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I. General Insurance Concepts

10 single line/16 combo exam questions

Acronyms may be helpful tools to remember certain concepts. The 3 we have included here are put together in a phrase as another memory trigger.

The **CALM CHAP** sitting by the **CCOAL**s of the campfire watching a shooting **STARR**.

A. Risk

1) Methods of Handling Risk: Risk is the potential for loss or possibility of loss. We face risk every day in our lives whether as quick as 'will the light stay green? Can I make it through? Or as simple as 'is this too hot? At times the risks can be costly. There are many studies on how to deal with, work with, or manage risk, specifically, the financial burden that risk can place on our wallet.

**** STARR: Share, Transfer, Avoid, Retain, Reduce (acronyms may help you remember)**

There are five basic tools of risk management:

a) **Share** (with another entity) –An example of sharing is the fence between my neighbor's house and mine If the wind blows it down, we will share the cost of rebuilding it.

b) **Transfer** The risk is transferred to an insurance company. The party assuming the risk will collect premium from a large number of clients in order to pay for any losses.

c) **Avoidance**– Watch for and avoid any potential risk. You don't want to be in a car accident, never get into a car. This will work, but it is really not feasible for most people. So perhaps avoid hazardous driving conditions.

d) **Retention** You pay for any losses. This is fairly common for small losses that may occur every day. You drop a cup and it breaks, that is a loss; you replace it, that is retention. A high deductible could also be considered retention; I pay for the first portion of any expenses covered by insurance.

e) **Reduction and Loss Prevention** – Wear a seatbelt, don't text while driving, annual wellness exams, flu shots and fire detectors, to numbered tags in a dressing room. These items will reduce the chance of a loss.

2) Elements of Insurable Risk: In order for an insurance company to take on any risk, there are certain criteria that need to be met. Not all risks are insurable.

**** Calm Chap: Catastrophic, Large, Measurable, Chance, Predictable**

a) The loss **cannot be Catastrophic**. This means not catastrophic to the insurance company, not the consumer. The cost of natural disasters such as flood or hurricane must be within the carrier's ability to pay claims.

b) The loss **exposures must be Large**. Utilizing the law of large numbers, insurance companies can predict the number of losses and, with that information; they can establish a premium.

c) The loss must be definite and **Measurable**; we must be able to tell when a loss has occurred and place a value on the loss. e.g.: Bills or receipts for repair.

d) The loss must be due to **Chance**, not something that is certain to happen.

e) The loss must be **Predictable**, meaning it must be of such a nature that its frequency and average severity can be readily determined to establish the required premium.

- *How do predictability and chance both work together? Your insurance company knows how many house fires will happen in your zip code this year based on past experience; that is predictable. They do not know which houses will suffer a loss; that is chance.*

3) Definitions

a) Risk – is the uncertainty of a loss, specifically, a financial loss. **Only pure risk is insurable** (the chance of a loss, no gain). With a speculative risk, there is a chance of gain as well as a chance of loss. However, a speculative risk is not insurable.

b) Hazard – Something that increases the chance of a loss. This can be hazardous hobbies, such as skydiving or SCUBA diving. This could be overgrown bushes in front of windows on a house or flammable materials left next to an open flame.

(a) Physical – Dirty windshields, broken headlights, exposed wiring, or severely worn car tires.

(b) Morale – Carelessness of attitude or irresponsibility. This would include failing to lock the front door of a house because any loss would be covered by insurance. **A careless person is a morale hazard.**

(c) Moral – Arises from people's habits and values… Dishonesty. Examples of poor moral risks include: intentionally setting a fire in order to collect the insurance, filing false claims, excessive speeding tickets, or poor credit report. **A dishonest person is a moral hazard.**

(d) Legal – Arises from court actions which increase the likelihood or size of the loss. For example, the growing tendency of people to file lawsuits and claim enormous sums for alleged damages.

