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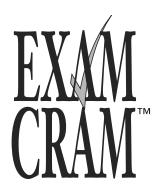
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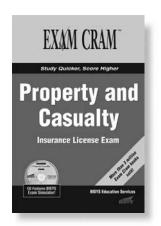
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Introduction

Welcome to *Life and Health Insurance Licensing Exam Cram!* Whether this is your first or your fifteenth *Exam Cram* series book, you'll find information here that will help ensure your success as you pursue knowledge, experience, and certification. This introduction explains state insurance licensing programs in general and talks about how the *Exam Cram* series can help you prepare for your state insurance licensing exam. Chapters 1 through 19 are designed to remind you of everything you need to know in order to take—and pass—your state insurance licensing exam. The two sample tests at the end of the book should give you a reasonably accurate assessment of your knowledge—and, yes, we provide the answers and their explanations to the tests. Read the book and understand the material, and you stand a very good chance of passing the test.

Exam Cram books help you understand and appreciate the subjects and materials you need to pass state insurance licensing exams. Exam Cram books are aimed strictly at test preparation and review. They do not teach you everything you need to know to pass the exam. Instead, we present and dissect the questions and problems I've found that you're likely to encounter on a test. I've worked to bring together as much information as possible about state insurance licensing exams.

Nevertheless, to completely prepare yourself for any state insurance licensing test, we recommend that you begin by taking the Self-Assessment that is included in this book, immediately following this introduction. The Self-Assessment tool will help you evaluate your knowledge base against the requirements for a state insurance licensing exam under both ideal and real circumstances.

Based on what you learn from the Self-Assessment, you might decide to begin your studies with some more comprehensive self-study or classroom training, some practice with state insurance exam simulators, or an audio review program. On the other hand, you might decide to pick up and read one of the many study guides available from third-party vendors on certain topics. We also recommend that you supplement your study program with a visit to your state insurance department's website to get all the details about

how to get your insurance license as well as how to schedule and take your insurance licensing exam.

Getting an Insurance License

Licensing is the way governments assure that only qualified individuals are allowed to practice certain important professions, such as being an insurance producer. Because insurance is regulated primarily at the state level, the rules for getting an insurance license vary somewhat from state to state.

Every state requires individuals to pass a qualification exam to get an insurance license. In addition, most states require individuals to meet a prelicensing education requirement before they can take the qualification exam. In some states, the prelicensing education requirement can be met through an approved self-study course—that is, you buy a book that has been approved in advance by the state insurance department and take an exam (not to be confused with the licensing qualification exam) that you send in to be graded. In other states, the prelicensing education requirement can be met only by attending an approved classroom course.



This Exam Cram text is not approved to meet the prelicensing education requirement in any state. It is designed only as a supplementary aid to help you pass the state insurance licensing exam.

Besides fulfilling any prelicensing education requirement and passing the licensing exam, insurance license candidates must also submit a license application to their state insurance department and have it approved. In some states, the license application must be submitted before taking the license qualification exam; in some states, it must be submitted after passing the exam. Call your state insurance department's licensing division or visit its website to find out what you need to do in your state.

Taking a Licensing Exam

As with other aspects of insurance licensing, specific instructions on how to register for your qualification exam are available from the insurance department. Ask for a licensing information bulletin or a licensing candidate handbook, which will describe where and when exams are given, the fees you must pay, and the testing procedures.

One thing all state insurance qualification exams have in common is that they are closed-book exams. You will not be allowed to take any study materials or notes into the testing room. Even phones and calculators might not be allowed. In some states, the only items exam candidates are permitted to take into the testing room are their wallet and keys.

In most states, insurance qualification exams are given on computers. However, you will not need any computer or typing skills to take the exam. You will be instructed on how to answer questions and given a short practice test to get comfortable with the equipment before the actual qualification exam begins.

When you complete a computer-administered exam, the software tells you immediately whether you passed or failed. Your states will have its own rules for retesting in the event you don't pass. Those rules will be described in your licensing information bulletin/candidate handbook.

How to Prepare for an Exam

Whether or not your state has a prelicensing education requirement, you'll want to study in preparation for the license qualification exam. And even if your state has a prelicensing education requirement, you'll probably want to do some additional studying to make sure you are fully prepared for the exam. Your options for additional study include the following:

- ➤ Self-study courses—Publishers such as BISYS Education Services offer courses designed to allow you to study on your own for the licensing qualification exam. BISYS license training packages are available in either web-based or print-based formats and contain a number of components:
 - ➤ A Property-Casualty Concepts text, which covers all the non-state-specific topics on the licensing exam
 - ➤ Practice exams, which help you evaluate your comprehension of the material in the Concepts text
 - Explanations to answers on the practice exams, so you know why each of your responses was right or wrong
 - ➤ A state insurance law digest, which covers all the state-specific topics on the licensing exam
 - ➤ An optional audio CD review program, which reviews the key information contained in the Concepts text

- ➤ An optional exam simulator, which gives you additional question-andanswer practice over the material covered in the *Concepts* text and the state insurance law digest
- ➤ Classroom training—Many colleges and commercial training companies offer classroom training for insurance license exams. Although classroom training generally costs considerably more than self-study, some individuals find that they learn best in a classroom situation. And of course, in many states, the prelicensing education requirement must be met with classroom study in any case.
- ➤ Other sources—There's no shortage of materials available on insurance topics. The "Need to Know More?" resource appendix at the end of this book will give you an idea of where we think you should look for further discussion.

