UNIT FOUR

LEGAL PRINCIPLES OF INSURANCE CONTRACTS:

1. Principle of Indemnity:

The principle of indemnity is one of the most important legal principles in the field of insurance. The principle of indemnity states that the insured should not profit from a covered loss but should be restored to approximately the same financial position that existed prior to the loss. Most of the property insurance contracts are indemnity contracts. If a covered loss occurs, the insured should not collect more than the actual amount of the loss.

The principle of indemnity has two fundamental purposes:

1. ***To prevent the insured from profiting from insurance***. The insured should not profit if a loss occurs, but should be restored to approximately the same financial position that existed before the loss. For example, if Mr. has insured his house for 100,000 birr and a loss amounted to 10,000 birr occurs, the principle of indemnity would be violated if 100,000 birr were paid to him; because he would be profiting out of insurance.
2. ***To reduce moral hazard***. If dishonest insured can profit from a loss, they may deliberately cause a loss with the intention of collecting the insurance. Thus, if the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced.

In property insurance, the standard method of indemnifying the insured is based on the actual cash value of the damaged property at the time of loss. The Courts have used three major methods to determine actual cash value;

i. Replacement cost less depreciation
ii. Fair market value
iii. Broad Evidence rule

(i) Replacement cost less depreciation:

Under this rule, actual cash value is defined as replacement cost less depreciation. This rule has been traditionally used to determine the actual cash value of property in property insurance. It takes into consideration both inflation and depreciation of property values over time. Replacement cost is current cost of restoring the damaged property with new materials of some kind and quality. Depreciation is a deduction for physical war and tear, age and economic obsolescence.

For example, machinery has been insured against fire. Assume that it burnt by fire. If the machinery was bought 5 years ago, and that machinery is 50% depreciated. The similar machinery would cost 10,000 birr. Under the actual cash value rule, the insured will collect only 5,000 birr for the loss of the machinery, because the replacement cost is 10,000 birr, but depreciation is 5,000 birr or 50%. If the insured were paid the full replacement value of 10,000 birr, the principle of indemnity would be violated, because the insured would be receiving the value of new brand machinery instead of one 5 years old. In short, 5,000 birr payment represents indemnification for the loss of 5 years old machinery. This can be summarized as follows;

Replacement Cost = 10,000 birr

Depreciation = 5,000 birr (Machinery is 50% depreciated)

Actual Cash Value = Replacement Cost – Depreciation

\ Actual cash value = 10,000 birr – 5,000 birr

= 5,000 birr.

(ii) Fair Market Value:

Fair market value is the price a willing buyer would pay a willing seller in a free market. The fair market value of a building may be below its actual cash value based on replacement cost less depreciation. This may be due to poor location, bad neighborhood or economic obsolescence of the building.

For example, in big cities, large homes in older residential areas often have a market value well below the replacement cost less depreciation. If a loss occurs, the fair market value may be used to determine the value of the loss. In one case, a building valued at $ 170,000 based on the actual cash value rule had a market value of only $ 65,000 when a loss occurred. The court ruled that the actual cash value of the property should be based on the fair market value of $ 65,000 rather than $ 170,000.

(iii) Broad Evidence Rule:

The broad evidence rule means that the determination of actual cash value should include all relevant factors an expert would use to determine the value of the property. Relevant factors include replacement cost less depreciation, fair market value, and present value of expected income from the property, comparison sales of similar property, opinions of appraisers and other factors.

Although the actual cash value is used in property insurance, different procedures are followed for other types of insurance.

- In liability insurance, the amount paid for a loss is the actual damage the insured is legally obligated to pay because of badly injury or property damage to another.

- In business income insurance, the amount paid is usually based on the loss of profits plus continuing expenses incurred when the firm is shut down because of a loss from a covered period.
- In Life insurance, the amount paid upon the insured's death is the face amount of the policy.

Exceptions to the principle of indemnity:

The important exceptions to the principle of indemnity are as follows;

I. Valued policy
II. Valued policy laws
III. Replacement cost insurance
IV. Life Insurance

A. valued policy: is one that pays the face amount of insurance regardless of actual cash value if total loss occurs. They are used to insure fine arts & rare paintings. Because of difficulty in determining the actual cash value of the property at the time of loss, the insured and insurer both agree on the value of the property when the policy is first issued.(E.g. Old clock)

B. Valued policy laws: is another exception to the principle of indemnity. The specified perils to which a valued policy law applies vary among the states. Some states cover only fire and others cover fire, lightning, wind storm and tornado. In addition, the laws generally apply only to real property and the loss must be total. For example, a building insured for 200,000 birr may have the actual cash value of 175,000 birr. If a total loss from a fire occurs, the face amount of 200,000 would be paid. Thus, the principle of indemnity would be violated.

