LEARNER GUIDE

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Apply the law of contract to insurance

Introduction

Contracts, and the way they are handled, should be viewed as an element of the risk management process for individuals as well as business entities. People often enter into contracts carelessly, without checking terms and fine print, with dire consequence later on.

Contracts, once concluded, are legally binding and all parties can be held to the terms of the contract in a court of law. The same holds true for insurance contracts, whether short or long term contracts.

A contract of insurance is a legally binding document.

In this module, we will look at how the law of contract can be applied to insurance.

Module 1

The law of contract as applied in insurance

This Module deals with:

- The concept of the law of contract with reference to its essential elements and how an insurance contract is bound by the law of contract
- Evidence that is required for an insurance contract to be legally binding for short term and/or Long-Term insurance
- The parties to a contract for a selected sub sector

1.1 The concept of the law of contract with reference to its essential elements and how an insurance contract is bound by the law of contract

A contract can be viewed as ***an agreement which creates or is intended to create legal obligations between the parties thereto.***

The law of contract describes the set of rules that these are agreements are subject to. This includes the essential elements which an agreement MUST comply with before it may be construed as a contract. Remember: Not all agreements are contracts, but all contracts are agreements!

These essential elements are:

- Capacity
- Consensus
- Performance
- Formalities
- Bona fides (Latin for ‘good faith’)

- Offer and acceptance

Capacity

Every valid contract must be entered into by two or more parties both of whom have the legal ability to do so. The following are examples of individuals who lack full legal capacity:

- Minors – this refers to individuals under the age of 18 (previously 21, but was reviewed when the Children's Act was amended.)
- Insane persons (individuals found to be mentally unsound and therefore unable to make rational and fair decisions as a reasonable result requiring the protection of the state.)
- Persons under the influence of drugs and/or alcohol
- Prodigals (Persons who have squandered (wasted) their property in an irresponsible manner)
- Insolvent persons

In an insurance contract all of the above applies, however insolvent persons have limited capacity as certain insurers do grant insurance to insolvents and an insurance contract will not tie an insured down in financial terms and can easily be terminated should it be necessary.

Consensus

All parties to a contract must agree to the all terms and conditions of the contract by their own free will without coercion. We are able to differentiate between conditional and unconditional consensus:

- Unconditional consensus – When one party makes an offer and the other party accepts without requiring any amendment to the conditions of the offer. E.g. Katy offers her second-hand mobile phone for sale at the price of R300. John accepts the offer without negotiating or attempting to revise the conditions of the agreement.
- Conditional consensus – When one party makes an offer and the other party negotiates certain conditions before accepting. E.g. Katy offers her second-hand mobile phone for sale at the price of R300. John agrees to buy the phone on condition that Katy repairs the cracked screen first.

An insurance contract is an example of conditional consensus. The proposer offers their business to the insurer and the insurer provides certain conditions under which they will accept the offer. The conditions include premium, security requirements

and other terms to which the cover may be subject.

Performance

Performance of the subject matter of a contract must be both *legally* and *physically* possible.

- Physical possibility – Performance must physically possible. E.g. a contract offering a trip to the sun would be considered physically impossible.
- Legal Possibility – Performance must be legally possible. E.g. a contract for taking someone's life is not legally possible as murder is against the law.

Legal and physical performance must exist at the time of the contract.

In an insurance contract this relates to various aspects. For example, legally the insurer would be required to be registered and licenced and the insured will be required to prove insurable interest indicating that they have a legal relationship with the insured item.

Furthermore, the insurer will be required to have the capability to pay any claims which are made in terms of the contract and the insured should be physically capable of paying premiums and fulfilling the other conditions of the policy such as security etc.

Formalities

For most contracts, no formalities are required. However, certain types of contracts require formalities.

- All contracts for the sale of land have to be in writing. If this formality is not met, no contract comes into existence.
- Contracts of purchase and sale do not require any formalities.
- Contracts of insurance do not have to be in writing

An insurance contract is NOT required to be in writing and may therefore be concluded via telephone, but evidence (includes policy schedule and wording) of the policy must be forwarded to the client within 30 days as per current legislation.

Bona Fides (Good Faith)

The expectation and belief that all parties to a contract is being true and honest.

The concept of truth and honesty is applicable to every insurance contract. The principle "uberrimae fidei" (utmost good faith) was widely accepted in insurance until it was rejected by the High Court during the case of Mutual and Federal vs. Oudtshoorn Municipality when it was ruled that one can only have good faith or not and that the addition of "utmost" in the concept was redundant.

