

## SECTION 2

### General Insurance

#### CONCEPTS

Insurance is a social device for spreading the chance of financial loss among a large number of people. By purchasing insurance, a person shares risk with a group of others, reducing the individual potential for disastrous consequences.

The insurance company, or insurer, receives relatively small amounts of money, referred to as premium, from each of the large number of people buying insurance. A large, uncertain loss is traded in this way for a small, certain loss, the premium.

The agreement between the insurer and the insured, the person who is covered by the insurance, is established in a legal document referred to as a contract of insurance, or a policy. The insurer promises to pay the insured according to the terms of the policy if a loss occurs. Loss is defined as reduction in the value of an asset. To be paid for a loss, the insured must notify the insurer by making a claim.

Risk is the possibility (uncertainty) that a loss might occur and is the reason that people buy insurance. If a certain event happens -- accident, sickness, or death -- loss occurs. Insurance is designed to provide for such losses, while not providing the insured with the possibility of gain from the accident, sickness, or death.

Speculative risk (such as gambling) creates a risk situation and offers the opportunity for gain as well as the possibility of loss. It is this type of risk that insurance won't cover.

Pure risk is the type of risk that insurers accept. With pure risk, there is the possibility that a certain event will occur, for example, accident or sickness. However, it is the purpose of insurance to restore the insured to his or her original position, not to provide a person with the opportunity of making a profit on an accident or sickness.

#### RISK MANAGEMENT

A hazard is defined as something that increases the risk, or chance of loss. There are three types of hazards: 1) a physical hazard, such as a dead tree next to your house that could blow over during the next windstorm causing damage to your roof; 2) a moral hazard, such as presented by a dishonest client who intentionally damages their own property; and 3) a morale hazard, such as presented by a careless client, or one with no pride of ownership in their property.

A peril is defined as a cause of loss, such as fire, lightning, wind, etc. Some property insurance policies are named peril, covering only those perils that are listed in the policy, while others are all risk, covering all perils, except for those excluded. A loss is generally defined as a reduction in the value of the insured property caused by an insured peril, such as fire.

Risk managers evaluate risks for loss frequency (probability of loss), severity, and potential dollar losses over time. Once the loss exposures are identified and analyzed, the best techniques for dealing with them must be examined.

There are several ways to manage risk. A risk may be retained, avoided, reduced, or transferred. A risk is retained when a person decides to assume financial responsibility for certain events. The deductible amount on an auto insurance policy may be seen as a way the insured retains some portion of the risk. In addition, his premium is reduced because of this assumption of risk. To avoid a risk, a person might stay home rather than drive somewhere. A risk is reduced when a person practices living a healthier lifestyle, thereby reducing the chance of major illness.

A risk may be transferred in two ways. If someone's negligence causes an injury, the person injured could sue the negligent party, transferring the burden of the risk to the negligent party.

The second method for transferring risk is accomplished through the use of insurance. The risk of loss is transferred to the insurance company. However, unlike the first instance of risk transfer, the entire burden is not merely transferred to one party, it is shared among a number of insureds who share the same chance and uncertainty of an event occurring. The characteristics for determining which group of individuals share a common risk are such things as age, gender, and occupation.

Insurance companies predict the potential losses of a large group by studying the past experiences of the group using the mathematical principles of probability and statistics. Looking at groups of individuals, rather than the individuals themselves, to make predictions is called the pooling concept and is an accurate way of predicting potential losses.

### **LAW OF LARGE NUMBERS**

The law of large numbers allows an insurance company to predict the expected losses of a group. The basic principle of this law is that the larger the number of separate risks of a like nature combined into one group, the more predictable the number of future losses of that group within a given time period. For the law of large numbers to operate, it is essential that a large number of exposure units be combined. The exposure unit in life and health insurance is the economic value of the individual person's life. In property and casualty insurance, it is the car, home, or other item to be insured. Insurance companies can only predict the number of losses expected for a group, not for each individual.

If large enough numbers of exposure units are combined, the degree of error in predicting future losses decreases as the number of individual exposure units in a group increases. The larger the group, the more closely the predicted experience will approach the actual loss experience.

Insurance companies collect premiums to cover expenses, profits, and the cost of expected losses. The expected losses are based upon the past experience of the average risk. The fact that some people never experience an automobile accident or that some live well beyond their life expectancy is immaterial, for they are balanced by other people who are involved in accidents or die prematurely. Those insureds who suffer loss are compensated, while many other insureds do not experience sizable losses.

### **INSURABLE INTEREST**

Individuals may not be able to purchase any kind of insurance they desire. To be insurable, a risk must involve the possibility of loss only, and not gain, and the applicant must have a legitimate interest in the preservation of the life or property insured. This requirement is called insurable interest.

A person is presumed to have an insurable interest in his or her own life. An individual is also considered to have an insurable interest in the life of a close relative or a spouse. Insurable interest can also be based on a financial loss that will take place if an insured individual dies. An example is two partners in a business, each of whom brings substantial expertise to that business. If one partner should die, the business could fail, resulting in a loss to the other partner.

For life insurance, insurable interest must exist at the time of the application for insurance, but it need not exist at the time of the insured's death. For property and casualty insurance, insurable interest must exist at the time of loss.

### **INSURABLE RISKS**

An insurance company must be able to predict future losses accurately. Also, the company must deal only with insurable risks. Not all risks are insurable, and it is important to outline those risks to which insurance concepts can be properly applied.

Large Number of Homogeneous Units. The expected loss experience of a group of exposure units cannot be predicted with any certainty unless there is a large number of exposure units in that group. Risks are not considered insurable unless the insurance company has a large enough number of similar risks and knows enough about its previous loss experience to be able to predict the future reliably.