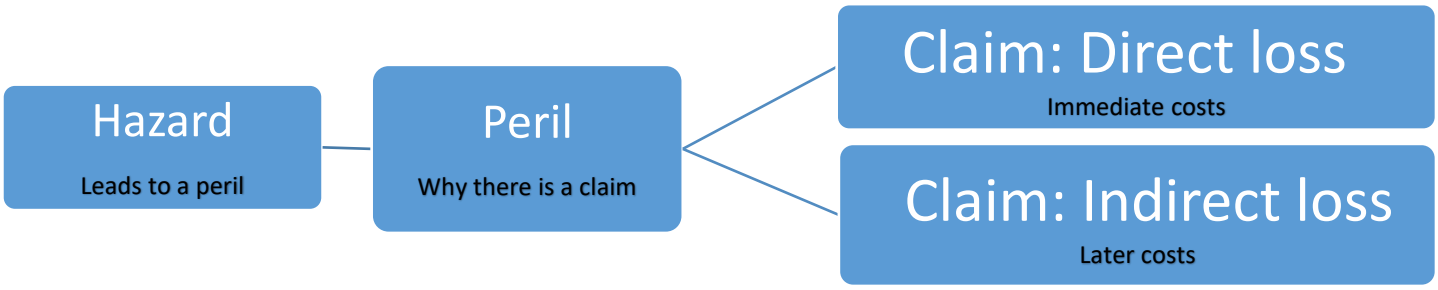
c) **Peril** – is anything that causes a loss. For example, a wet floor is a hazard, slipping on the floor and falling is a peril.

d) **Direct Loss** – A loss that is a direct consequence of a particular peril. Fire damage to an apartment building is an example of a direct loss.

e) **Indirect Loss** – A loss that is a result of a covered peril but is not caused directly and immediately by that peril. Loss of an apartment building by fire is a direct loss. The loss of rental income as a result of the fire is an indirect loss.

f) **Proof of Loss** – This is a form completed by the claimant listing the property that has been either lost or damaged due to a covered loss.

**Work a scenario backwards to determine which item is a peril, hazard, etc.
**Know the difference between moral and morale hazards.



For example, an oily rag left near a furnace causes a fire. The oily rag is the hazard, fire is the peril, the immediate damage from the fire is the direct loss, bills that pop up later (hotel to stay at while the damage is being repaired) are an indirect loss.

Or

I sprained my ankle resulting in a doctor visit. The direct loss was the cost of the visit, the reason for the visit was the sore ankle due to a fall. The fall was the peril. Why did I fall? The dog dug a new hole and I stepped in it, the hole in the yard is the hazard.

B. Classifications of Insurers

Classifications of Insurance Companies - An insurance company is a business that takes on the responsibility of transferring risk (chance of a loss) from the general public to itself through insurance contracts. There are three distinct ways to classify insurance companies that we will review. They are Ownership, License, and Location.

1. The first is ownership, i.e., who owns the company.

A Stock Insurance Company is an incorporated business organization organized as a profit-making entity and is owned by the **stockholders. Dividends are paid to the stockholders** and are fully taxable as they are pure profit for the owners of the company. (Ownership of the company has nothing to do with ownership of the product.)

The remaining 3 types of companies are owned by the owners of the policies.

Mutual Insurance Companies… are owned by the policy owners. Policy owners vote for a board of directors which directs the affairs of the company. The board of directors elects how much of a ***dividend (profit) to pay to the policy owners***. This dividend is a refund of excess premium as the profit came from the premiums paid by the policy owners and so, is not taxable. *Guaranteeing dividends is a form of illegal rebating*. The amount of ownership in the company is limited to the amount of coverage you purchase

A **Reciprocal Inter-Insurance Exchange** is a form of insurance company. A reciprocal inter-insurance exchange is not a "mutual insurance company," which is generally an incorporated entity; rather it is an **unincorporated** association of subscribing members who exchange contracts of indemnity with each other. It is run by an attorney-in-fact and will pay dividends to the subscribers or policyholders when the company makes a profit.

Fraternal (48.36A.010), a.k.a. Fraternal Benefit Society, is an incorporated society or order which is a nonprofit organization that operates on the basis of "**lodge,**" with a representative form of government. **It is formed solely for the benefit of its members**. It issues ***assessable*** (premiums may go up) and *par* policies (pays dividends), and sells only life and disability insurance. Examples include Knights of Columbus, Thrivent for Lutherans and Independent Order of Foresters.