Offer and acceptance

One party indicating a willingness to enter into a contract with another party. When the second party accepts all terms and conditions of the contract, it becomes binding. The party making the offer would be referred to as the "offerer" and the party who accepts the offer the "offeree".

A contract is said to come into existence when acceptance of an offer has been communicated to the offeror by the offeree.

In an insurance contract the concept of offer and acceptance is illustrated when the proposer (offerer) offers their business to the insurer (offeree) for consideration. After careful consideration the insurer will either accept or decline the offer. Should the insurer choose to accept the business, they will provide certain terms and conditions to the proposer. Should the proposer accept the insurer's terms and conditions then a contract will come into existence.

1.2 Evidence that is required for an insurance contract to be legally binding for short term and/or Long-Term insurance

It was indicated in the previous section that insurance contracts need not be in writing in order to be enforceable. However each verbal contract requires evidence proving that a contract existed. In insurance, evidence illustrating an insurance contract are:

- ***Premium*** (the amount of money that the insured and insurer agrees upon that should be paid monthly or annually by the insured to the insurer in order to have cover)
- The ***proposal*** (the telephone conversation between the insured and proposer - or this could be a written document referred to as a proposal form - depending on the insurer/intermediary). The proposal is basis for the contract between the insurer and the insured.
- The ***policy schedule*** (referred to as the schedule that is sent with the policy wording). It is a 'blue print' of the telephone conversation with the client or a printed copy of the proposal form that the insurer issues.

1.3 The parties to a contract for a selected sub sector

The parties to the contract usually agree to do or not to do something, or to give or not to give something. A person cannot contract with him- or herself, and therefore there must be two or more parties to constitute a valid contract.

The parties to a contact of insurance are:

- The product supplier (also referred to as the insurer)

- The policy holder (also referred to as the insured or client)

In some cases the client would make use of the services of an intermediary (a broker) that will assist the client with the contract. The intermediary is never a party to a contract of insurance, but merely helps to bring it about.

Module 2

The application of legal capacity in an insurance contract

This Module deals with:

- The concept of legal capacity with examples of how it is applied in insurance
- The difference between legal capacity in a contract and legal capacity in an insurance contract with examples
- Three examples of case law are analysed and discussed in terms of the precedents set

2.1 The concept of legal capacity with examples of how it is applied in insurance

Insurance is about the transfer and distribution of the financial consequences of a risk. It is an arrangement under which an insurer contracts to do something of value to the insured (pay, replace, reinstate or repair) on the happening of a specified harmful chance event.

The insurance policy is the written evidence of this contract.

Note that, with a short-term contract, the purpose of the insurance is indemnification for a determinable loss and not the unnecessary enrichment of the insured. In the case of a long-term insurance contract this takes the form of a cash payment (or payments) to assist the insured or his or her beneficiaries in overcoming the trauma associated with death, illness, injury or disablement. Cover is usually unrelated to any specific value placed on the life of the insured.

As was mentioned earlier there are other instances in which a person's contractual capacity is restricted. The following, although not an exhaustive list, are a few examples of the more common occasions.

Mentally ill persons

A person whose mind at the time of entering into the purported contract was such that s/he could not understand the nature of the transaction because of his or her specific mental illness or condition, is not bound by the contract because s/he did not have the requisite capacity.

Drunkenness

Drunkenness will invalidate the contract only if the person who entered into it could not understand the provisions because of his or her state of inebriation. One must however appreciate that the person will not be able to gain from the contract as a result of this defence.

Prodigals

A person who wastes away his or her means may, on application, be declared a prodigal by the High Court. A curator is then appointed to manage his or her affairs, and s/he will not be able to enter into any contracts with financial implications without the consent of the curator.

Insolvents

A person who has been sequestrated under the Insolvency Act may enter into contracts so long as s/he does not purport to alienate any portion of his or her estate.

2.2 The difference between legal capacity in a contract and legal capacity in an insurance contract with examples

Refer Module 1 – Essential Elements.

2.3 Three examples of case law are analysed and discussed in terms of the precedents set

The easiest way to explain the coming into existence of a contract is to state that it consists of an offer and acceptance. This is generally the case, but it cannot always be stated that one party made an offer and another accepted. “Consensus”, or “agreement”, implies an actual “meeting of the minds”. There are, however, cases where a contract comes into being, or is given a certain content, even though there is no actual meeting of the minds. The courts do not work only with a simple psychological concept of contract but will also consider a normative view so, while the courts use “meeting of the minds” as a point of departure, in certain instances a normative view (i.e. where the parties are expected to behave in certain ways and their acts attract particular consequences), will be held. In *Anglo Carpets (Pty) Ltd v Snyman (1978)* judge Coetzee said: “It is perfectly true that there is no evidence of a crisp offer and acceptance … but this is not a fatal flaw.”