Loss Must Be Calculable. Since the purpose of insurance is to reduce or eliminate the uncertainty of economic loss, it is essential that the insured's economic loss be ascertainable. In other words, the insurer must be able to place a monetary value on the loss. In life insurance, monetary value is placed on the insured's income-earning capacity. It is especially difficult to determine economic loss under health insurance. For this reason, economic loss is measured by lost wages or by actual medical expenses incurred. The potential loss must be measurable so that both parties can agree on the precise amount payable in the event the loss occurs.

Loss Must Be Uncertain. Since the purpose of insurance is to reduce or eliminate uncertainty, it is obviously not in the public interest to permit the writing of insurance for intentional acts, such as a person committing suicide two days after purchasing an insurance policy. Uncertainty arises out of NOT knowing what is going to happen, or being unable to predict what is going to happen to the individual exposure unit. If insurance is provided for other than uncertain losses, the element of chance is not a factor. Nor is there any element of uncertainty in losses occasioned by natural wear and tear or deterioration, depreciation, or defects in property covered under insurance. Losses are expected in these situations, therefore such losses would not be uncertain.

Economic Hardship. The nature of the loss must be such that an economic hardship would occur should the loss occur. There would be little point in obtaining insurance to cover occurrences so minor that a loss would not produce economic hardship. For example, if a person loses one day's pay because of an injury, a loss occurs, but it is not significant enough to be covered by insurance.

The nature of the loss must be such that it is worthwhile to incur the premium cost to cover potential loss. It must be economically feasible to insure. A comparison of the potential loss with the cost of premium is a major consideration to the insurance buyer.

Exclusion of Catastrophic Perils. While the ability to predict future losses with a reasonable degree of accuracy is critical to the insuring function, certain types of perils do not lend themselves to prediction. Such perils, when they cause losses, do not establish a pattern of predictability that can be relied upon for

future predictions of anticipated loss. These perils are usually excluded from coverage. Examples of excluded catastrophic perils are war, nuclear risk, and earthquakes.

Adverse Selection. Many exclusions are also designed to prevent adverse selection, such as the exclusion of damage due to flood on most property insurance policies. From the insurer's point of view, offering coverage for flood damage would constitute adverse selection, since only those clients living in potential flood zones would buy it. As a result, the insurer would very likely lose money writing this coverage. To solve this problem, flood insurance is available in designated flood areas through the federal government's National Flood Insurance Program (NFIP).

## **PRINCIPLE OF INDEMNITY**

The principle of indemnity restores the insured person, in whole or in part, to the condition he or she enjoyed prior to the loss. Restoration may take the form of payment, repair, or replacement.

In life and health insurance, the principle of indemnity takes on a different meaning because value cannot be placed on a human life. With respect to life insurance, the "value" is assigned not to the person's life, but to the person's potential earning power. The intent of a life-insurance policy is to allow the family to continue financially as if the principal breadwinner were still alive.

## **INSURERS**

### **Types of Insurers:**

Insurance is provided to the public by three major sources: private commercial insurers (profit-making), private noncommercial insurers (nonprofit service organizations), and the United States Government. Other types of private insurers include reciprocals, fraternal insurers, Lloyd's Associations, and re-insurers.

Private life and health insurers are in the business to make a reasonable profit, and are, therefore, called commercial insurers. Stock and mutual insurers are private insurers. Private noncommercial service organizations, such as Blue Cross and Blue Shield, operate on a nonprofit basis. A nonprofit status exists when profits are returned to subscribers in the form of reduced premium or expanded benefits.

1. *Stock Insurers*: A stock insurance company, like other stock companies, consists of stockholders who own shares in the company. The individual stockholder provides capital for the insurer. In return, they share in any profits and any losses. Management control rests with the Board of Directors, selected by the stockholders. The Board of Directors elect the officers who conduct the daily operations of the business.
2. *Mutual Insurers*: In a mutual company, there are no stockholders. In a mutual company, ownership rests with the policyholders. They vote for a Board of Directors, which in turn elects or appoints the officers to operate the company. Funds not paid out after paying claims and not used in paying for other costs of operation may be returned to the policyholders in the form of policy dividends. Dividends from a mutual may never be guaranteed and are not taxable.
3. *Reciprocal Insurers*: Reciprocal insurers are un-incorporated groups of people providing insurance for one another through individual indemnity agreements. Each individual who is a member of the reciprocal is known as a subscriber. Administration, underwriting, sales promotion, and claims handling for the reciprocal insurance is handled by an attorney-in-fact.

4. *Fraternal Insurers:* Fraternal benefit societies are primarily life insurance carriers that exist as social organizations and usually engage in charitable and benevolent activities. Fraternal insurers are distinguished by the fact that their membership is usually drawn from those who are also members of a lodge or fraternal organization. One characteristic of fraternal life insurance is the open contract, which allows fraternal insurers to assess their policyholders in times of financial difficulty.
5. *Reinsurance:* Reinsurance is a form of insurance between insurers. It occurs when an insurer (the re-insurer) agrees to accept all or a portion of a risk covered by another insurer.

Companies often use reinsurance to reduce the risk of a catastrophic loss. Insurance against loss by earthquakes and aviation accidents might not be available if a single carrier had to assume all of the risk. Reinsurance makes it possible for a carrier to issue a policy and then share the risk with a larger insurer or a group of insurers.

Reinsurance may be written on an excess of loss basis, which means the re-insurer will pay only the portion of loss that exceeds a threshold, on a quota share basis, which means that the insurers will share loss on a pro rata or fixed-percentage basis, or as facultative, where the insurer elects to reinsure certain risks, but not others.