In addition, you will surely find Que Publishing's *Exam Cram* insurance licensing preparation materials useful in your quest for insurance knowledge. *Exam Cram* books provide you with a review of the essential information you need to know to pass the tests. They focus on the detailed information in the *Concepts* texts available from BISYS Education Services. Together, the BISYS Education Services license training packages and the *Exam Cram* review materials create a powerful exam preparation program.

This set of required and recommended materials represents an unparalleled collection of sources and resources for insurance licensing qualification and related topics. Our hope is you'll find that this book belongs in that company.

What This Book Will Not Do

This book by itself will *not* teach you everything you need to know to pass your insurance licensing exam. It does not cover the state-specific topics that appear on the exam, usually dealing with laws that apply only in your particular state. That information, although it represents a small proportion of the entire exam, is critical to passing the exam. State-specific topics are covered in the state insurance law digests available from BISYS Education Services. This book reviews the rest of what you need to know before you take the test, with the fundamental purpose dedicated to reviewing the non–state-specific information on the insurance licensing exam.

What This Book Is Designed to Do

This book uses a variety of teaching and memorization techniques to analyze the exam-related topics and to provide you with ways to input, index, and retrieve what you need to know in order to pass the test.

This book is designed to be read as a pointer to the areas of knowledge on the test. In other words, you may want to read the book through once to get an insight into how comprehensive your knowledge of insurance is. The book is also designed to be read shortly before you go for the actual test and to give you a distillation of the topics covered by the exam in as few pages as possible. We think you can use this book to get a sense of the underlying context of any topic in the chapters—or to skim-read for Exam Alerts, bulleted points, summaries, and topic headings.

We draw on material from each state's exam outlines and from other preparation guides, in particular, BISYS Education Services' Property-Casualty Concepts text. Our aim is to walk you through the knowledge you will need and point out those things that are important for the exam (Exam Alerts, practice questions, and so on).

We demystify insurance jargon, acronyms, terms, and concepts. Also, wherever we think you're likely to blur past an important concept, we define the assumptions and premises behind that concept.

About This Book

We structured the topics in this book to build on one another. Therefore, the topics covered in later chapters might refer to previous discussions in earlier chapters. We suggest you read this book from front to back.

After you read the book, you can brush up on a certain area by using the Index or the Table of Contents to go straight to the topics and questions you want to reexamine. We use headings and subheadings to provide outline information about each given topic. After you pass the exam and obtain your insurance license, we think you'll find this book useful as a tightly focused reference and an essential foundation of insurance information.

Chapter Formats

Each Exam Cram chapter follows a regular structure, with graphical cues about especially important or useful material. The structure of a typical chapter is as follows:

- ➤ *Topical coverage*—After the opening hotlists, each chapter covers the topics related to the chapter's subject.
- ➤ Alerts—Throughout the topical coverage section, we highlight material most likely to appear on the exam by using a special Exam Alert layout that looks like this:



This is what an Exam Alert looks like. An Exam Alert stresses concepts or terms that will most likely appear in one or more license exam questions. For that reason, we think any information found offset in Exam Alert format is worthy of special attention.

Even if material isn't flagged as an Exam Alert, *all* the content in this book is associated in some way with test-related material. What appears in the chapter content is critical knowledge.

➤ *Notes*—This book is an overall examination of entry-level insurance knowledge. As such, we touch on many aspects of insurance that open doors for further inquiry. Where a topic goes deeper than the scope of the book, we use notes to indicate areas of concern or further training.



Cramming for an exam will get you through a test, but it won't make you a fully competent insurance professional. Although you can memorize just the facts you need in order to become licensed, your daily work in the field will rapidly put you in water over your head if you don't continue your insurance education.

➤ *Tips*—Besides *Alerts* and *Notes*, we also include tips to help you remember or distinguish certain information that may appear on your license exam.



Pay special attention to Tips because they provide you with various techniques that may improve your exam score!

➤ Exam Prep Questions—This section presents a short list of multiple-choice test questions related to the specific chapter topic. Each question has a following explanation of both correct and incorrect answers. The practice questions highlight the areas we found to be most important on the exam.

➤ Need to Know More?—At the end of the book is a section titled "Need to Know More?" This section provides pointers to resources that we found to be helpful in offering further details on the book's subject matter. If you find a resource you like in this collection, use it, but don't feel compelled to use all these resources. We use this section to recommend resources that we have used on a regular basis, so none of the recommendations will be a waste of your time or money. These resources may go out of print or be taken down (in the case of websites), so we reference widely accepted resources.