The element of certainty can also be regarded as an essential for a valid contract, although this is often seen as part of the “consensus” requirement – the parties must be certain about what they agree upon. The courts are reluctant to hold void for uncertainty any provision in an agreement between parties which was intended to have legal effect.

The courts always try to balance matters so that, without violating essential principles, the dealings of persons in business may as far as possible be treated as effective, and that the law may not incur the reproach of being a destroyer of bargains.

Forms that Contracts can take

A contract can exist in various forms:

- in writing;
- verbal;
- tacit; or
- implied.

Writing is a legal requirement for certain contracts (which are discussed under “formalities”), but in most cases an oral, tacit or implied contract is just as valid. A

contract can come into existence without a word being said and in such a case is referred to as a tacit contract. A typical example would be where a person takes a newspaper from a vendor and offers money. A contract has come into being.

- **The Parol Evidence Rule and Rectification of Contracts**

This rule states that if a contract has been reduced to writing, the writing is the sole source of the contract and evidence may not be given as to verbal negotiations or other terms which preceded the actual signing. The document is the only source of the terms of the contract. However there are exceptions to this rule, and the law also provides for rectification where the written document does not fully or correctly reflect the parties' true agreement but, in general, they should ensure that the contract which has been reduced to writing contains all the terms upon which consensus was reached.

- **Caveat Emptor versus Uberrima Fides (Legal Contracts versus Insurance Contracts)**

There are basically two distinct ways that contracts can differ legally. Contracts undertaken in the normal course of business are generally based on the premise of *caveat emptor* or "let the buyer beware", but contracts of insurance are based on a different concept – *uberrima fides* or "utmost good faith":

One must appreciate that in all business dealings one undertakes some form of contract, even if most of these are simply oral. Examples of these are the purchasing of a loaf of bread or a packet of cigarettes from a local tea room. Some contracts will not be as simple. They could be for large amounts, such as the purchase of a car or even a house.

All of these contracts are based on "*caveat emptor*". The terms and conditions offered by the seller are either queried at purchase or are otherwise accepted as true and correct. However, if it can subsequently be proved that the seller deliberately withheld information from the buyer that would in all likelihood have affected his or her decision to buy the buyer will have recourse, if necessary, to the courts. Should this not be the case, it is only where the seller provides some form of warranty that there is a possibility of a "comeback". It is often thought that there is a "cooling off" period when a major purchase is made. This is, strictly speaking, not correct. The cooling off period applies only to any credit agreement entered into. However, based on the principles of common law a purchaser will be able to apply to the courts in the event of deliberate fraud or misrepresentation of the facts. Note that ignorance of the facts cannot and will not be accepted as a valid defence. One is expected to be aware of what one signs or agrees to at all times and, as is often repeated, "Ignorance is no excuse in the eyes of the law."

The very nature of an insurance contract requires that the "seller" (the proposer) provides the "buyer" (the insurer) with all the facts at his or her disposal. Nondisclosure or misrepresentation of any of the fact will give the insurer the right to claim that the policy was void *"ab initio"* (from the beginning). The duty of disclosure was highlighted in the well-known case of **Carter v Boehm (1766)** where Lord Mansfield stated the rule and the reasons for it.

"The duty of disclosure is imposed by law (ex lege) and it is not based upon an implied term of the contract of insurance. It does not flow from the requirement of bona fides, nor from the special circumstances of insurance law, being only an example of the application of general principles, especially relating to misrepresentation."

Over the years this has led to a certain amount of confusion as to whether insurance contracts are contract of *"uberrima fides"* (utmost good faith) or contracts of *"bona fides"* (good faith). The often quoted case of **Mutual and Federal Insurance Company Ltd. v Oudtshoorn Municipality (1985)** finally cleared up this confusing principle. The Appellate Division decided that "utmost good faith" was an impractical concept since there can only be good faith or bad faith. A person may be less than honest but cannot be more honest than honest and "utmost good faith" was thus declared to be meaningless in South African law. With a contract *"uberrima fides"* it was accepted that there was an obligation placed on the proposer to disclose all that s/he knows, and the hiding of any material circumstance, whether the proposer thought it was relevant or not, would allow the insurer to void the contract from inception. The implication of this court ruling resulted in the conclusion that the principle of *uberrima fides* placed too heavy a responsibility on the proposer. Further rulings have resulted in what is today known as the "**reasonable man test**". The reasonable man test is equally important to long-term as well as short-term business. While the following section therefore provides a general overview of its application it will be dealt with in considerably more detail in the long-term and short-term units of the Insurance Institute's legal framework subjects that concentrate exclusively on these insurance disciplines.