6. *Surplus Lines:* Occasionally, it may be difficult to place a risk in the normal marketplace. If the risk is very large or unusual in nature, typical carriers may be unwilling to assume it. For some special risks, the only market may be with specialty carriers. Such business must be placed through a licensed excess or surplus lines broker, who will attempt to place it with an unauthorized carrier located in another state or out of the country (such as Lloyd's of London).
7. *Lloyd's Association:* Similar, but not connected to Lloyd's of London, a Lloyd's Association is an unincorporated group of individuals who band together to assume risks in the area of Surplus Lines. Each person is individually responsible only for the share of the risk they agree to assume.
8. *Government Insurers:* The federal government provides life and health insurance through various sources. The federal government has offered a variety of military life insurance plans including United States Government Life Insurance, National Service Life Insurance, and Servicemen's Group Life Insurance.

Because private insurance policies exclude catastrophic risks, the federal government has stepped in to provide War Risk Insurance, Nuclear Energy Liability Insurance, National Flood Insurance, Federal Crime Insurance, Federal Crop Insurance, and insurance on mortgage loans. At the state level, governments are involved in providing unemployment insurance, workers compensation programs and secondary-injury funds, and state-run medical-expense insurance plans.

Federal, state, and local governments provide social insurance to a segment of the population who would otherwise be without disability income, retirement income, or medical care, such as Medicaid.

9. *Domestic, Foreign, and Alien Insurers:* An insurer is defined not only by its corporate status, but also by its locality, or "domicile of incorporation." If an insurer is incorporated under the laws of the state in which it conducts business, that insurer is considered a domestic insurer. If an insurer conducts business in a state where it is not resident, the insurer is considered a foreign insurer. If an insurer is incorporated in a country other than the United States, it is considered an alien insurer.

Therefore, an insurer incorporated in Ohio and conducting business in Ohio is considered a domestic insurer. This same Ohio-based insurer conducting business in Utah is considered a foreign insurer. An insurer incorporated in Canada and conducting business anywhere in the United States or its territories is an alien insurer.

10. *Authorized vs. Unauthorized Insurers:* Before an insurance company can conduct business it must, by law, receive a Certificate of Authority to do so. Insurance statutes require a company to secure a license from the Department of Insurance to sell insurance in a particular state. Once the insurer receives the license, it is considered "admitted" into the state as a legal insurer, and is "authorized" to transact the business of insurance. This licensing power is used to regulate company activities. Licenses may be issued to domestic companies, foreign companies, or alien companies. Surplus Lines carriers are exempt from licensing.

## **INDEPENDENT FINANCIAL RATING SERVICES**

In today's market, no matter what the type of insurance company, agents and clients are very concerned about financial stability. To determine the financial strength of a prospective carrier, agents and clients often turn to independent rating services such as Best's Guide, Standard & Poor's, and Moody's. These private publications may be purchased direct from the publishers or are available at most larger libraries. They rate insurance companies according to the amount of financial reserves the company has available to pay future claims and other liabilities.

## **MARKETING SYSTEMS**

Insurance companies market their products generally by using agents to sell their products or by selling directly through mass marketing. The majority of policies are sold through agents.

Companies that sell through agents vary by whether their agents are their employees or independent businesspersons, and by who owns the policy expirations.

Independent insurance agents sell the insurance products of several companies and work for themselves or for other agents. They sell their clients the policies that fit the clients' needs best among the many insurers they represent, and are paid a commission for each sale. The independent agent owns the expirations of the policies sold, meaning that that individual may place that business with another insurer upon renewal if it is in the best interest of the client.

Exclusive or captive agents represent only one company, and may be paid a salary or compensated by commissions. Exclusive agents do not own the policy expirations. If the exclusive agent has a group of agents working for him, the employing agent then becomes a general agent. The general agent is paid by an overriding commission, a commission paid to the general agent in addition to the commission paid to the soliciting agent or broker.

Managing General Agents (MGA's) are usually required to obtain an MGA license from the state Department of Insurance. MGA's may be independent, representing several insurance companies, or they may have an exclusive agreement with just one carrier.

Direct writing companies pay salaries to employees whose job function is to sell their company's insurance products. In this case, the insurance company owns the expirations and the agents' business.

Mass marketing has grown in general use over the past several years. The most common types of mass marketing systems are direct-response, franchise, non-insurance sponsors, and vending machine sales.

Direct-response marketing is conducted through the mail, by advertisement in newspapers and magazines, and on television and radio. Policies sold by this method usually have limited benefits and low premiums.

The franchise marketing system provides coverage to employees of small firms or to members of associations. Unlike group policies, in which benefits are standard for classes of individuals, persons insured under the franchise method receive individual policies that vary according to the individuals' needs.

Franchise plans are attractive to employers who do not, according to the laws of their state, meet the qualifications for a "true group." They allow the employers to offer individual insurance to their employees at a lower premium than for insurance purchased on an individual basis. Premiums may be deducted from the individual's paycheck.

Non-insurance sponsors are being used more and more. The most common are banks and companies that issue credit cards. This marketing system reaches a select group of individuals who have a history of periodic payments. Usually the sponsor is responsible for the billing of premium, which is added to the billing statement or deducted from checking accounts. Vending-machine sales usually consist of travel-accident policies sold at airport counters. A large amount of coverage is available at low premiums. The coverage is good only for the duration of a single trip and usually covers accidental death only.

### AGENTS (PRODUCERS)

Property and Casualty agents appointed by property and casualty insurance companies generally are granted more authority than life and health agents. These agents may bind or commit their companies by oral or written agreement. Binders are considered to be temporary insurance and are considered to include all of the terms of the policy to be issued. Binders may be written for a specific period of time or may be considered to be valid until superceded by the policy. An agent's binding authority, if any, is contained in their contract with the insurance companies they represent. They sometimes inspect risks for the insurance company and collect premiums due.

Property and casualty agents are also often licensed as brokers in some states. Unlike an agent, a broker is not the direct representative of any particular company, nor is she under contract to any. She is an independent salesperson who selects for her client insurance coverage from whatever company best fills the client's needs. Like the agent, the broker may operate as an individual, although some of the very largest insurance sales offices are brokerage firms that operate nationwide and employ hundreds of agents and brokers. Brokers may not make binders of coverage, since they do not represent the insurer.