C. Replacement cost insurance: means no deduction is taken for depreciation in determining the amount paid for a loss. For example, assume the roof on your home is 5 years old and has a useful life of 20

years. The roof is damaged by a tornado, and the current cost of replacement is 10,000 birr. Under the actual cash value rule, you would receive only 7,500 birr (10,000 – 2,500 = 7,500 birr). Under a replacement cost policy, you would receive the full 10,000 birr. Since you receive the value of a brand new roof instead of one that is 5 years old, the principle of indemnity is technically violated.

D. Life insurance: is another exception to the principle of indemnity. A life insurance contract is not a contract of indemnity but it is a valued policy that pays a stated sum to the beneficiary upon the insured's death. The indemnity principle is difficult to apply, because the historical actual cash value rule is meaningless in determining the value of a human life.

2. Principle of Insurable Interest:

The principle of insurable interest states that the insured must lose financially if a loss occurs, or must incur some other kind of harm if the loss takes place. For example, a person has an insurable interest in his automobile, television or VCR have been damaged or stolen.

Purposes of Insurable Interest:

Insurable interest is essential in an insurance contract for the following reasons;

1. ***It prevent gambling***. If an insurable interest were not required, the contract would be a gambling contract and would be against the public interest. For example, one could insure the property of another and hope for an early loss. In the same way, one could insure the life of another and hope for an early death.
2. ***Reduces moral hazard***. If an insurable interest is not required, a dishonest person could purchase a property insurance contract on some one's property and then deliberately cause a loss to receive the

insurance claims. But, if the insured person stands to lose financially, nothing is gained by causing the loss. Thus, moral hazard is reduced.

3. ***Measures the amount of the insured's loss*** *i*n ***property insurance***; most contracts of property insurance are contracts of indemnity. Thus, the measure of recovery is the insurable interest of the insured. The amount of indemnification is measured by calculating the insurable interest in monetary terms. For example, if a person's property worth 1million Birr is insured and it was destroyed totally after some time, his insurable interest on that property depends on the financial loss met by him. Here, as the entire property is destroyed, his insurable interest tends to be 1 million Birr on that property. Thus, he will be indemnified the 1 million Birr.

3. Principle of Subrogation:

Subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance. This means that the insurer is entitled to recover from a negligent third party, any loss payments made to the insured.

For example, assume that a negligent motorist smashes into Mr.X's car, causing damages of 5,000 Birr. If Mr.X has the collision insurance on his car, his insurance company will pay 5,000 Birr and then attempt to collect from the negligent motorist who caused the accident. Alternatively, if Mr..X directly collect from the negligent motorist, the principle of subrogation does not apply. Because, the loss payment is not made by the insurance company. However, to the extent that a loss payment is made, the insured gives to the insurer legal rights to collect damages from the negligent third party.

Purposes of Subrogation

Subrogation has three basic purposes;

1. ***Subrogation prevents the insured from collecting twice for the same loss***. In the absence of subrogation, the insured could collect from the insurer and from the person who caused the loss.
2. ***Subrogation is used to hold the guilty person responsible for the loss***. By exercising its subrogation rights, the insurer can collect from the negligent person who caused the loss.
3. ***Subrogation tends to hold down insurance rates***. Subrogation recoveries can be reflected in the rate making process, which tends to hold rates below where they would be in the absence of subrogation.

Importance of Subrogation:

1. The general rule is that by exercising its subrogation rights, the insurer is entitled only to the amount it has paid under the policy.

For example, Mr. A has a Birr 100,000 home insured under a home owner's policy. Assume that the house is totally destroyed in a fire because of faulty wiring by an electrician. The insurer would pay Birr 100,000 to Andrew and then attempt to collect from the negligent electrician. After exercising its subrogation rights against the electrician, the insurer has a net recovery of 100,000 Birr.

2. ***The insured cannot impair the insurer's subrogation rights***; the insured cannot do anything that prejudices the insurer's right to proceed against a negligent third party. For example, if the insured waives the right to sue the negligent party, the right to collect from the insurer for the loss is also waived.

