Insuring Agreement describes the coverage provided by the policy, usually in very broad language, and includes the insurer's **promise to pay** for covered claims. The broad coverage that may be granted in this section is narrowed by the next three sections, Exclusions, Conditions and Definitions.

Exclusions

The exclusions section is necessary to narrow the scope of coverage to that intended by the policy. There are three basic reasons for exclusions: (i) to eliminate coverage provided by other types of policies, (ii) to eliminate coverage for certain types of losses not contemplated by the rate and (iii) to eliminate coverage for uninsurable perils.

Conditions and Miscellaneous Provisions

Insurance policies are "conditional" contracts requiring the insured to perform certain duties if he expects to finalize a claim. This section identifies those duties and establishes certain "rules" concerning cancellation, dispute resolution, other insurance and other rights of both parties to the contract.

ISO Common Policy Conditions

The series of policies supported by the Insurance Services Office are all tied together by a single Common Policy Conditions form. This form is attached to all ISO policies, whether written as a single coverage form or as a package of several coverage forms. The standard form includes the following sections:

- **Cancellation** – describes provisions related to cancellation of the policy, including the methods by which the policy can be canceled, the number of days' advance notice the insurance company must give the insured when the company cancels, and the method for determining the return premium in the event of cancellation. It is not unusual for a state-specific amendatory endorsement to be attached to the policy, specifying additional or different cancellation requirements based on state law.
- **Changes** – provides that only the first named insured is authorized to make changes to the policy, subject to the insurance company's consent, and that the policy's terms can only be amended by an endorsement issued by the company.
- **Examination of your books and records** – authorizes the insurance company to examine and audit the insured's books and records related to the policy for up to three years after the policy expires. Such an audit is usually related to a policy that has been issued with a provisional premium based on an estimated value, such as payroll or sales.
- **Inspections and surveys** – authorizes the insurance company to inspect and survey the insured's operations, but makes it clear that the company is not obligated to do so. If the company does make an inspection, the company does not guarantee that conditions are safe.
- **Premiums** – specifies that the first named insured is responsible for premium payment and is the only payee for any return premium.
- **Transfer of your rights and duties under this policy** – prohibits the assignment of the policy to another without the written consent of the insurance company, except in the case of the insured's death.

Definitions

Definitions of key terms may be "hidden" within other sections or, as in more recent policy forms, may be included in a special section of the policy. These must be studied carefully because additional exclusions or coverage grants may be found within definitions.

Additional/Supplemental Coverages

Many policies include a section that adds coverage for exposures that are otherwise excluded or not contemplated by the plain language of the policy. For example, liability insurance policies agree to pay the expenses involved in the insured's legal defense in a separate section of the policy. Property policies usually add limited amounts of coverage on property that is not otherwise covered.

Endorsements

The standard "boiler plate" language of most policies is designed to provide adequate coverage at an affordable rate for the majority of persons needing that particular type of policy. **Endorsements**—forms that are attached to and become a part of the policy—permit the policyholder and the insurance company to customize a policy for one or more of the following reasons:

- The policyholder does not need a portion of the coverage offered in the standard policy and wants to eliminate the coverage and reduce the premium.
- The policyholder needs additional coverage not offered in the standard policy and is willing to pay an additional premium to obtain it.
- The insurance company is unwilling to provide a portion of the coverage but offers a policy with that exposure deleted.

Insureds

Insurance policies may cover persons other than the person or entity named in the Declarations (**the named insured**), either within the terms of the basic policy or by endorsement. These are called **additional insureds**. It is permissible to name more than one person or entity in the Declarations as named insureds, but generally these persons or entities will be related by family or ownership. Many policies include special provision for the person or entity named first in the Declarations (**the first named insured**). This person or entity is the one who is authorized to request cancellation of or make changes to the policy, or to receive a notice of nonrenewal or cancellation, and is the one who is responsible for payment of the premium.

Cancellation and Nonrenewal

State laws and TDI rules govern the reasons for which an insurance company may cancel or nonrenew a policy, and may also determine the number of days' notice the policyholder will receive.