The bulk of the book follows this chapter structure, but there are a few other elements that we would like to point out:

- ➤ Practice Exams—The sample tests, which appear in Chapters 25 and 27 (with answer keys in Chapters 26 and 28), are intended to test your comprehension of the material in this book. They are also intended to be in a similar format and degree of difficulty as the questions you are likely to see on the license exam. However, because the questions on the actual exam are kept highly confidential, you should expect that the questions on the actual license exam will be ones that you have never seen before.
- ➤ Answer Key—These provide the answers to the sample tests, complete with explanations of both the correct responses and the incorrect responses.
- ➤ Glossary—This is an extensive glossary of important terms used in this book.
- ➤ Cram Sheet—This appears as a tear-away sheet inside the front cover of this Exam Cram book. It is a valuable tool that represents a collection of the most difficult-to-remember facts, terms, and concepts we think you should memorize before taking the test.
 - You might want to look at the Cram Sheet in your car or in the lobby of the testing center just before you walk into the testing center. The Cram Sheet is divided under headings, so you can review the appropriate parts just before each test.
- ➤ CD-ROM—The CD contains the BISYS Education Services Exam Simulator, Preview Edition software. The preview edition exhibits most of the functionality of the commercially available version, but offers a reduced number of unit review questions and a 25-question practice exam. To get the complete set of practice questions and 100-question exam functionality, visit www.bisyseducation.com or call 800-241-9095.

Contacting the Source

Life and Health Insurance Licensing Exam Cram is a real-world tool that you can use to prepare for and pass your state insurance licensing exam. We're interested in any feedback you would care to share about the book, especially if you have ideas about how we can improve it for future test-takers. We'll consider everything you say carefully and will respond to all reasonable suggestions and comments. You can reach us via email at customerservice@bisys-education.com.

Let us know if you found this book to be helpful in your preparation efforts. We'd also like to know how you felt about your chances of passing the exam *before* you read the book and then *after* you read the book. Of course, we'd love to hear that you passed the exam—and even if you just want to share your triumph, we'd be happy to hear from you.

Thanks for choosing us as your license exam preparation coach, and enjoy the book. We wish you luck on the exam, but we know that if you read through all the chapters and work with the product, you won't need luck—you'll pass the test on the strength of real knowledge!

Self-Assessment

We include a Self-Assessment in this *Exam Cram* to help you evaluate your readiness to take and pass your state insurance license qualification exam. It should also help you understand what you need to master for an entry-level knowledge of the industry in which you are about to embark on a career.

Getting Prepared

Whether you attend a class to get ready for your exam or use self-study materials, some preparation for your insurance license qualification exam is essential. You want to do everything you can to pass on your first try.

You can get all the confidence you need from knowing that many others have gone before you. If you're willing to tackle the process seriously and do what it takes to gain the necessary knowledge, you can take—and pass—the insurance license qualification exams. In fact, the *Exam Crams* and the companion state license training packages from BISYS Education Services are designed to make it as easy as possible for you to prepare for these exams—but prepare you must!



You can obtain an outline of exam topics, practice questions, and other information about insurance qualification exams from your state insurance department's website. If your state has contracted with an exam administration company to administer its insurance licensing exams (which is usually the case) you can get the exam information from the exam administrator's website. Contact your state insurance department for more information.

Put Yourself to the (Practice) Test

We have included in this book several review exam questions for each chapter and two practice exams at the end of the book. If you don't score well on the chapter questions, you can study more and then retake the review questions at the end of each part. When you have gone through all the chapters, take the first practice exam and then score yourself. Review by reading the

explanations that accompany the answer key in the chapter following that exam. If you don't earn a score of at least 80% on the first practice exam, you'll want to do some additional study. Go back through this book, and also consult your notes and/or your text from any licensing exam preparation course you took. Then try the second practice exam in this book. Again, shoot for a score of 80% or better on your first try.



There is no better way to assess your exam readiness than to take a high-quality practice exam and pass with a score of 80% or better on your first try for that exam. When you take the same practice exam over and over, you begin to memorize the answers to the specific questions on that exam. It may help you improve your knowledge, but it spoils the value of the exam as an indication of how well you might respond to an exam containing questions over the full range of topics on your state's exam outline. Even though you must score only 70% to pass the actual exam, shoot for 80% on a practice exam to leave room for the fact that you might be nervous during the actual exam and that the questions on the actual exam might be more difficult than those on your practice exam.

If you did not score 80% or better on your first try, investigate the other study resources available (see the "Need to Know More?" addendum at the end of this book).

If you've given your utmost to self-study materials and then taken the exam and failed anyway, consider taking a class. For some people, self-study is not the optimal learning format. The opportunity to interact with an instructor and fellow students can make all the difference. For information about classes available in your area, ask your state insurance department or call BISYS Education Services (800-241-9095) to see whether there are schools using BISYS insurance licensing textbooks nearby.

One last note: Do not use practice exams as your only means of study for the exam. Next to not preparing at all, the best way to assure you'll fail your license qualification exam is to skip studying and go directly to taking question-and-answer practice tests to assess your readiness to take the exam. Practice exams are a gauge of how well you've comprehended your study material—they are not an accurate reflection of the questions you will see on your license qualification exam.