3. ***The insurer can waive its subrogation rights in the contract***; this may be to meet the special needs of some insured. For example, in order to

rent an apartment house, a land lord may agree to release the tenants from potential liability if the building is damaged. If the land lord's insurer waives its subrogation rights, and if a tenant negligently starts a fire, the insurer would have to reimburse the land lord for the loss, but could not recover from the tenant since the subrogation rights were waived.

4. Subrogation does not apply to life insurance and to most individual health insurance contracts; Life insurance is not a contract of indemnity, and subrogation has relevance only for contracts of indemnity. Individual health insurance contracts usually do not contain subrogation clauses.

5. The insurer cannot subrogate against its own insured; if the insurer could recover a loss payment for a covered loss, the basic purpose of purchasing the insurance would be defeated.

4. Principle of Utmost Good faith:

Utmost good faith means that a higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts. This, principle has its historical roots in marine insurance. The marine insurer had to place great faith in statements made by the applicant for insurance concerning the cargo to be shipped. The property to be insured may not have been visually inspected.

The principle of utmost good faith is supported by three important legal principles;

i. Representations
ii. Concealment
iii. Warranty

(i***) Representations***:

Representations are statements made by the applicant for insurance. For example, if a person wants to apply for life insurance, he may be asked questions concerning his age, weight, height, occupation, state of health and other relevant questions. The answers given by that person are called representations.

The legal importance of a representation is that the insurance contract is voidable at the insurer's option if the representation is (a) material, (b) false, and (c) relied on by the insurer.

Material means that if the insurer knew the true facts, the policy would not have been issued, or would have been issued on different terms. False means that the statement given by the insured is not true or it is misleading. Reliance means that the insurer relies on the misrepresentation in issuing the policy at the specified premium.

For example, Mr. X may apply for life insurance and state in the application form that he has not visited a doctor within the last 5 years. But, he may have undergone surgery six months earlier. In this case, he has made a statement that is both false & material and the policy is voidable at the insurer's option.

Finally, an innocent or unintentional misrepresentation of a material fact, if relied on by the insurer also makes the contract voidable.

(ii) Concealment:

Concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer. Here, the applicant for insurance deliberately withholds material information from the insurer. The legal effect of a material concealment is also voidable at the insurer's option.

To deny a claim based on concealment, an insurer must prove two things; (a) the concealed fact was known by the insured and (b) the insured intended to defraud the insurer. For example, Mr.Joseph De Bellis applied for a life insurance policy on his life. 6 months after the policy was issued, he was murdered. The death certificate named the deceased as Joseph De Luca, his true name. Thus, the insurer denied payment on the ground that Joseph had concealed a material fact by not revealing his true identity, and he had also an extensive criminal record. Thus, the court held that intentional concealment of his true identity was material and the insurer need not pay the claim.

(iii) Warranty:

The doctrine of warranty also reflects the principle of utmost good faith. A warranty is a statement of fact or promise made by the insured, which is part of the insurance contract and which must be true if the insurer is to be liable under the contract. For example, in order to pay a reduced premium, the owner of a shop may warrant that an approved burglary and robbery alarm system will be operational at all times. The conditions describing the warranty become part of the contract.

A warranty is a harsh legal principle. Any breach of the warranty allows the insurer to deny payment of a claim. However, the courts have softened and modified the harsh common law of doctrine of warranty.

5. Principle of Contribution:

Contribution is the right of the insurer who has paid under a policy, to call upon other insurers equally or otherwise liable for the same loss to contribute to the payment. Where there is over-insurance because a loss is covered by policies affected with two or more insurers, the principle of indemnity still applies. In these circumstances the insured will only be entitled to recover the full amount of his loss and if one insurer has paid out in full, he will be entitled to nothing more.

The similarity between contribution and subrogation

- Like subrogation, contribution supports the principle of indemnity and applies only to contracts of indemnity.

The difference between contribution and subrogation.

- Subrogation is concerned with the rights of recovery against third parties or elsewhere in respect of payment of indemnity, and need not involve any other insurance, although it frequently does.
- Contribution necessarily involves two or more insurance each covering the interest of the same insured.

Contribution according to the Sums Insured:

This is the normal method of contribution. Insurers will pay proportionately to the cover they have provided, in accordance with the following formula;

$$\frac{\text{Sum insured with the particular insurer}}{\text{Total sums insured with all insurers}} \times \text{Loss} = \text{Contribution}$$

Eg: Assume that Mr.X has insured his house, which worth 80,000 Birr against fire with three insurers namely A, B & C for 60,000 Birr, 40,000 Birr, and 20,000 Birr respectively. Mr.X's house was completely destroyed by a fire caused by Mr.Y's negligence. The amount of indemnity that Mr.X

will be entitled to receive would be 80,000 Birr, the value of the actual loss or the amount of insurance covered.