Suit Against Insurer

In the event of a controversy between the insured and the insurer, the insured must bring suit against the insurer within two years and one day of date of the occurrence giving rise to the controversy.

Policy Period

All policies begin and end at **12:01 a.m.** on the dates specified in the Declarations. A loss that begins prior to the expiration date or time and continues past that time is fully covered on the policy that was in force when the loss began.

Policy Territory

This section of the policy describes where the loss must occur in order to be covered. Some policies limit coverage to the United States and its territories, plus Canada and Puerto Rico. Other policies provide coverage on a worldwide basis, subject to limitations on some.

Insurance Policy Analysis

The process of determining if, and to what extent, a particular loss is covered on a policy must be accomplished by a systematic analysis of the policy. Specific questions must be posed in a certain order.

- What persons or organizations are protected?
- What locations, operations or properties are covered?
- What causes of loss are covered?
- Do any exclusions apply?

The "degree" of coverage must next be addressed with another set of questions.

- Is there other insurance applicable?
- Is there a deductible?
- What is the limit of coverage?
- With what conditions must the insured comply in order to effect a successful recovery?

This text will be using this format to analyze all of the insurance contracts in the following sections.

Review at a Glance—Chapter 1

Insurance Principles & Concepts

Property Insurance	Protects individuals and businesses from the financial loss that arises from the destruction of property assets
Casualty Insurance	Includes a variety of coverages such as general liability, automobile liability, crime insurance, bonds and others
Stock Companies	<ul style="list-style-type: none"> • Majority of insurance companies • Owned by stockholders
Mutual Companies	Owned by policyholders
Domestic Insurer	Organized under the laws of a particular state, such as Texas
Foreign Insurer	Organized under the laws of another state, such as Illinois
Alien Insurer	Organized under the laws of another country, such as Germany
Admitted Insurer	<ul style="list-style-type: none"> • Complies with standards for admission to a state • Approved by Commissioner of Insurance
Nonadmitted Insurer	Authorized to write insurance in the state, but not approved as an admitted insurer
Reinsurance	The practice of selling to another insurance company part of the risk assumed by the insurer
Agents	Represent an insurance company
Brokers	<ul style="list-style-type: none"> • Act on behalf of the insured • Do not represent the company with which insurance is placed
Independent Agent	<ul style="list-style-type: none"> • Represents several insurance companies • Paid by commission on policies sold • Can place business with another insurer if contract is terminated
Captive Agent	<ul style="list-style-type: none"> • Represents only one insurer • Cannot place business with another insurer if contract is terminated
Direct Writer	<ul style="list-style-type: none"> • Usually an employee of the insurer • May be compensated, in part, by salary
Direct Marketing	A marketing method used by companies that are not represented by agents
Risk	Chance of financial loss

	<ul style="list-style-type: none"> • Pure risk—loss only, no gain (damage by fire—insurable) • Speculative risk—loss or gain (stock market investment—uninsurable)
Insurance	<p>Contractual device</p> <ul style="list-style-type: none"> • Transfers risk to insurance company • In exchange for premium payment
Insurable Risks	<p>Must satisfy these to be commercially insurable:</p> <ul style="list-style-type: none"> • Independence • Similarity of exposures • Definiteness (cause, time, place and amount) • Calculability • Accidental
Loss	<ul style="list-style-type: none"> • Reduction in asset value (direct) • Financial consequences (indirect)
Peril	Cause of loss
Proximate Cause	Unbroken connection between the peril and the loss without the intervention of a new and independent cause
Indemnity	Same financial position held prior to a loss
Insurable Interest	<p>Financial interest in the continued existence of the subject of insurance</p> <ul style="list-style-type: none"> • Life insurance—must exist when policy is issued • Property & liability—must exist at the time of loss
Risk Management	<p>Process designed to systematically manage pure risks</p> <p>Steps:</p> <ul style="list-style-type: none"> • Identify and analyze exposures <ul style="list-style-type: none"> ■ survey forms and checklists ■ flow charts ■ financial statements ■ personal inspection • Formulate alternatives for dealing with each exposure <ul style="list-style-type: none"> ■ Avoidance ■ Retention ■ Sharing ■ Reduction ■ Transfer • Select best alternative • Implement chosen technique • Monitor results
Contracts	<p>Essential elements:</p> <ul style="list-style-type: none"> • Agreement (offer and acceptance) • Competent parties (legal and mental capacity to make a contract) • Legal object (not an illegal or immoral activity) • Consideration (exchange of something of value)