Other Preparation

Besides studying for the exam, there are some other things you should do to make sure you perform well on the exam:

- ➤ Get a good night's sleep the night before the exam. When you're tired, you're more likely to make careless—that is, needless—mistakes. Getting a good night's sleep will help assure that you feel refreshed and at your best.
- ➤ Eat a nourishing breakfast the morning of the exam. Your brain needs nutrients to function at its best—make sure you provide them! At the very least, you don't want your attention to be distracted by hunger while you're trying to concentrate on a question.
- ➤ Give yourself plenty of time to get to the exam site. Rushing to get somewhere can put you in a less-than-optimum frame of mind even if you end up arriving on time. Leave early to allow for unforeseen problems such as traffic delays. If you arrive well before the exam is scheduled to start, you can always use the extra time to go over your notes.

No Experience Required

Insurance license exams are designed so that they can be passed by individuals with no insurance industry experience or formal insurance schooling, other than any state-required prelicensing education requirement. So if you are completely new to this business, don't worry. Everything you need to know to pass your qualification exam can be obtained in the study materials referenced here.

In terms of having a successful insurance career after you pass your exam, the most important requirement is a sincere desire to help people solve their financial problems and reach their financial goals. However, there is certain background that can be an asset as you start out in the job. If you have run your own business, you already understand the type of self-discipline and motivation that will help you succeed in your insurance sales activities. If you have some prior sales experience—such as a customer service representative, real estate agent, or some other sales position—you'll probably have a comfort level with meeting people to discuss and solve their needs. But again, if you're new to insurance or to sales, have no fear on that account. You will have ample opportunity and resources for learning everything you need to know.

Onward to Exam and Career Success!

After you've undertaken the right studies and reviewed the many sources of information to help you prepare for the license qualification exam, you'll be ready to take a practice exam. When your scores are positive enough to indicate that you will get through the exam, you're ready to go after the real thing. Good luck!



Insurance Law

Terms you need to understand:

- ✓ Express authority
- ✓ Implied authority
- ✓ Apparent authority
- ✓ Waiver
- ✓ Estoppel
- ✓ Policy face
- ✓ Insuring clause
- ✓ Conditions
- ✓ Exclusions
- ✓ Aleatory contract

- ✓ Contract of adhesion
- ✓ Unilateral contract
- ✓ Executory contract
- ✓ Conditional contract
- ✓ Personal contract
- ✓ Warranty
- ✓ Representation
- ✓ Misrepresentation
- ✓ Concealment

Concepts you need to master:

- ✓ Presumption of agency
- ✓ Agent errors and omissions exposure
- ✓ Contract formation
- ✓ Offer and acceptance
- ✓ Consideration

- ✓ Competent parties
- ✓ Legal purpose
- ✓ Utmost good faith
- ✓ Parol evidence rule

Agency Law

An understanding of the law of agency is important because an insurance company, like other companies, must act through agents.

Agency Law Principles

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*.

In the field of insurance, the principal is the insurance company and the sales representative or producer is the agent. When one is empowered to act as an agent for a principal, he or 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 his or her authority, is payment to the principal. The knowledge of the agent is assumed to be the knowledge of the principal.

Presumption of Agency

If a company supplies an individual with forms and other materials (signs and evidences of authority) that make it appear that he or she is an agent of the company, a court will likely hold that a presumption of agency exists. The company is then bound by the acts of this individual regardless of whether he or she has been given this authority.

Authority

An agent has one of three types of authority:

- ➤ *Express authority* is an explicit, definite agreement. It is the authority the principal gives the agent as set forth in his or her contract.
- ➤ 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 him or her the express authority of collecting and submitting the premium, but the agent does so on a regular basis, and the company accepts the premium, the agent is said to have implied authority.

Lingering implied authority means that the agent carries "signs or evidences of authority." By having these evidences of authority, an agent

who is no longer under contract to an insurer could mislead applicants or insureds. When the agency relationship between agent and company has been terminated, the company will try, or should try, to get back all the materials it supplied to the former agent, including sales materials.

On the other hand, the public cannot assume that an individual is an agent merely because he or she says so. The agent must carry the credentials (for example, the agent's license and appointment) and company documents (such as applications and rate books) that represent him or her as being an agent for an insurance company.

➤ Apparent authority is the authority the agent seems to have because of certain actions undertaken on his or her part. This action may mislead applicants or insureds, causing them to believe the agent has authority that he or she 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 policyowner had the right to assume that the agent's acceptance of premiums was within the scope of his or her authority.

Collection of Premium

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. Any agent who takes funds held in trust for his or her own use is guilty of theft and will be punished as provided by law.

Agent's Responsibility to Insured/Applicant

An agent has a fiduciary responsibility to the insured, the insurer, the applicant for insurance, current clients, and so forth. The agent has a fiduciary duty to just about any person or organization that he or she comes into contact with as part of the day-to-day business of transacting insurance.



By definition, a *fiduciary* is a person in a position of financial trust. Thus, attorneys, accountants, trust officers, and insurance agents are all considered fiduciaries.

As a fiduciary, the agent has an obligation to act in the best interest of the insured. The agent must be knowledgeable about the features and provisions

of various insurance policies and the use of these insurance contracts. The agent must be able to explain the important features of these policies to the insured. The agent must recognize the importance of dealing with the general public's financial needs and problems and offer solutions to these problems through the purchase of insurance products.