Solution:

The amount that each insurer is entitled to contribute would be as follows;

A's share of loss = $\frac{\text{Br.60, 000 X Br.80, 000}}{\text{Br.120, 000}}$ = **Br.40, 000**

B's share of loss = $\frac{\text{Br.40, 000 X Br.80, 000}}{\text{Br.120, 000}}$ = **Br.26, 666.7**

C's share of loss = $\frac{\text{Br.20, 000 X Br.80, 000}}{\text{Br.120, 000}}$ = **Br.13, 333.3**

Total Indemnity **= share of (A + b + C) = Br.80, 000**

6. Principle of Proximate Cause:

The rule is that immediate and not the remote cause is to be regarded. The real cause must be seen while payment of the loss. If the real cause of loss is insured, the insurer is liable to compensate the loss; otherwise the insurer may not be responsible for loss.

The efficient cause of a loss is called the proximate cause of the loss. For the policy to cover, the loss must have an insured peril as the proximate cause of the loss. The proximate cause is not necessarily the cause that was

nearest to the damage, but is rather the cause that was actually responsible for loss. (E.g.) In marine insurance, sea water.

Determination of proximate cause:

i. If there is a single cause of the loss, the cause will be the proximate cause and further if the peril (cause of loss) was insured, the insurer will have to indemnify the loss.
ii. If there are concurrent causes, the insured perils and excepted perils have to be segregated. The concurrent causes may be separable or inseparable. Separable causes are those which can be separated from each other. The loss occurred due to a particular cause may be known. In such a case, if any cause is excepted peril, the insurer will have to pay up to the extent of loss which occurred due to insured perils. If the circumstances are such that the perils are inseparable, then the insurers are not liable at all when there exists any excepted peril.

iii. If the causes occurred in form of chain, they have to be observed seriously.

a. If there is unbroken chain to excepted and insured perils have to be separated. If an excepted peril precedes the operation of the insured peril so that the loss caused by the insured peril is the direct and natural consequences of the excepted peril, there is no liability. If the insured peril is followed by an excepted peril there is valid liability.

b. If there is a broken chain of events with no excepted peril involved, it is possible to separate the losses. The insurer is liable only for that loss which is caused by an insured peril; when there is an excepted peril, the subsequent loss caused by

an insured peril will be a new and indirect cause because of the interruption in the chain of events. Similarly, if the loss occurs by an insured peril and there is subsequently loss by an excepted peril, the insurer will be liable for loss occurred due to the insured peril.

INSURANCE CONTRACTS

Understanding of the legal interpretation of Insurance Contract can be important to a risk manager, for several reasons. One reason in fundamental in deciding whether to use insurance or some other risk management tools, the insured or the risk manager should know what the insurer promises to do under the contract. The risk manger also should understand the rights and responsibilities of the insurer and the insured under the contract.

Insurance contracts are subject to the same basic law that govern all types of contracts. But insurance contracts have many characteristics not found in most other contracts. A set of special features discussed below applies to insurance contracts.

Insurance contracts are agreements between the insurance companies and the insured for the purpose of transferring from the insured to the insurer part of the risk or loss arising out of contingent events. The contract serves the following functions:

- Define the risk to be transferred
- Explain the procedures for selling loss claims.

- State the conditions under which the contract parties should know such as premium and performance of certain acts.

REQUIREMENTS OF AN INSURANCE CONTRACT

An insurance policy is based on the law of contracts. To be legally enforceable, an insurance contract must meet *four* basic requirements: offer and acceptance, consideration, competent parties, and legal purpose.

1. **Offer and Acceptance** The first requirement of a binding insurance contract is that there must be **an offer and an acceptance** of its terms. In most cases, the applicant *for* insurance makes the offer and the company accepts or rejects the offer. An agent merely solicits or invites the prospective insured to make an offer. The requirement of offer and acceptance can be examined in greater detail by making a careful distinction between property and liability insurance, and life insurance.