2. *The second is whether or not the company has a license to sell in the state.*

As a producer you will have passed an exam, applied for a license and had your fingerprints processed. You will receive a producer's license and it allows you to sell anywhere in the state of Washington. The route a company goes through is different, but the end result is the same. They will have a 'license' to sell insurance anywhere in the state, their license is called a Certificate of Authority.

An insurance company may not transact insurance in Washington unless the Commissioner grants it a **Certificate of Authority**. A Certificate of Authority is issued by the Commissioner and authorizes a company to sell insurance in our state. A certificate must specify the:

- Name of the insurer
- Location of its principal office
- Kind(s) of insurance it is authorized to transact in this state

Once the company has received a Certificate of Authority they are known as an **authorized** company, a **licensed** company, or an **admitted** company, all meaning they are licensed in the state. Once a company has the Certificate of Authority it must follow the laws and rules of the state.

Admitted Companies (a.k.a. authorized companies) have been approved by the Office of the Insurance Commissioner, are admitted to the state of Washington to do business, and have a *Certificate of Authority*. The certificate of authority is the insurance company's license to sell insurance in our state. An admitted (or authorized) company must comply with all state regulations regarding companies and are covered by the states guarantee associations.

A **Non-Admitted** company does not have a certificate of authority, does not have to comply with the state laws and is not covered by a guarantee association. An **unauthorized** (non-admitted) insurance company **may not** transact business in the State of Washington.

- ✓ An **unauthorized** insurance company **may not** transact business in the State of Washington. Each violation is punishable by a **$25,000 fine**. The Commissioner may order a policy that was improperly placed with an unauthorized insurer, to be replaced with a policy issued by an authorized insurer.

  Exception: If certain insurance coverage cannot be obtained from authorized insurers, coverage may be obtained through a ***surplus lines broker***. **A Surplus Lines *(a.k.a. excess lines)* Broker** is hired to find "*unauthorized*" insurance companies that accept risks not otherwise insurable in the State of Washington.

  - ***Coverage may not be procured for securing lower premiums.***
  - Diligent effort must be made to first place the business with an authorized insurer in Washington State and the certification sent to the commissioner within 60 days.

3. Finally, the third way to classify companies is by the location of their home or corporate office.

Domestic… companies are insurers formed under the laws of the state the person is a resident of. We are in Washington so companies formed in the State of Washington are domestic (a.k.a. domiciled). Examples include Premera and PEMCO.

NOTE: Pay attention on the exam to where the person is a resident of. If the person is a resident of Oregon, companies headquartered in Oregon would be domestic.

Foreign… companies are formed in the United States outside of the state of residence. We are in Washington, so any company formed under the laws of a place other than WA are considered foreign. Examples include Farmers, State Farm and Aflac. **These companies need *three years* of insurance experience** before being "authorized" in our State. (Track record)

Alien… companies are formed under the laws of a nation other than the United States. An example is Sun Life of Canada. **These companies need *three years* of insurance industry experience** before being "authorized" in our State.

3. Elements of a Contract/ Essential Elements

Insurance Contract… Insurance policies are legal contracts and are enforceable by law. The ***Entire Contract Provision*** states the contract consists of the application, the policy and any riders or endorsements. All statements on an application are deemed to be representations, not warranties.

- The 2 parties in an insurance contract are the insurer and the owner. The owner could also be known as the Named Insured or the First Named Insured (for a contract with multiple owners).

In order for the contract to be considered a legal and binding contract the following elements must be in place.

**** CCOAL: Consideration, Competent Parties, Offer, Acceptance, Legal Object**

1) Offer… The applicant makes the ***offer*** to the insurance company. Remember, the legal contract is between two parties, the insurer and the insured. One must make the offer, and the other accepts it. Insurance, even though advertised by a company, must be initiated by the client.

2) Acceptance… The insurance company ***accepts*** the ***offer*** by issuing the policy. A ***counter-offer*** is made by the insurance company if it issues the policy other than how it was requested. The applicant ***accepts*** the ***counter-offer*** when the additional premium is paid, and the counter-sheet is signed by the owner/applicant (insured).

Note: Offer and Acceptance together constitute an **agreement.** The agreement is meant to create a legal relationship.