As a fiduciary, the agent must collect and account for any premiums collected as part of the insurance transaction. It is the agent's duty to make certain that these premiums are submitted to the insurer promptly. Failure to submit premiums to the insurer, or putting these funds to one's own personal use, is a violation of the agent's fiduciary duties and possibly an act of embezzlement.

The insured's premiums must be kept separate from the agent's personal funds. Failure to do this can result in *commingling*—mixing personal funds with the insured or insurer's funds.

Waiver and Estoppel

The legal doctrines of waiver and estoppel are directly related to the responsibilities of insurance agents. An insurer may, by waiver, lose the right of making certain defenses that it might otherwise have available.



Waiver is defined as the intentional and voluntary giving up of a known right. An insurance company may waive its right to cancel a policy for nonpayment by accepting late payments.

Waiver and estoppel often occur together, but they are separate and distinct doctrines.



Estoppel means that a party may be precluded by his or her acts of conduct from asserting a right that would act to the detriment of the other party, when the other party has relied upon the conduct of the first party and has acted upon it. An insurer may waive a right, and then after the policyowner has relied upon the waiver and acted upon it, the insurer will be estopped from asserting the right.

The agent must be alert in his or her words, actions, and advice to avoid mistakenly waiving the rights of the insurance company. As a representative of the company the agent's knowledge and actions may be deemed to be knowledge and actions of the company.

Agent's Responsibilities to Company

The agent's contract or agency agreement with the insurer will specify the agent's duties and responsibilities to the principal. In all insurance transac-

tions, the agent's responsibility is to act in accordance with the agency contract and thus for the benefit of the insurer. In accordance with the agent's fiduciary obligation to the insurer and his or her agency agreement, the agent has a responsibility of accounting for all property, including money that comes into his or her possession. As part of the agent's working relationship with the insurer, it is important that pertinent information be disclosed to the insurer, particularly with regard to underwriting and risk selection. If the agent knows of anything adverse concerning the risk to be insured, it is his or her responsibility to provide this information to the insurer. To withhold important underwriting information could adversely affect the insurer's risk selection process. In accordance with agency law, information given to the agent is the same as providing the information to the insurer.

It is the agent's responsibility to obtain necessary information from the insurance applicant and to accurately complete the application for insurance. A signed and witnessed copy of the application becomes part of the legal contract of insurance between the insured and the insurer.

Finally, the agent has a responsibility to deliver the insurance policy to the insured and collect any premium that might be due at the time of delivery.

The agent must be prepared to provide the insured with an explanation of some of the policy's principal benefits and provisions. If the policy is issued with any changes or amendments, the agent will also be required to explain these changes and obtain the insured's signature acknowledging receipt of these amendments.

Company's Responsibility to Agent

The company is required to permit the agent to act in accordance with the terms of the agent's employment contract, and the company must recognize all the provisions of that contract.

In addition, the company must pay the agent the compensation agreed upon in the contract, must reimburse the agent for proper expenditures made on behalf of the principal, and must indemnify the agent for any losses or damages suffered without fault on the part of the agent but occurring on account of the agency relationship.

Potential Liabilities of Agent/Errors and Omissions (E&O) Exposure

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 producer who is the insurer's representative. E&O policies protect pro-

ducers from financial losses they may suffer if insureds sue to recover for their financial loss due to a producer giving them incorrect advice (error) or not informing them of an important issue (omission). Because a producer's office is very busy, he or she must take special care to follow strict procedures in regard to taking applications, explaining coverages, collecting premiums, submitting changes to policies upon an insured's request, and preparing claim forms.

Formation of a Life and Health Insurance Contract

The formation of a life or health insurance contract differs from the formation of other insurance contracts because the life or health producer usually does not have the authority to bind the insurer.

Contract Elements

Insurance policies are legal contracts and are subject to the general law of contracts. This is a distinct body of law that is separate from criminal law (crimes against society) and tort law (legal liability issues usually involving damages for negligence). A contract is a legal agreement between two or more parties promising a certain performance in exchange for a valuable consideration. Under the law, the following elements are necessary for the formation of a valid contract:

- ➤ Agreement (offer and acceptance)
- ➤ Consideration
- ➤ Competent parties
- ➤ Legal purpose

Agreement (Offer and Acceptance)

There can be no contract without the agreement or mutual assent of the parties. A common intention on all terms of the contract is essential to an agreement and no essential terms of the contract may be left unsettled. Further, the intention of the parties to a contract must be communicated to one another.

The parties to an insurance contract are the insurance company and the applicant, who may become the insured or may name another person to be

insured. Unless otherwise indicated, it is assumed that the applicant is the prospective insured.

Offer

An offer is a proposal that creates a contract if accepted by another party according to its terms. If an applicant gives the insurer a completed application and pays the first premium, the application is an offer. If the policy is issued as applied for, the insurer accepts the offer.

There is no offer if the applicant sends the application to the insurance company without payment of the premium. Such an application is merely an invitation to the company to make an offer. The insurance company makes an offer by issuing the policy. The applicant accepts it by paying the first premium.