Module 3

Interpretation of the basic principles required for an insurance contract to be legally binding

This Module deals with:

- The basic principles of an insurance contract with examples
- Conditions under which a contract is not legally binding with examples

3.1 The basic principles of an insurance contract with examples

In addition to the essential elements already explored, insurance contracts are subject to additional basic principles which need to be present.

In addition to the essential elements applicable to all contracts, an insurance contract must also contain the following elements:

Premium:	The payment of a sum of money on the estimated value of the risk
Indemnity:	The act of putting the insured back into the same financial position held before the loss
Insurable Interest:	A person has 'insurable interest' in something when loss or damage to it would cause that person to suffer a (financial) loss
Uncertain event:	The loss or damage to the insured goods must be uncertain

3.2 Conditions under which a contract is not legally binding with examples

- **Breach of Contract**

Parties enter into contracts for the purpose of having obligations performed, but in some cases the obligations arising from the contract are not always fully appreciated and may thus not be fulfilled. This is known as breach of contract and gives the innocent party the option to cancel, so creating a further means whereby a contract may be discharged. State of mind (e.g. fault or intent) is not considered relevant. There are a number of ways in which a party can be considered to be in breach of a contract.

- late performance by the debtor (*mora debitoris*);
- late performance by the creditor (*mora creditoris*);
- repudiation;
- prevention of performance;
- defective performance.

To determine whether the debtor is late in his or her performance it will be necessary to determine when this is due. There are three possibilities:

- time for performance is stipulated in the contract (*mora ex re*);
- from the nature of the contract it is clear that although not stipulated time is of the essence and performance must be on or before a given date. Alternatively there should be no undue delay.
- time for performance has not been determined in the contract and is not therefore of the essence: here the debtor has to be given reasonable notice to perform (*mora ex persona*).

In a case where the time for performance is stipulated, the contract is breached if the specified date arrives and the debtor fails to perform. If there is a cancellation (*lex commissoria*) the creditor is entitled to invoke it and cancel the contract, otherwise s/he may only cancel when time is of the essence. Where no date for performance has been fixed by the parties in the contract the creditor may place the debtor in *mora* by demand, giving him or her a reasonable time to perform, failing which it will be regarded as a breach (*mora ex persona*). This entitles the creditor to cancel and use the other remedies available on breach of contract.

Where the parties to a contract are required to perform simultaneously, or where the plaintiff is obliged to perform before the defendant, the latter can raise the so-called *exceptio non adinipleti contractus* if s/he is sued for an alleged breach of contract. By raising this defence the defendant admits that s/he has not performed, but alleges that the plaintiff also has failed to do so - it is the "exception of the unfulfilled contract".

A creditor is in breach if s/he should delay fulfilment of the debt when performance completion is possible. This is also the case where the debtor offers to perform but the creditor refuses to cooperate. It is a fundamental duty of the creditor to co-operate and his or her failure to do so constitutes a breach of contract.

Breach of contract by repudiation is said to arise when one party, either expressly or by implication, indicates that s/he does not intend to perform his or her obligations or, having performed part thereof, does not propose to complete performance. In *Hochster v de la Tour (1853)* the defendant agreed to employ the plaintiff as from 1 August, but before that date, repudiated the agreement. The plaintiff immediately brought an action for damages, and it was held that he was entitled to do so, and did not need to wait until the time for performance. However, the innocent party may ignore the repudiation and wait for the day set for performance, at which time, if the other persists in his or her refusal to perform, there will be a breach of contract in the form of *mora debitoris*. Repudiation may be made by words or conduct, provided it is clearly made.

The test of an intention being sufficiently evinced by conduct is whether the party repudiating has acted in such a way as to lead a reasonable person to the conclusion that s/he does not intend to fulfil his or her part of the contract.

Module 4

Evaluate a proposed insurance contract

This Module deals with:

- A proposal analysed in terms of risk and the law of contract as applied to insurance
- Business rules that are applied in addition to legal requirements for a specific insurer and an indication of why the organisation applies the requirement(s)

4.1 A proposal analysed in terms of risk and the law of contract as applied to insurance

- **The True Nature of the Contract Prevails**

Parties may themselves misunderstand the true nature of the contract between them or they may, for some reason best known to themselves, desire to clothe it in a form which is not true. Thus a contract of sale may be called a lease. In this regard the law states that the true nature of the agreement prevails and not what the parties say they are doing (*plus valet quod agitur quam quod simulate conciptur* – it is more valid what parties do than what apparently comes into being).