Insurance Contracts	<p>Unique features:</p> <ul style="list-style-type: none"> • Aleatory (not an equal value) • Adhesion (take-it-or-leave-it) • Executory (action in the event of a future occurrence) • Doctrine of Reasonable Expectations (court considers insured's reasonable and objective expectations in determining coverage) • Unilateral (only one enforceable promise) • Conditional (certain acts to be legally enforceable) • Utmost good faith (depends on no misrepresentation, breach of warranty or concealment)
Representation	Statements made by the applicant. A misrepresentation may void a policy if it is material to the risk and the company can prove it would not have issued the policy if it had known the truth.
Fraud	Intentional perversion of the truth; may void the insurance contract
Warranty	A stipulation in the policy representing an insured's promise relating to the nature of the risk; a breach of a warranty may void the policy
Concealment	Failure to disclose known facts; if material to the risk with intent to defraud, concealment may void the policy
Application	Information regarding the insured and identification of insurance to be purchased
Binder	Written or oral evidence that coverage is in effect, executed by an authorized representative of the insurance company
Waiver	Intentional or voluntary relinquishment of a known legal right
Estoppel	The legal result of a waiver
Parts of a Policy	<ul style="list-style-type: none"> • Declarations • Insuring agreement • Exclusions • Conditions • Definitions
Declarations	<ul style="list-style-type: none"> • Identifies parties • Customizes policy
Insuring Agreement	Describes coverage in broad terms and promises to pay
Exclusions	<ul style="list-style-type: none"> • Eliminate coverage provided by other policies • Eliminate coverage for certain losses • Eliminate coverage for uninsurable perils
Conditions	Outlines rights and duties of both parties

ISO Common Policy Conditions

- Cancellation
- Changes
- Examination of your books and records
- Inspections and surveys
- Premiums
- Transfer of your rights and duties under this policy

Definitions

- Key terms
- May include additional exclusions or coverage

Additional/ Supplemental Coverages

Adds coverage for excluded exposures

Endorsements

Customize policy when:

- Policyholder wants to eliminate coverage and reduce premium
- Policyholder needs additional coverage not offered in standard policy
- Insurer unwilling to provide a portion of the coverage

Policy Period

Coverage begins and ends at 12:01 a.m. on dates in Declarations

Policy Analysis

Is it covered?

- Persons protected
- Locations, operations, properties
- Causes of loss
- Exclusions

To what extent is it covered?

- Other insurance
- Deductible
- Limit

Review Questions—Chapter 1

Insurance Principles & Concepts

1. A stock insurance company is owned by:
 - a. Policyholders
 - b. Stockholders
 - c. Private companies
 - d. A large corporation

2. Which of the following insurance companies would be organized under the laws of another country?
 - a. Alien insurer
 - b. Foreign insurer
 - c. A reinsurance company
 - d. Domestic insurer

3. A broker in an insurance transaction is said to represent:
 - a. An insurance company
 - b. A foreign insurer
 - c. The insured seeking insurance
 - d. A surplus lines company

4. Which of the following agents is usually compensated, in part, by salary?
 - a. An independent agent
 - b. A captive agent
 - c. A direct writer agent
 - d. A direct mail agent

5. The chance of a hurricane damaging a home is best described as:
 - a. A loss
 - b. An occurrence
 - c. A risk
 - d. A hazard

6. Insurance is a method of treating pure risk, but is **NOT** used to treat speculative risk. Which of the following involves speculative risk?
 - a. Chance of fire
 - b. Liability
 - c. Gambling
 - d. Accident

7. All the following are prerequisites for an insurable risk, **EXCEPT**:
 - a. Independence of exposures
 - b. Similarity of exposures
 - c. Random, accidental events
 - d. Significant exposure to financial loss