3) Consideration… Means that something of value must be exchanged by all parties for the contract to be legal. It is the signed and completed application, plus the premium from the insured. If there is no application, the company does not know what policy you need. The insurance company issues a contract (policy) that represents a promise to pay.

This consideration date is usually the effective date of coverage. The company has the consumers money and signatures and the consumer has the policy or the promise of (binder). The only time you can have coverage without consideration is a verbal binder.

4) Legal Object… In order for a contract to be legal, it must be for legal purposes only. This is why *insurance contracts do not cover intentional or criminal acts of the insured,* why there must be insurable interest and why stolen property cannot be insured. A contract to commit a crime is not legal and cannot be upheld in a court of law.

5) Competent Parties… The insured must be of legal age, not be under the influence of intoxicants and not be mentally handicapped. Any person 18 years of age or older will be considered of full legal age and may contract for or with respect to insurance. A person under 18 years old will be considered a minor.

- Consent must be freely given in order to enter into the contract.
- The meaning of the contract must be certain
- The contract must be possible. If the act is impossible or illegal the contract is void.

B. Characteristics of an Insurance Contract:

1) Contract of Adhesion means that since ***the insurer prepares the provisions of the contract,*** and the policyholder simply **adheres** (or agrees) to them, a court will rule in favor of the **insured** if there is any ambiguity in the contract terms. The contract is issued as a take it or leave it proposition. The insured must accept it as is.

2) Unilateral Contract means that one party is required to perform under the contract. The insurer cannot demand that the **insured** make the premium payments, but if the premiums are paid, the **insurer** is obligated to pay.

3) Conditional Contract refers to the fact that insurance contracts are conditional. That is, the insurance company is obligated to pay a claim based on the condition that premiums were paid and a proof of loss was submitted to the insurance company.

4) Aleatory Contracts are agreements that have an *unequal exchange* of values and an uncertain or random event determines the loss. The insured will pay premium but may never file a claim due to a loss,

the consumer is paying more than the insurer. If there is a claim, the insurer pays out to cover the loss and will pay out more than the premium it has received from that claimant.

C. Authority and Powers of Producers/Agents

Insurance agents have very broad powers because courts decide most contests over the existence of coverage in favor of the insured. The fact that a relationship exists between an insurer and an agent, one must show that:

- An insurer either expressly or by implication consented to an agent acting on their behalf; and
- The agent was subject to their control.

This agreement allows authority for the agent, either actual authority or apparent authority. Actual authority may be separated into either express powers or implied powers.

- **Actual authority is created by the insurers' directions to the agent;**
- **Apparent authority is created by the carriers' implications to a third party.**

Express powers - those expressly written in the agent contract with the company. These will include what an agent can and cannot do. ***(Agreement or Contractual)***

Implied powers- sometimes **customary powers**, are those that are implied due to the expressed powers. When delivering a policy where there is premium due, expressed powers include the requirement to deliver the policy, implied powers mean collect any due premium upon delivery. ***(Common sense, how do I fulfill the obligations imposed by the expressed powers, meet people, learn the product, learn how to fill out an application)***

Apparent powers (authority) - if the agent does something that is apparent to the consumer that the agent has the authority to do, even if it is not expressed or implied by contract, then the agent does have that power. (Protects the consumer) This authority is assumed if the third party can reasonably infer, from the principal's conduct, that the principal granted this authority to an agent. ***(Agents Actions)***

Law of Agency – it is the Law of Agency that infers these apparent powers of the agent. As an agent, one represents the insurance company and is acting on behalf of the insurance company (A.K.A. the principal) when contracting insurance with a prospective insured and the company.

D. Legal Interpretations Affecting Contracts

1) Reasonable Expectations are those expectations a reasonable person (not trained in law) would have regarding a contract. It is a legal principle that will protect the weaker party in a contract of adhesion, in other words, the consumer. For example, if I have a homeowner's policy and there is a fire, it is reasonable to assume the insurance company will pay any damages caused by the fire.

It refers to the potential ambiguity in a contract. If a person believes they purchased insurance and the policy should pay, courts will rule in favor of the insured if there are any provisions that may cause the claim to be denied if those provisions are not conspicuous, plain and clear.