Acceptance

An acceptance must be unconditional and unqualified. If an insurance company, after receiving an application and premium payment, issues a policy with more restrictive coverage than that applied for, the company has made a counter offer.

For example, a *counter offer* occurs if an applicant applies for a standard health insurance policy, pays the premium, and receives a policy containing an exclusionary endorsement for specified physical conditions. The applicant must decide whether to accept the policy as modified. If he or she accepts the policy, there is a contract. If he or she rejects the modified policy, there is no contract, and the applicant is entitled to a return of his or her premium.

Consideration

Each party to the contract must give valuable consideration. In the insurance contract, the value given by the insurer consists of the promises contained in the policy contract. The consideration given by the insured consists of the statements made in the application and the payment of the initial premium.

The consideration may consist of any of the following:

- ➤ A monetary payment
- ➤ An act
- ➤ A forbearance from action
- ➤ The creation, modification, or destruction of a legal right
- ➤ A return promise

It is important to know that part of the applicant's consideration consists of the statements in the application. A great deal of importance is placed on the representations in the application because the insurance company's entire decision of whether to contract is based on its evaluation of the information in the application.

Competent Parties

For a contract to be binding, both parties must have the legal capacity to make a contract. To have the legal capacity to make insurance contracts, an insurance company must have authority under its charter to issue contracts and be authorized by the state to issue contracts. The company's representative must also be licensed by the state.



The insured or applicant must be of legal age and be mentally competent to make an insurance contract. Applications of minors must usually be signed by an adult parent or guardian to comply with the legal age requirement for making contracts.

Legal Purpose

To be valid, a contract must be for a legal purpose and not contrary to public policy. An insurance contract is not against public policy where an insurable interest exists.

Parts of the Insurance Contract

Although it is not a legal requirement that all contracts be in writing, insurance contracts always are because of their complex nature. The number of pages that make up an insurance contract varies because of the types of insurance and the individual risks being insured, but all life/health insurance contracts contain four basic parts:

- ➤ Policy face (Title page)
- ➤ Conditions
- ➤ Insuring clause
- ➤ Exclusions

Policy Face (Title Page)

The *policy face* is usually the first page of the insurance policy. It includes the policy number, name of the insured, policy issue date, the amount of premi-

um and dates the premium is due, and the limits of the policy. The policy face also includes the signatures of the secretary and president of the issuing insurance company. In addition, there are generally clauses required by law to give the insured information on his or her right to cancel, and a warning to the insured to read the policy carefully.

Insuring Clause

The *insuring clause* generally also appears on the policy face. It is a statement by the insurance company that sets out the essential element of insurance—the promise to pay for losses covered by the policy in exchange for the insured's premium and compliance with policy terms.

Conditions

This section spells out in detail the rights and duties of both parties. *Conditions* are provisions that apply to the insured and insurer. For example, the conditions include the reinstatement provision, suicide clause, payment of claim provision, and similar standard policy provisions.

Exclusions

In this section, the company states what it will not do. The *exclusions* are a basic part of the contract and a complete knowledge of them is essential to a thorough understanding of the agreement. Certain risks must be excluded from insurance contracts because they are not insurable.

Legal Requirements

When the courts have a case involving contracts, it looks at the "rules of construction" to interpret the contract. The rules of construction help identify and establish the intent of the parties to the contract.

Contract Construction

There are five major areas that the courts review in order to interpret the contract, establish the intent of the parties, and hand down a ruling.

Plain Language and Word Definitions

If the language of the contract is clear the courts do not have to interpret the meaning of the contract. The courts give the words in the contract their "ordinary meaning." In cases where ordinary words have been used in a technical capacity, the technical meaning of the word is accepted.

The Entire Contract

The courts look at the entire contract to determine the intent of the parties. It does not consider material added to the basic contract, nor does it take only parts of the contract to make a determination.

Interpretation in Favor of Valid Contract

Because the courts assume that when people make a contract they intend for it to be valid, the courts will, if possible, render an interpretation of the contract that makes it valid rather than invalid.

Unclear Contract of Adhesion Interpreted Against the Insurer

If a contract contains wording that is unclear the courts will interpret the language used against the writer of the contract, unless the wording used is required by law to be stated in a specific manner. Insurance contracts are contracts of adhesion, which means the insured had no part in determining the wording of the contract; therefore, the courts will interpret the contract in favor of the policyholder, insured, or beneficiary.

Written Contracts

If a contract contains unclear or inconsistent material between printed, typed, or handwritten text in the contract, the typed or handwritten material will determine intent.

Contract Characteristics

The insurance contract has certain characteristics not typically found in other types of contracts.

Utmost Good Faith

The insurance contract requires utmost good faith between the parties. This means that each party is entitled to rely on the representations of the other and each party should have a reasonable expectation that the other is acting in good faith without attempts to conceal or deceive. In a contact of utmost good faith, the parties have an affirmative duty to each other to disclose all material facts relating to the contract. That is not just a duty not to lie, but also a duty to speak up. Failure to do so usually gives the other party ground to void the contract.