An understanding of the Law of Agency is important, as an insurance company, like other companies, must act through agents and are vicariously liable for their activities.

Agency is a relationship in which one person is authorized to represent and act for another person or for a corporation. Although a corporation is a legal "person," it cannot act for itself, so it must act through agents. An agent is a person authorized to act on behalf of another person, who is called the principal. When one is empowered to act as an agent for a principal, she is legally assumed to be the principal in matters covered by the grant of agency. Contracts made by the agent are the contracts of the principal. Payment to the agent, within the scope of her authority, is payment to the principal. The knowledge of the agent is assumed to be the knowledge of the principal. The authority of an agent is of three types: **express, implied, and apparent**.

Express authority is an explicit, definite agreement. It is the authority the principal gives the agent as set forth in her contract. It is very important for an agent to know the limitations of the contract and to operate within its limits. To do otherwise could place her in a position of personal liability for Errors and Omissions (E&O). Her actions and knowledge are binding on the insurance company, so she must be alert to the consequences of her actions and words.

Implied authority is not expressly granted under an agency contract, but it is actual authority that the agent has to transact the principal's business in accordance with general business practices. For example, if an agent's contract does not give her the express authority of collecting and submitting premium, but the agent does so on a regular basis and the company accepts the premium, then the agent is said to have implied authority. That is, it is a general business practice to collect premium, and by accepting the premium from the agent, the company has implied that the agent has the authority to conduct this practice.

Apparent authority is the authority an agent seems to have because of certain actions taken on his part. This action may mislead applicants or insureds, causing them to believe the agent has authority that he does not, in fact, have. The principal adds to this impression by acting in a manner that reinforces the impression of authority. For instance, an agent's contract usually does not grant him the authority to reinstate a lapsed policy by accepting past due premiums. If, in the past, the company has allowed the agent to accept late premiums for that purpose, a court would probably hold that the policyholder had the right to assume that the agent's acceptance of premium was within the scope of his authority.

All premiums received by an agent are funds received and held in trust. The agent must account for and pay the correct amount to the insured, insurer, or other agent entitled to the money.

An agent has a fiduciary duty to the insured or applicant. A fiduciary relationship is developed when a person relies on, or places confidence, faith, or trust in, another person's action or advice. An agent, as a "fiduciary," has accepted the obligation of acting in the insured's best interest. To do this, the agent must become familiar with not only the features of the various policies that she sells to the public, but also the many uses to which these policies can be put. The agent must also explain the features of each policy, including its provisions, riders, exclusions, and all possible options to the client.

The agent also owes certain general responsibilities to the company. First, an agent owes the duty of loyalty. Second, the agent owes a duty to obey the company and to perform in accordance with instructions given by the company. If the agent violates the instructions and causes the company a loss, he may be liable to the company for any breach of duty.

Third, an agent has a duty to act with that degree of care that a reasonable person would exercise under comparable circumstances. Fourth, an agent must account for all property or money belonging to the company that comes into the agent's possession. Fifth, an agent is required to inform his company of all facts that are pertinent to the agency relationship in order that the company will be best protected.

Since an agent acts in the place of his company, the act of the agent is, under the eyes of the law, considered to be the act of the company. Each agent should stress to a potential insured the importance of filling out the insurance application completely and honestly. False statements made therein may invalidate the insurance contract if they are not true.

Errors and Omissions (E&O) insurance is needed by professionals who give advice to their clients. It covers negligence, error, or omission by the insurer or the agent who is the insurer's representative. E&O policies protect agents from financial losses they might suffer if insureds sue to recover for their financial loss due to an agent giving them incorrect advice (error) or not informing them of an important issue (omission).

E&O policies cover only losses due to negligence, error, or omission. E&O policies usually have a high deductible that provides an added incentive for an agent to minimize his errors. E&O coverage may be written with both a limit per claim and a limit for all claims during the policy period. They are usually written on a “claims made” basis. E&O policies do not cover embezzlement or filing of false financial statements or bodily-injury or property-damage liability.

## CONTRACTS

Insurance policies are contracts. In order to be enforceable in court, they must contain four essential elements, often given the acronym “COAL”:

**Consideration:** The exchange of something of value between the parties. The client pays the premium and the insurance company promises to provide coverage. The consideration given between parties does not necessarily have to be equal.

**Offer:** This must be clearly communicated. Usually, the offer is made by the client when he completes and signs the application and writes out his check for the first premium payment.

**Acceptance of the offer:** This is usually done when the underwriter approves the application and issues the policy for delivery.

**Legal Purpose and Legal Capacity:** Contracts for illegal purposes are unenforceable in court, and, of course, all parties to a contract must be competent to contract, meaning they must be of age, of sound mind, and not under the influence of drugs or alcohol.

Since insurance contracts are unique in that the client must buy them as written without any chance to modify or clarify the contract language, the Doctrine of Adhesion states that if the insurance contract language is vague or unclear, any ambiguity will be construed in favor of the insured, since that person had no chance to change it when she bought it. This is why insurance companies don't like to go to court, since they usually lose!

Of course, insurance companies issue most policies based on the answers contained in the application, which are considered to be representations, or the truth to the best of the client's knowledge. If everyone lied, the insurance industry would not be able to function. It is based on the Doctrine of Utmost Good Faith, which applies to all parties involved, including the applicant, the agent, and the insurer.

The legal doctrine of Waiver and Estoppel also relates directly to the responsibilities of insurance agents. Waiver is defined as the voluntary giving up of a known right. Once given up, it cannot be used as a defense in court. In other words, once a waiver of a known right has occurred, the party waiving those rights is stopped from asserting that right in the future. This is known as the Doctrine of Estoppel.