In property and liability insurance, the offer and acceptance can be oral or written. In the absence of specific legislation to the contrary, oral insurance contracts are valid. However, as a practical matter, most property and liability insurance contracts are in written *form.* The applicant *for* insurance fills out the application and pays the first premium (or promises to pay the first premium). This constitutes the offer. The agent then accepts the offer on behalf of the insurance company. In property and liability insurance, agents typically have the power to bind their companies through use of a binder. A **binder** is a *temporary contract for insurance and can be either written or oral.* The binder is used to bind the company immediately prior to receipt of the application and issuance of the policy. Thus, the insurance contract can be effective immediately, since the agent accepts the of*fer* on behalf of the company. This is the usual procedure followed in personal lines of property and liability insurance, including homeowners' policies and

automobile insurance. However, in some cases, the agent is not authorized to bind the company, and the application must be sent to the company *for* approval. The company may accept the offer and issue the policy.

In life insurance, the procedures followed are different. A life insurance agent does not have the power to bind the insurer. Therefore, the application *for* life insurance is always in writing, and the applicant must be approved by the insurer before the life insurance is in *force.* The usual procedure is *for* the applicant to fill out the application and pay the first premium. A **conditional premium receipt** is then given to the applicant. The most common conditional receipt is the "insurability premium receipt." *If the applicant* is *found insurable according to the insurer's normal underwriting standards, the life insurance becomes effective as of the date of the application or the date of the medical examination, whichever* is *later.* For example, assume that Aaron applies *for* a $100,000 life insurance policy on Monday. He fills out the application, pays the first premium, and receives a conditional premium receipt from the agent. On Tuesday morning, he takes a physical examination, and on Tuesday afternoon, he is accidentally killed in a boating accident. The application and premium will still be forwarded to the insurer, as if he were still alive. If he is found insurable according to the insurer's underwriting rules, the life insurance is in *force,* and $100,000 would be paid to his beneficiary.

However, if the applicant *for* life insurance does not pay the first premium when the application is filled out, a different set of rules applies. Before the life insurance is in *force,* the policy must be issued and delivered to the applicant, the first premium must be paid, and the applicant must be in good health when the contract is delivered. These requirements are considered to be "conditions precedent" - in other words, they must be fulfilled before the life insurance is in *force.*

2. **Consideration.** The second requirement of a valid insurance contract **is consideration.** Consideration refers to the value that each party gives to the other. The insured’s consideration is payment of the first premium (or a promise to pay the first premium) plus an agreement to abide by the conditions specified in the policy. The insurer's consideration is the promise to do certain things as specified in the contract. This can include paying *for* a loss *from* an insured peril, providing certain services, such as loss prevention and safety services, or defending the insured in a liability lawsuit.

3. **Competent Parties.** The third requirement of a valid insurance contract is that each party must be legally competent. This means the parties must have legal capacity to enter into a binding contract. Most adults are legally competent to enter into insurance contracts, but there are some exceptions. Insane persons, intoxicated persons, and corporations that act outside the scope of their authority cannot enter into enforceable insurance contracts. Minors normally are not legally competent to enter into binding insurance contracts; but most states have enacted laws that permit minors, such as a teenager age 15, to enter into a valid life or health insurance contract.

4. **Legal Purpose.** A final requirement is that the contract must be for a legal purpose. An insurance contract that encourages or promotes something illegal or immoral is contrary to the public interest and cannot be enforced. For example, a street pusher of heroin and other hard drugs cannot purchase a property insurance policy that would cover seizure of the drugs by the police. This type of contract obviously is not enforceable since it would promote illegal ventures that are contrary to the public interest.

DISTINCT LEGAL CHARACTERISTICS OF INSURANCE CONTRACTS

Insurance contracts have distinct legal characteristics that make them different from other legal contracts. Several distinct legal characteristics of insurance contracts have already been discussed.

As stated earlier, most property and liability insurance contracts are contracts of indemnity; all insurance contracts must be supported by an insurable interest; and insurance contracts are based on utmost good faith. Other distinct legal characteristics are as follows:

1. **Aleatory Contract.** An insurance contract is aleatory rather than commutative. An aleatory contract *is one in which the values exchanged are not equal.* Depending on chance, one party may receive a value out of proportion to the value that is given. For example, assume that Edith pays a premium of $500 for $100,000 of homeowners insurance on her home. If the home were totally destroyed by fire shortly thereafter, she would collect an amount that greatly exceeds the premium paid. On the other hand, a homeowner may faithfully pay premiums for many years and never have a loss.

In contrast, other commercial contracts are commutative. A commutative contract *is one in* which *the values exchanged by both parties are theoretically even*. For example, the purchaser of real estate normally pays a price that is viewed to be equal to the value of the property.