2) Indemnify… (Verb… an action) Means to restore a person back to the original position they were in before a loss, no gain. It is to 'make whole', a company does this when they pay a claim. Disability, property, and casualty are indemnification contracts. Life insurance is a **valued** contract, meaning it pays the face value of the contract.

If I have 2 auto policies and there is a loss, both will not pay 100%. If the policies have identical coverages, each one pays ½ of the loss. This is due to the indemnification concept.

3) Indemnity… (Noun… a thing) is the restoration to a person. It is the obligation of one 'person' to make good any loss or damage another has incurred or the amount a company will pay. It refers to the total shifting of a loss to the party responsible for that loss. While a company may pay for the total loss of a vehicle due to an accident, if the accident was caused by another party then the company has the right to insist they be compensated by the at fault party

4) Subrogation… (a.k.a. Transfer of Right of Recovery Against Others) allows the transfer to the insurance company of the insured's rights of recovery from a third party when the insurer pays for the losses. For example, your health insurance may pay up front for injuries caused by a car accident. Your health insurance company will then contact your auto carrier for reimbursement for expenses paid. This is very closely related to indemnity. The insurance company pays the insured, then, if there is another 'person' responsible for the loss, they will collect from that 'person'. 'Person' here includes individuals as well as companies, corporations, etc.

5) Good Faith (Latin: bona fide)… Is honesty, fair and open dealings between parties, without intent to deceive. The good faith doctrine requires that all parties act honestly, fairly and avoid deception in insurance matters.

6) Representation… Is a statement by the insured which he represents to be true to the best of his knowledge and belief. Statements made on an insurance application are deemed to be representations.

7) Misrepresentation… Is *lying* about information asked on the application. If the misrepresentation is material, it can void coverage. Material information has direct bearing on the decision to issue or not to issue an insurance policy.

8) Concealment… Is the withholding of facts from the insurance company. Coverage may be voided if concealment is found to be of fraudulent intent. It is a lie of omission and will be considered concealment if the fact had been known at underwriting, that fact would have either caused the policy to be not issued or issued under significantly different circumstances.

- ✓ Life and Disability policies have a 2-year limit on discovery of a material fact. This is known as the incontestability clause.
- ✓ Property and casualty policies, due to the fact they renew and are updated annually do not have this limit.

9) Warranty is a written guarantee *(in all respects and details)* ***in the policy***. A breach of a warranty may cause a ***suspension of the policy*** and may **void** all claims.

- A policy may warrant the sprinkler system is on 24/7. If there is a fire and the sprinkler system is off, the insurance company may not pay for the damages as the warranty was breached.
- The warranty in every policy is from the company to the policy owner. It is the insuring agreement or the promise to pay.
- A warranty is part of a policy, a representation is not.

10) Insurance fraud… Is any act committed with the intent to obtain a fraudulent outcome from an insurance process. This may occur when a claimant attempts to obtain some benefit or advantage to which they are not otherwise entitled, or when an insurer knowingly denies some benefit that is due. Fraudulent claims account for a significant portion of all claims received by insurers, and cost billions of dollars annually. What this means for the average consumer, is that they are paying between $400 and $700 more in premiums each year due to fraud.

- ✓ Courts generally require the presence of the first four of the following six elements in order for a contract to be rescinded on the basis of fraud. The sixth element is added if damages are sought. The elements are:

  1. *False representation* - of a past or existing fact.
  2. *Knowingly made* - party must know a fact to be false or must have made representation in reckless indifference of the truth or falsity of the statement made.
  3. *Intent to influence or deceive* - party must have intended to influence or deceive.
  4. *Material fact* - the fact influenced or induced the other party to enter the contract.
  5. *Reasonable reliance* - it must appear that the innocent party was justified in relying on the statement.
  6. *Detriment* - in a suit for damages injury or lost must be shown.

11) Assignment… Is the waiver of some or all of the owners' rights in a contract. Regarding life insurance, it can be a partial assignment using the cash value as collateral. Patients who have the doctors' office bill the insurance company have signed a form assigning their claim provision rights. This is not automatic, you need to sign your name.

12) Insurable Interest… The reason for insurance is so that a person does not experience an economic or financial loss when there is a loss. For a potential loss to be insurable, there must be insurable interest at the time of application. In property and casualty, insurable interest must be proven at the time of loss.