Of course, some clients do make misrepresentations on applications or attempt to conceal material facts from the agent and underwriter. Concealment is defined as the deliberate omission of a material fact. Fraud is defined as a deliberate attempt to deceive the agent or insurance company. Either could cause the policy or claim to be voided by the insurance company. However, since fraud is very hard to prove, most insurance companies are reluctant to use it as a defense, since if they fail to prove it, the other party may sue the insurance company for libel or slander and will probably win.

Insurance contracts also contain several other distinct characteristics. An insurance policy is considered to be unilateral, since only one party to the contract, the insurance company, makes an enforceable promise. The insurer promises to pay covered claims if the insured pays the required premium.

A policy is also conditional, meaning that both parties must comply with certain specified conditions. For example, on fire insurance, the insured must submit notice of claim to the insurer immediately and the insurer must pay covered claims within a specified number of days. Notice of Claim and Payment of Claims are both conditions in the contract.

Insurance policies are also considered to be aleatory, in that the outcome depends upon chance. Further, the consideration exchanged need not be equal. The policyholder pays a premium and may collect nothing from the insurer or may collect a good deal more than the amount of the premium if a loss occurs.

Most property and casualty policies are also based upon the Principal of Indemnity, which states that the insured may only collect the amount of the claim, or the policy limit, whichever is less.

Insurance contracts are also based upon the Doctrine of Utmost Good Faith, which requires all parties to the contract to be honest. For example, if the insured “warrants” on his application for commercial fire insurance that he has a working sprinkler system, the insurer may allow him a substantial premium discount. However, if the insured in fact has no such safeguard, this breach of warranty could possibly void coverage.

However, insurance contracts must also comply with the Doctrine of Reasonable Expectations, which means that a client may reasonably expect certain perils to be covered. Remember, very few clients actually read their policies, and are really not expected to. It is the agent’s job to explain any limitations in coverage.

# General Insurance

## KEY FACTS

- Insurance is defined as the transfer of PURE risk to the insurance company in consideration for a premium.
- An MGA (Managing General Agent) is a person who exercises general supervision over the business of an insurance company, including hiring and firing agents.
- Concealment is defined as the failure to disclose a material fact.
- Conditions state the insured's duties in the event of a claim (for example, Notice of Claim).
- Errors & Omissions insurance protects professional persons such as insurance agents in case they are sued for negligent performance of their duties.
- Surplus Lines coverage is usually sold by unauthorized companies, such as Lloyd's of London.
- A representation is defined as the truth to the best of your knowledge. A warranty is defined as a sworn statement of truth, guaranteed to be true.
- Stock insurance companies may pay dividends to stockholders.
- A reciprocal insurance company is managed by an attorney-in-fact.
- You can only share commissions with other agents who are licensed for the same lines of insurance that you are.
- Dividends paid by a stock company to stockholders are taxable as ordinary income.
- A policy may be "modified" only by a company officer by written endorsement.
- A "foreign" company has their home office in another state.
- Binders may start coverage. Binding authority is in the agents contract.
- Independent Agents own their own accounts & are not insurance company employees.
- The doctrine of "Utmost Good Faith" states parties to the contract rely on the honesty of each other.

- If a policy is vague, all doubts will be resolved against the insurer. This is called the “Doctrine of Adhesion”.
- Insurance laws are not required to be uniform from one state to another.
- Moral hazard is presented by a dishonest client.
- Speculative risk has the possibility of gain or loss & is not insurable.
- The Law of Large Numbers allows insurers to predict claims more accurately.
- Direct writing insurance companies use salaried agents.
- An agent's Express Authority is contained in their agent's contract.
- The chance of loss without any chance of gain is called Pure Risk.
- An “Aleatory” contract is one where the outcome depends upon chance.
- A “friendly” fire is one confined to an intended area, such as your fireplace.
- A “hostile” fire is one that escapes it’s intended area.

# General Insurance

## Practice Examination

1. All of the following are true about “speculative risk” except:
  - A. Speculative risk involves an uncertainty of loss
  - B. Speculative risk involves a possibility of gain
  - C. Speculative risk is a feature of gambling
  - D. Speculative risk is a feature of insurance
  
2. Not all risks are insurable. Certain characteristics must be present for a particular risk to be considered an “insurable risk”. Which of the following characteristics might make a risk uninsurable:
  - A. Risk of loss can be defined in terms of a specific number of dollars
  - B. Risk of loss exists because of a catastrophic exposure
  - C. Expected loss can be predicted when dealing with a large number of exposure units
  - D. If a loss occurs, it would result in an economic hardship
  
3. In the property and casualty insurance field, "insurable interest" must exist:
  - A. At the time application is made for the insurance
  - B. At the time the loss occurs
  - C. At the time of application or at the time of loss
  - D. At the time of application and at the time of loss
  
4. An insurer incorporated under the laws of the state in which it is operating is considered to be a(n):
  - A. Foreign insurer
  - B. Alien insurer
  - C. Domestic insurer
  - D. Reciprocal insurer
  
5. An insurance company owned by its policyholders, who receive a return of unused premiums in the form of policy dividends, is a(n):
  - A. Stock company
  - B. Assessment insurer
  - C. Mutual company
  - D. Fraternal insurer