Where one person makes an unambiguous statement of fact to another intending that the latter should act upon it, and the representation turns out to be untrue, the representor is prevented or "estopped" from denying its truth if the other does act upon it to his or her prejudice. As the result of the application of the doctrine of estoppel, a person may be prevented from proving the actual position as s/he gave the other party the impression that a different situation prevailed.

The state interferes in the contractual relationship between parties to a greater or lesser extent. Three situations can be distinguished where the state:

i) forces parties to make contracts which contain certain terms;

ii) prevents a person from enforcing his or her rights under contract; and

iii) actually amends the terms of the contract between the parties.

Many contracts today are in a standard form drawn up by the party in the stronger bargaining position. S/he simply says to the other: "These are my terms of contract, take it or leave it". In many instances the other party will find that the terms are virtually "standard" throughout the particular industry, as is well illustrated by standard clauses used by life insurers, and the short-term industry's use of products such as "Commercial Policy".

It must be appreciated that the making of a contract is not – if it ever was – a completely private thing. There are other than merely private interests in the making of a contract and the state, by legislation and through the courts, and by applying

normative rather than psychological criteria, have given due weight to these. The existence of a contract and the exact terms thereof cannot be determined by simply looking at what the parties thought (psychologically) they were doing. The norms of society, as expressed in legislation, the common law and by the courts, must be superimposed on the parties' "agreement", in order to determine the true and exact nature of the contract. "Consensus" is objectively determined, not subjectively.

4.2 Business rules that are applied in addition to legal requirements for a specific insurer and an indication of why the organisation applies the requirement(s)

- **Law of Delict**

When considering the law of contract (*ex-contractu*) and its legal status, and the legal responsibilities associated therewith, the following can be considered a summary thereof:

- contractual actions can be brought only by the parties to the contract - these are easily recognised, and limited in number;
- liability under contract law is assumed voluntarily.

By contrast a delictual action can be brought by anyone who has suffered harm through a breach of general duty not to harm him or her in person, property or personality (character/reputation). Therefore:

- no contractual relationship is needed;
- there may be many claimants involved; delictual duty does not depend on anyone's consent. It arises involuntarily, although as a result of our actions or omissions.

Naturally some overlap between contract and delict can occur. For example, a surgeon performs an operation on a patient in terms of a contract. If s/he leaves a swab in the patient's body, the patient (plaintiff) has the option of suing the surgeon in contract or in delict.

In essence therefore a delict is a civil wrong for which damages can be claimed as compensation and for which redress is not usually dependent on a prior contractual undertaking to refrain from causing harm. Thus the distinction between delict and crime can be stated as follows:

- delict is a civil wrong whereas crime is a public wrong;
- the main aim of an action in delict is to compensate the victim, not to punish the guilty;
- action of delict are brought by the person who suffered the harm. Criminal actions are brought by the State;

- it may be easier to succeed in a delictual action than in criminal proceedings. Crime must be proved beyond reasonable doubt. Delict can be settled on the balance of probabilities.

Note that for delict to be alleged there needs to be an element of each of the following:

- wrongfulness
- conduct (either as intent, positive actions, negligence or omission);
- fault;
- causation;
- loss or harm.

(Some commentators combine the first two, but they are perhaps best split from each other.)

In delict conduct is defined as a voluntary human act or omission. A juristic person (such as a close corporation) may act through its members and thus be delictually liable. Allied to this is the capacity to act, and/or to understand the consequences of one's actions. For liability to attach prejudice (harm) must be caused in a wrongful (legally reprehensible or unreasonable) manner. Without wrongfulness a defendant cannot be held liable. Wrongfulness is a conclusion of law that the court draws (or does not draw) from the facts pleaded and proved by the plaintiff. One cannot "prove wrongfulness" though one can prove facts from which the court is prepared to draw the conclusion that the defendant acted wrongfully. This can therefore relate to either a defendant's positive act or a defendant's omission to act. The general rule is that an author of a deed does not deliberately act unlawfully when s/he merely fails to prevent damage or bodily injury to another. Liability only follows if its failure was unlawful, and it would only be unlawful if, under the specific circumstances, there was a legal duty on the author to act positively to prevent the damage, and s/he failed in this legal duty. Whether such a legal duty actually exists is answered by means of the legal conception of society, the *boni mores*.

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