Although the essence of an aleatory contract is chance, or the occurrence of some fortuitous event, an insurance contract is not a gambling contract. Gambling creates a new speculative risk that did not exist before the transaction. Insurance, however, is a technique for handling an already existing pure risk. Thus, although both gambling and insurance are aleatory in nature, an insurance contract is not a gambling contract since no new risk is created.

2. **Unilateral Contract.** An insurance contract is a unilateral contract. A unilateral contract *means that only one party makes a legally enforceable promise.* In this case, only the insurer makes a legally enforceable promise to pay a claim or provide other services to the insured. After the first premium is paid, and the insurance is in force, the insured cannot be legally forced to pay the premiums or to comply with the policy provisions. Although the insured must continue to pay the premiums to receive payment for a loss, he or she cannot be legally forced to do so. However, if the premiums are paid, the insurer must accept them and must continue to provide the protection promised under the contract.

In contrast, most commercial contracts are *bilateral* in nature. Each party makes a legally enforceable promise to the other party. If one party fails to perform, the other party can insist on performance or can sue for damages because of the breach of contract.

3. **Conditional Contract.** An insurance contract is a **conditional contract.** This means the insurer's obligation to pay a claim depends on whether or not the insured or the beneficiary has complied with all policy conditions. *Conditions are provisions inserted in the policy that qualify or place limitations on the insurer's promise to perform.* The conditions section imposes certain duties on the insured if he or she wishes to collect for a loss. Although the insured is not compelled to abide by the policy conditions, he or she must do so in order to collect for a loss. The insurer is not obligated to pay a claim if the policy conditions are not met. For example, under a homeowner’s policy, the insured must give immediate notice of a loss. If the insured delays for an unreasonable period in reporting the loss, the company can refuse to pay the claim on the grounds that a policy condition has been violated.

4. **Personal Contract.** In property insurance, insurance is a **personal contract.** *This means the contract* is *between the insured and the insurer.* Strictly speaking, a property insurance contract does not insure property, but insures the owner of property against loss. The owner of the insured property is indemnified if the property is damaged or destroyed. Since the contract is personal, the applicant for insurance must be acceptable to the insurer and must meet certain underwriting standards regarding character, morals, and credit. Since a property insurance contract is a personal contract, it normally cannot be assigned to another party without the insurer's consent. If property is sold to another person, the new owner may not be acceptable to the insurer. *Thus, the insurer's consent* is *normally required before the policy can be validly assigned to another party,* In contrast, a life insurance policy is not a personal contract. Therefore, it can be freely assigned to anyone without the insurer's consent.

The loss payment can, however, be freely assigned to another party without the property insurer's consent. Although the insurer's consent is not required, the contract may require that the insurer be notified 01 the assignment of the proceeds to another party.

5. **Contract of Adhesion. A contract of adhesion** *means the insured must accept the entire contract, with all of its terms and conditions,* The insurer drafts and prints the policy, and the insured generally must accept the entire document and cannot insist that certain provisions be added or deleted or the contract rewritten to suit the insured, Although the contract can be altered by the addition of endorsements or forms, the endorsements and forms are drafted by the insurer. However, to redress the imbalance that exists in such a situation, the *courts have ruled that any ambiguities or uncertainties*

in the contract are construed against the insurer. If the policy is ambiguous, the insured gets the benefit of the doubt.

The general rule that ambiguities in insurance contracts are construed against the insurer is reinforced by the principle of reasonable expectations. The **principle of reasonable expectations** *states that an insured* is *entitled to coverage under a policy that he or she reasonably expects it to provide, and that to be effective, exclusions or qualifications must be conspicuous, plain, and clear.* The courts have ruled that insureds are entitled to the protection that they reasonably expect to have, and that technical restrictions in the contract should not be a hidden pitfall. For example, in one case, a liability insurer refused to defend the insured on the grounds that an intentional act was excluded under the policy, However, the court ruled that the insurer was responsible for the defense costs, because the insured had a reasonable expectation that these costs were covered under the policy since the policy covered other types of intentional acts.

6. **Contracts of Uberrimae Fidei**

The literal meaning of "**Uberrimae Fidei**" is utmost good faith that can be restated as the highest standard honesty.

Insurance contracts are contracts of the utmost good faith. Both parties to the contract are bound to disclose all the facts relevant to the transaction. Neither party is to take advantage of the other's lack of information.

7. **Contract of Indemnity**

Property and liability insurance contracts are **contracts of indemnity**. The person insured should not benefit financially from the happening of the even insured against. Because insurance do not allow insured's to make profit from happening of a particular risk. Life and frequently health insurance contracts are not contracts of indemnity.