6. Which of the following is not one of the available methods for dealing with an exposure to risk:
- A. Retain the risk
  - B. Transfer the risk
  - C. Avoid the risk
  - D. Ascertain the risk
7. An agent's obligation to act in an insurance applicant's or insured's best interest, based on the faith and trust placed on the agent by members of the insurance-buying public, is known as:
- A. Warranty of the agent
  - B. The duty owed to a principal
  - C. A fiduciary duty
  - D. A presumption of agency
8. All of the following are true about an agency relationship between an insurance agent and an insurer EXCEPT:
- A. An agent is authorized to act on behalf of the insurer
  - B. Acts of an agent are considered to be acts of the insurer
  - C. An agent has unlimited authority over insurance matters within agency
  - D. Knowledge of an agent is considered to be knowledge of the insurer
9. The authority of an insurance agent that is spelled out in the written words of the agency contract between the agent and the insurer is:
- A. Apparent authority
  - B. Presumed authority
  - C. Express authority
  - D. Implied authority
10. Under contract law, the actions by a party may intentionally and voluntarily give up a known right. When this occurs, it is known as:
- A. Warranty
  - B. Waiver
  - C. Representation
  - D. Binding contract
11. When a party appears to have given up a particular right by acts or by inaction that another party has relied on, the legal basis for asserting the original right may have been lost. This is known as the legal doctrine of:
- A. Estoppel
  - B. Warranty
  - C. Waiver
  - D. Conditional precedent

12. Each of the following elements is necessary for formation of a legally valid contract EXCEPT:
- A. Consideration
  - B. Agreement
  - C. Signatures of each party
  - D. Competent parties
13. In the formation of a legal contract, each party must give something of value. Under contract law, this is referred to as:
- A. Adhesion
  - B. Consideration
  - C. Indemnity
  - D. Agreement
14. Because an insurer writes the policy language and the insured has little or no control over the content, any ambiguity in the wording is usually resolved in favor of the insured. Because the design and wording of a policy are in the hands of the insurer, insurance policies are said to be:
- A. Aleatory contracts
  - B. Unilateral contracts
  - C. Contracts of adhesion
  - D. Contracts of indemnity
15. When a property insurance applicant makes a statement on an application that becomes part of the contract and includes a promise by the insured, the statement is considered to be a:
- A. Condition precedent
  - B. Waiver
  - C. Representation
  - D. Warranty
16. A group of individuals who band together to assume risks, where each individual is responsible only for the share of the risk they assumed is known as:
- A. Lloyd's Association
  - B. Excess Lines
  - C. Lloyd's of London
  - D. Reinsurance
17. The uncertainty about loss that exists whenever more than one outcome is possible is called:
- A. Insurable interest
  - B. Hazard
  - C. Indemnity
  - D. Risk

18. Insurable interest exists only when a number of conditions are met. Which of the following is not one of the requirements for insurable interest?
- A. The applicant must face a risk of loss
  - B. The applicant must have an interest in protecting what is insured
  - C. The applicant must not have a potential for gain because of the insurance
  - D. The applicant must not share the interest with anyone else
19. All of the following are true about "insurance" EXCEPT:
- A. It is a social device for spreading loss over large numbers of people
  - B. It involves the pooling of large numbers of individual risks
  - C. It is a form of gambling because it may or may not pay off
  - D. It transfers risk from one party to a group
20. Something that may increase the seriousness of a loss if loss occurs, or that increases the likelihood that a loss will occur, is called a:
- A. Catastrophe
  - B. Risk
  - C. Peril
  - D. Hazard
21. What is the name of the type of insurer consisting of an unincorporated group of persons who provide insurance among themselves through an inter-exchange of indemnity agreements?
- A. Fraternal insurer
  - B. Reciprocal insurer
  - C. Self-insurer
  - D. Re-insurer
22. Apparent authority of an insurance agent is the authority:
- A. The agent tells an insurance applicant she has
  - B. Given by the agent's contract with the insurer
  - C. The public has a right to assume that the agent has
  - D. Acts of the insurer may lead the public to believe the agent has
23. Failure to disclosed known facts when filling out an insurance application is an act of:
- A. Impersonation
  - B. Estoppel
  - C. Concealment
  - D. Aleatory action

24. In property and casualty and in medical-expense insurance, the principle of making someone “whole” again after a loss by paying only for actual losses is called:
- A. Subrogation
  - B. Warranty
  - C. Indemnity
  - D. Estoppel
25. A property and casualty insurance agent frequently has the authority to provide temporary insurance coverage known as a:
- A. Binder
  - B. Quotation
  - C. Certificate
  - D. Policy
26. Which type of licensee represents insureds or prospective insureds and does not represent an insurance company?
- A. An insurance agent
  - B. An independent insurance agent
  - C. An insurance broker
  - D. A service representative
27. The insurance business is regulated primarily by:
- A. State laws
  - B. Federal laws
  - C. Individual insurance companies
  - D. The National Association of Insurance Commissioners
28. A contract where only one party, the insurer, makes an enforceable promise is said to be:
- A. Aleatory
  - B. A Contract of Indemnity
  - C. Unilateral
  - D. A Contract of Adhesion
29. In which company may stockholders share in the profits and losses of the insurer:
- A. Stock
  - B. Service
  - C. Mutual
  - D. Assessment
30. In which company may policyholders receive policy dividends when there is a profit:
- A. Stock
  - B. Service
  - C. Mutual
  - D. Assessment

31. The Law of Large Numbers states that:
- A. The predictions become more accurate as the number of units being considered increases
  - B. Large losses are easier to predict
  - C. Small losses are predictable
  - D. All losses are predictable
32. Insurable risks must involve:
- A. Certain and uncertain losses
  - B. The possibility of loss only
  - C. Certain losses only
  - D. Gambling
33. An agent is a representative of:
- A. The insured
  - B. The insurance company
  - C. The general agency system
  - D. The policyholder
34. An agent's responsibilities may include all of the following EXCEPT:
- A. Collection of premiums
  - B. Informing the principal of pertinent facts
  - C. Changing provisions in the policy
  - D. Delivering the policy
35. Which element of an insurance contract requires that the insured have the legal capacity to make a contract:
- A. Agreement
  - B. Competent parties
  - C. Consideration
  - D. Legal object
36. Which of the following terms means that an insurance contract is dependent upon chance or uncertain outcome:
- A. Valued
  - B. Unilateral
  - C. Aleatory
  - D. Adhesion
37. All of the following statements regarding concealment are false EXCEPT:
- A. Concealment is never grounds for rescission of a policy
  - B. Concealment is the failure to disclose any material fact
  - C. If concealment is suspected, the burden of proof is on the insured
  - D. Concealment involves answering a question without an intent to defraud