Aleatory

An insurance contract is said to be *aleatory*, or dependent upon chance or uncertain outcome, because one party may receive much more in value than

he or she gives in value under the contract. For example, an insured who has a loss may receive a greater payment from an insurer for the loss than he or she has paid in premiums. On the other hand, an insured might pay his or her premiums and have no loss, so the insurer pays nothing.

Adhesion

In insurance, the insurer writes the contract and the insured adheres to it. When a contract of adhesion is ambiguous in its terms, the courts will interpret the contract against the party who prepared it.

Unilateral

Insurance contracts are unilateral. This means that after the insured has completed the act of paying the premium, only the insurer promises to do anything further. The insurer has promised performance and is legally responsible. The insured has made no legally enforceable promises and cannot be held for breach of contract. For example, the insured may stop paying premium because he is not legally responsible to continue paying premium.

Executory

An insurance contract is an *executory contract* in that the promises described in the insurance contract are to be *executed in the future*, *and only after certain events (losses) occur*:

Conditional

Insurance contracts are also *conditional* contracts because when the loss occurs certain conditions must be met to make the contract legally enforceable. For example, a policyholder might have to satisfy the test of having an insurable interest and satisfy the condition of submitting proof of loss.

Personal Contract

Generally, insurance policies are personal contracts between the insured and insurer. Generally, insurance is not transferable to another person without the consent of the insurer. Fire insurance, for example, does not follow the property.

Warranties and Representations

A *warranty* is something that becomes part of the contract itself and is a statement that is considered to be *guaranteed* to be true. Any breach of warranty provides grounds for voiding the contract.

A *representation* is a statement *believed* to be true to the best of one's knowledge. An insurer seeking to void coverage on the basis of a misrepresentation usually has to prove that the misrepresentation is material to the risk.



Under most state laws, an applicant's statements or responses to questions on an application for insurance (in the absence of fraud) are considered to be representations and not warranties.

An example would be a question on the application asking for your sex or date of birth. You represent yourself to the insurance company as being male or female and a certain age. The accuracy of these items is very important to the insurance company issuing the policy. If they are incorrect, they may be considered misrepresentations, and the policy may be voided as a result.

There is a difference between representation of a fact and an expression of opinion. A good example is a question on many applications: "Are you now to the best of your knowledge and belief in good health?" If the applicant answers "yes" while knowing in fact that he or she is not, there is a misrepresentation of actual fact. If, on the other hand, he or she has had no medical opinion and suffers from no symptoms recognizable to a layman, his or her answer is an opinion and thus not a misrepresentation.

Impersonation

Impersonation means assuming the name and identity of another person for the purpose of committing a fraud. The offense is also known as *false pre-tenses*. In the case of life insurance, an uninsurable individual applying for insurance may ask another person to substitute for him to take the physical examination.

Misrepresentation and Concealment

A *misrepresentation* is a written or oral statement that is false. Generally, in order for a misrepresentation to be grounds for voiding an insurance policy, it has to be material to the risk.

Concealment is the failure to disclose known facts. Generally, an insurer may be able to void the insurance if it can prove that the insured *intentionally* concealed a material fact.

Material information or a material fact is crucial to acceptance of the risk. For example, if the correct information about something would have caused the insurance company to deny a risk or issue a policy on a different basis, the information is material.

Fraud

Fraud is an intentional act designed to deceive and induce another party to part with something of value.



Fraud may involve misrepresentation and/or concealment, but not all acts of misrepresentation or concealment are acts of fraud. If someone intentionally lies in order to obtain coverage or to collect on a false claim, that would be a matter of fraud. If someone misrepresents something on an application (perhaps a medical treatment the person is embarrassed to talk about) without any intent to obtain something of value, no fraud has occurred.

Parol (Oral) Evidence Rule

The parol evidence rule limits the impact of waiver and estoppel on contract terms by disallowing oral evidence based on statements made before the contract was created. It is assumed that any oral agreements made before contract formation were incorporated into the written contract. After contract formation, earlier oral evidence will not be admitted in court to change or contradict the contract. An oral statement may waive contract provisions only when the statement occurs after the contract exists.