8. To recover under a property insurance policy, insurable interest must exist:
 - a. At the time of loss
 - b. When the policy is issued
 - c. When the application is completed
 - d. When the claim check is typed

9. A business suffers a loss of income following damage by fire to the business property. This loss is considered a:
 - a. Indirect loss
 - b. Direct loss
 - c. Uninsurable loss
 - d. Speculative loss

10. A peril that causes a loss without the intervention of a new and independent cause is said to be the _____ of the loss.
- Proximate cause
 - Risk
 - Definition
 - Cause
11. A business implements a safety program to reduce injuries to employees. This is an example of what loss control technique?
- Retention
 - Avoidance
 - Sharing
 - Reduction
12. An insurance policy is a contract and must:
- Be in writing
 - Provide equal value by both parties
 - Have a legal object
 - Be paid for before it is effective
13. The insurance contract requires "utmost good faith." This is taken to mean:
- The insured will leave no stone unturned to prevent a loss.
 - Insurance is an abstract promise to pay in the future, and with no control over the loss, both parties must bargain in good faith.
 - The insured relies on the company to give him every benefit of the doubt if a loss occurs.
 - Regardless of circumstances, each party will assume that the other acted in utmost good faith.
14. A representation is:
- A statement made by the applicant in the process of obtaining the policy
 - Usually grounds for voiding the policy, if proven false
 - Presumed material to the contract
 - The insured's promise that something is true and that he will do or will refrain from doing something in the future
15. A warranty is:
- A fact presumed to be material to the contract and, if breached by the insured, may void the contract
 - An oral statement, with no presumption that it is material to the risk
 - Not part of the insurance contract
 - All of the above
16. An insurance contract is referred to as aleatory because:
- The company writes the contract and the insured cannot change it
 - The contract can be modified by endorsement
 - Equal value is not paid by each party
 - Both parties to the contract have obligations
17. An insurance binder:
- Serves to confirm the company's intent to issue a policy
 - Binds the agent to apply to the company for policy issuance
 - Binds the insured to pay the premium promptly when the policy is delivered
 - Is actually a temporary contract used when coverage is required before a policy can be issued

18. The Declarations section of a policy includes:
- Exclusions
 - Policy period
 - Definition of Insured
 - Cancellation provisions
19. A section of the policy that describes the duties of both parties to the contract is:
- Declarations
 - Exclusions
 - Insuring Agreement
 - Conditions
20. A section of the policy that limits coverage is:
- Declarations
 - Exclusions
 - Insuring Agreement
 - Conditions
21. What is an Insuring Agreement?
- A promise to pay
 - A statement of exclusions
 - A description of covered property and perils
 - Names and addresses of the insured and insurer
22. The first named insured on many insurance policies is the only insured who can:
- Make changes to the policy
 - Sign the policy
 - Receive the proceeds of the policy
 - Fill out the application for coverage
23. Under most policies of insurance, coverage becomes effective:
- 12:01 a.m. on the first day of coverage
 - 12:01 p.m. after coverage is requested
 - 11:00 a.m. the day coverage is effective
 - 12:01 a.m. the day after coverage is requested
24. An insured sells her house. Shortly after the sale, the home is damaged in a fire. Although the policy in the insured's name has not been cancelled, the insurance company refuses to pay the insured. What principle does this illustrate?
- Misrepresentation
 - Insurable interest
 - Proximate cause
 - Adhesion
25. In a coverage dispute, the court grants coverage to the insured, on the basis that the insurance policy language is ambiguous. This illustrates that the insurance contract is:
- A contract of utmost good faith
 - Unilateral
 - Conditional
 - A contract of adhesion
26. Which of the following best describes the concept of pure risk?
- Uncertainty of loss
 - Certainty of loss
 - Chance of gain or loss
 - Results of a loss
27. The concept of indemnity in insurance means:
- The insured must own insured property.
 - A reduction in value of an asset.
 - To place the insured in the same financial position.
 - A contractual device for transferring risk.