38. All of the following statements are true about a representation EXCEPT:
- A. A representation of a fact is the same as an expression of opinion
  - B. It usually appears in an application
  - C. A policy is usually voided if a misrepresentation is of a material fact
  - D. Representations are sometimes given orally
39. Which of the following contractual elements consists of the “offer” and the “acceptance”:
- A. Consideration
  - B. Competent parties
  - C. Agreement
  - D. Legal object
40. Insurance is a means of:
- A. Eliminating risk
  - B. Avoiding risk
  - C. Transferring risk
  - D. Retaining risk
41. Which of the following is an insurable risk:
- A. Wear and tear on a valuable oriental rug
  - B. Theft of a paperback book
  - C. Hail damage to the roof of a car
  - D. All of the above
42. A moral hazard:
- A. Arises through an individual's carelessness or irresponsible action
  - B. Is the tendency to create a loss on purpose, to collect from the insurance company
  - C. Arises from the condition, occupancy, or use of the property itself
  - D. Is not a consideration in insurable risk
43. In which of the following would a person have an insurable interest:
- A. The house she owned but has rented to a tenant
  - B. The car on which she is still paying
  - C. Both A and B
  - D. Neither A nor B
44. All of the following are required elements of a legal contract EXCEPT:
- A. Offer and acceptance
  - B. Legal purpose
  - C. Competent parties
  - D. Waiver and Estoppel

45. A binder:
- A. Is always a written agreement
  - B. Guarantees that a policy will be issued
  - C. May only be issued by the insurance company
  - D. May be oral or written
46. An independent agent:
- A. Represents only direct writers
  - B. Works for a solicitor
  - C. Represents more than one insurance company
  - D. Is a “captive” agent
47. Statements provided by an applicant for insurance are considered to be:
- A. Warranties
  - B. Considerations
  - C. Legal instruments
  - D. Representations
48. All of the following choices are true about “insurance” EXCEPT:
- A. It is a social device for spreading loss over a large number of people
  - B. A large, uncertain loss is traded for a small, certain loss
  - C. Insurance is a mechanism for handling speculative risk
  - D. Insurance transfers risk from one party to a group
49. Supreme Court decisions and case law have contributed to the regulation of the insurance business. This is an example of:
- A. State regulation
  - B. Federal regulation
  - C. Legal precedent
  - D. Impending regulation
50. Some agents supervise all of an insurance company’s business within a specified territory. These agents appoint other agents, supervise their business, and receive an overriding commission on that business. What is the formal name for this type of agent:
- A. General agent
  - B. Captive agent
  - C. Exclusive agent
  - D. Independent agent

# General Insurance

## Practice Exam Answers & Rationales

1. **D** Only pure risk is insurable, which is defined as the chance of loss without any possibility of gain. Speculative risk, like investing in the stock market which has the chance of gain or loss, is not insurable.
2. **B** Insurers avoid insuring catastrophic situations, such as floods or earthquakes, due to adverse selection. The only people who need flood insurance are those living next to the river, and since there isn't enough of them, the insurer would lose money selling flood insurance.
3. **D** Insurable interest must also exist at the time of loss. For example, you sell your house but have not yet canceled your fire insurance policy. If the house burns down, you have no coverage under your policy since you no longer own it. The new owner better have his own policy.
4. **C** A domestic company is incorporated in this state. A foreign company is incorporated in another state and an alien company in another country.
5. **C** A mutual company has no stock although it is a corporation. Ownership of the company rests with the policyholders, who might receive a dividend from accumulated surplus, if declared. Dividends are not guaranteed. Dividends paid by mutuals are not taxable. A stock company is owned by shareholders, who have "equity" in the company. The stockholders may also receive dividends, which are taxable. Stock companies issue "non-participating" policies. A fraternal insurer is non-profit with a lodge system who sells L&H insurance only to their own members.
6. **D** Once a risk is identified, it can be dealt with in several ways. Self insurance is risk retention. Insurance is defined as the transfer of risk. Avoiding risk is difficult.
7. **C** A fiduciary is someone you have trust and confidence in, such as an insurance agent or banker. People who handle other people's money are considered to be fiduciaries.
8. **C** Agents represent the insurer and sign an agent's contract which spells out their authority. For example, if you sell P&C, what is your "binding" authority? Look in your agents contract to find out.
9. **C** Express authority is written down or "expressed" in your agent's contract. Implied authority is the authority an agent has based on the reasonable expectations of his customers. Apparent authority is the authority created when the action or inaction of an insurer gives the impression that such authority exists.