Exam Prep Questions

O D. Express authority

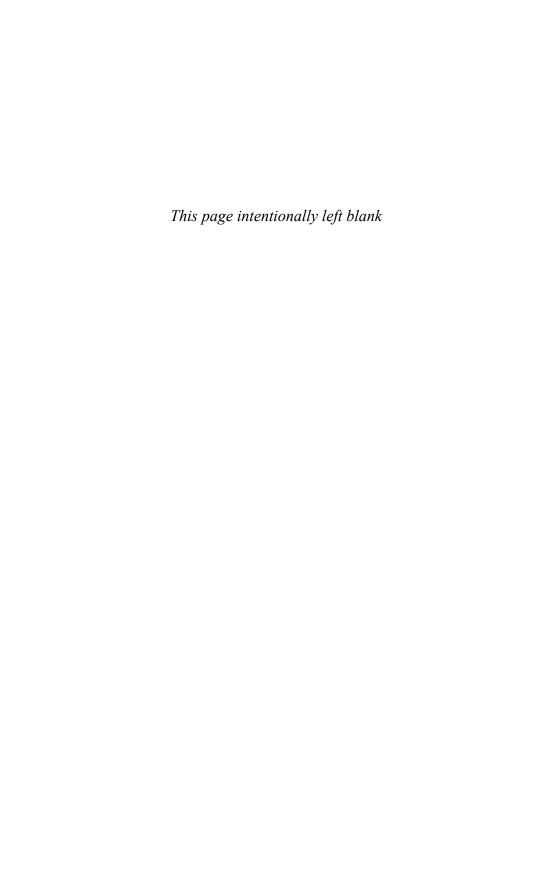
1. Ralph is a producer for Hoosier Insurance Company. His contract states that he is allowed to put the company's logo on his business cards and the door to his office. This is an example of O A. Express authority O B. Implied authority O C. Lingering implied authority O D. Apparent authority Tom has always made a practice of having his policyholders mail their premium checks directly to him, and forwarding them on to the insurer, so that he is aware of anyone missing a payment and can contact policyowners directly if that should happen. His contract does not allow this, but the insurer is aware of the practice and has not asked him to stop. This practice is an example of O A. Express authority O B. Implied authority O C. Lingering implied authority O D. Apparent authority 3. Gina accepts the initial premium when she sells an insurance policy and sends it to the company with the application. Nothing in her contract mentions handling of initial premiums. This is an example of O A. Express authority O B. Implied authority O C. Lingering implied authority O D. Apparent authority 4. Albert's life insurance premium is due on the 10th of the month. Because he gets paid at the end of the month, he has always sent the premium late. The insurer has been accepting his premium this way for 3 years. A new CEO comes in and decides to crack down on late premiums, canceling Albert's policy for nonpayment of premium. Albert contests this decision legally and gets the policy reinstated. The decision to reinstate the policy is an example of A. Estoppel B. Waiver O C. Contract of adhesion

5. When representing an insurer, a producer acting as an agent has a responsibility to act with the degree of care that
 O A. A licensed insurance producer would apply under similar circumstances O B. A reasonable person would apply under similar circumstances O C. A lawyer would apply under similar circumstances O D. Any person would apply under similar circumstances
6. Which element is not necessary for the formation of a valid contract?O A. Consideration
O B. Competent parties
O C. Written document
O D. Legal purpose
7. The initial premium payment sent with an application constitutes which part of the formation of an insurance contract?
O A. Consideration
O B. Acceptance
O C. Offer
O D. Legal purpose
8. Life insurance contracts contain all the following except
O A. Policy folder
O B. Insuring clause
O C. Conditions O D. Exclusions
9. Ken has paid only four premiums on his health insurance policy when he is hit by a car. The insurance company pays out nearly half a million dollars to cover his treatment and a lengthy stay in intensive care. This is an example of
O A. Contract of adhesion
O B. Aleatory contract
O C. Unilateral contract
O D. Utmost good faith
 Carol applies for a life insurance policy and pays the initial premium. Carol has
O A. Accepted an offer from the insurer
O B. Made an offer to the insurer
O C. Accepted a counter offer from the insurer O D. Made a counter offer to the insurer
D. Made a counter oner to the insurer

- 11. The insurer looks at Carol's application and decides to offer Carol a modified policy, including an exclusion Carol did not request. The insurer has
 - O A. Accepted an offer from Carol
 - O B. Made an offer to Carol
 - O C. Accepted a counter offer from Carol
 - O D. Made a counter offer to Carol
- 12. The failure to disclose known facts is
 - O A. Misrepresentation
 - O B. Concealment
 - O C. Fraud
 - O D. Impersonation

Exam Prep Answers

- A is correct. Express authority is spelled out in an agent's written contract.
- 2. **D** is correct. Apparent authority is the authority an agent appears to have because of past actions that have not been challenged by the insurance company.
- 3. **B** is correct. Implied authority is not expressly stated in an agent's contract but it is actual authority related to common business practices, such as accepting premiums for the insurer.
- 4. **A is correct.** Under the principal of estoppel, a pattern of past behavior may prevent the insurer from exercising a right it might have had if it had exercised it earlier.
- 5. **B** is correct. A producer has a duty to act with a reasonable degree of care when representing an insurer.
- C is correct. Valid contracts do not need to be in writing. Oral contracts are legally binding.
- 7. **A is correct.** The premium is the consideration given by the insured in exchange for the insurer's promise to pay if a loss occurs.
- 8. **A is correct.** All life insurance policies include an insuring clause, conditions, and exclusions. There is no requirement for a policy folder.
- 9. **B** is correct. An aleatory contract is one that depends on chance or an uncertain outcome. Ken may have received far more in benefits than he paid as premiums, but others who pay premiums may never have a loss and never receive even a dollar in benefits.
- 10. **B** is correct. The act of submitting an application with a premium payment is an offer that is still subject to acceptance by the insurer.
- 11. **D** is correct. By not accepting the initial offer and offering alternative terms, the insurer has made a counter offer.
- 12. **B is correct.** The failure to disclose known facts is concealment. Intentionally giving false answers or misstating facts would be misrepresentation, and possibly fraud.



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