10. **B** Waiver is defined as the voluntary giving up of a legal right. The doctrine of estoppel states that once you voluntarily waive a legal right, you can't get it back.
11. **A** See # 10 above. Waiver and estoppel generally go together.
12. **C** The requirements of a legal contract include: Consideration, offer, acceptance and legal purpose and capacity. Signatures are commonly required, but not always. For example, a binder is a legal contract, but the insured is not required to sign it.
13. **B** Consideration is defined as the exchange of values. A client exchanges a small certain amount (the premium) for a large uncertain amount (the possibility of a claim). The Principal of Indemnity states that you cannot recover more than you lost. The doctrine of adhesion states that any ambiguity in an insurance contract is always construed against the party who wrote it, the insurer. This is why the insured often wins in court, since they had to buy the policy without any negotiation. Insurance contracts are one sided, meaning unilateral.
14. **C** See # 13 above.
15. **D** Warranties are defined as something you guarantee to be true, and are usually not required, although some P&C policies ask that the customer "warrant" that a protective safeguard (such as a fire alarm or a sprinkler system) has been installed in order to get a rate reduction.
16. **A** Although organized along the same lines, a Lloyd's Association is not connected to Lloyd's of London. Lloyd's Associations are a group of unincorporated individuals who pledge their personal assets to underwrite risks that authorized insurers will generally not accept. Lloyd's of London is the best known, but there are many other similar organizations in the Surplus Lines area.
17. **D** Risk is the chance or uncertainty of loss. A hazard is something that increases the risk. The word indemnity means to pay or to reimburse the insured for covered losses. The principal of indemnity states that an insurance policy cannot pay you more than you actually lost.
18. **D** Both husband and wife could have an insurable interest in their home. Insurable interest is based on economics, meaning the chance of monetary loss.
19. **C** Insurance is not considered to be gambling. Remember, only pure risk is insurable, which is the chance of loss without any possibility for gain.
20. **D** A hazard increases the risk, such as storing gasoline in your garage next to your hot water heater with a pilot light. Risk is defined as the chance of loss. A peril is a cause of loss.
21. **B** A reciprocal insurer sells only P&C. Reciprocal subscribers interexchange agreements of indemnity through an attorney-in-fact.
22. **D** If the insurer you work for allows you to accept a premium check on their behalf, then you apparently have that authority, even though it is not expressly stated in your agent's contract.

23. **C** Misstating a material fact is misrepresentation but failure to disclose a material fact is concealment. Both are grounds for voiding coverage. An aleatory contract is one where the outcome depends upon chance. You buy insurance in case you might have a claim, but maybe you won't.
24. **C** The Principal of Indemnity states you cannot make a profit from insurance. Subrogation is a provision that allows your insurance company to stand in your place to recover moneys they have already paid you.
25. **A** Binders are temporary insurance until the policy is issued. They can be oral or written.
26. **C** Brokers represent the customer. Agents represent the insurer. A service representative works for an insurance company in a marketing capacity. An independent agent may represent as many insurers as he wants and is paid on a straight commission basis.
27. **A** Insurance is regulated by state law. The National Association of Insurance Commissioners (NAIC) works to provide some uniformity in state insurance laws, but there is a long way to go.
28. **C** Most contracts are bilateral, or two-sided, where both parties make enforceable promises to the other. However, an insurance contract is unilateral, or one-sided, in that only the insurance company is bound to perform. A court can require that an insurer pay a covered claim, but they cannot require an insured to pay a premium.
29. **A** Stockholders may receive dividends from the shares of stock they own in a stock company. These dividends are not guaranteed, but if paid, are taxable as ordinary income.
30. **C** A mutual company may pay dividends to policy holders since they issue a "participating policy." Dividends, if paid, are not taxable and are never guaranteed.
31. **A** The more people an insurer covers, the easier it is to predict future claims based on the law of large numbers. This is why life insurance companies usually make a profit. They can measure the chance of death at any given age very accurately based on a mortality table, which tracks 10,000,000 people.
32. **B** Remember, pure risk involves the chance of loss only. If there is any chance for gain, the risk is not insurable. In addition, if it is certain there will be a loss, the insurer will decline coverage since they are sure to lose money.
33. **B** Agents represent the insurer. Brokers represent the insured and solicitors represent either an agent or a broker.
34. **C** Only a company officer can approve changes in a policy requested by an insured.
35. **B** Legal capacity means that the parties to the contract are not minors and are not incapacitated in any way, such as being under the influence of drugs or alcohol.
36. **C** Aleatory means that the consideration is not necessarily equal. A valued contract is like life insurance, where the insurer agrees to pay a specified amount upon the death of the insured, regardless of his human life value. All insurance contracts are unilateral,

meaning one sided. The doctrine of adhesion states that any vague language in an insurance contract will be construed against the insurance company, since they wrote it.

- 37. **B** Concealment is the failure to disclose a material fact and can be grounds for voiding the contract.
- 38. **A** A representation is the truth to the best of your knowledge and is the basis for writing the contract. Insurance contracts are based on the doctrine of “utmost good faith,” which states that all parties to the application are expected to tell the truth.
- 39. **C** Mutual agreement of the parties is also known as offer and acceptance. The client makes the offer when they sign the application and write the initial premium check. The underwriter accepts the risk by issuing the policy.
- 40. **C** Insurance is defined as the transfer of risk in consideration of a premium paid. If you drive without auto insurance, you are retaining the risk by self insuring. If you take the bus, you are avoiding the risk. If you sell your car, you are eliminating risk.
- 41. **C** Small losses are not generally insurable, which is why the insurer often requires a deductible. Wear and tear is always excluded.
- 42. **B** A moral hazard is created by a dishonest person, such as someone who may use arson to collect on their fire insurance. Moral hazards are best spotted by the agent, who is considered to be the “front line” underwriter.
- 43. **C** Insurable interest is based on economics and must exist at the time of loss in P&C insurance.
- 44. **D** Waiver and estoppel are legal doctrines, but are not parts of the contract.
- 45. **D** This was discussed previously.
- 46. **C** Captive or exclusive agents work for only one insurer and are often company employees. Independent agents are self employed and usually represent more than one insurer on a straight commission basis.
- 47. **D** This was discussed previously.
- 48. **C** Speculative risk, like the chance of winning the lottery, is not insurable.
- 49. **C** Legal precedent often has an effect on insurance regulation. This is why insurers are reluctant to change their policy forms, since many prior court cases rest on that language. For example, the standard fire policy hasn’t been changed since 1943.
- 50. **A** A general agent or managing general agent (MGA) is like a sales manager who is responsible for recruiting and training agents on behalf of an insurer in a specific territory. They need a special MGA license in most states and are compensated on a commission over-ride basis.