

Risk Management Overview

Introduction

This module addresses risk management with emphasis on the prudent use of insurance. As noted in Module 1, *Introduction to Personal Financial Planning*, risk management is important to cover the catastrophic risks that could derail the best of financial plans. Specifically, comprehensive plans should address:

- Risk to the person, AND
- Risk to property, AND
- Liability

Objectives

This unit should enable you to:

- Be aware of the sections of insurance policies
- Understand the principles of risk and insurance
- Differentiate between perils, hazards, and risk
- Select the most appropriate risk management technique
- Comprehend certain legal aspects
- Understand the Law of Torts
- Comprehend certain aspects of agency relationships

Insurance Policy Sections

All insurance policies have similar sections:

- 1) Declarations – information on the property or activity being insured, and the definitions. Who is the insured and/or what is covered?
- 2) Insuring Agreement – the insurance company's promise(s) in case of a valid claim.
- 3) Exclusions – those perils, losses, and property not covered under the policy.

- 4) Conditions – particularly, the responsibilities of the insured, for example, paying the premiums.

Additionally, there may be endorsements or riders that can add to or amend the basic contract.

Principles of Risk and Insurance

Risk is the possibility of an undesirable event causing harm to a person (death, injury, sickness), harm to property (fire, theft), and liability (threatening assets and/or income). To attempt to insure each of these on a “first dollar” basis would be economically impossible for most clients to afford.

Therefore, the task is to identify those “catastrophic” risks (such as premature death) and select the appropriate means to manage the risks. Often, this will involve insurance as a means of “pooling individual risk” with other insureds. Thus, a large pool of people with similar risks will be covered by the insurance companies.

Perils, Hazards, and Risks

A peril is the cause of a possible loss; hazard is a specific situation or condition that increases the probability of a peril. Hazards may be of three types:

1. Physical (e.g. fire, theft)
2. Moral (e.g. fraud, dishonesty)
3. Morale (attitudinal, e.g., a tree falls on a house and the homeowner neglects to protect the house from further damage because of insurance coverage)

All of these, especially moral hazards, increase the cost of insurance.



1.1 Which of the following would be a peril (P) and which a hazard (H)?

- ___ Storing flammables in a hot garage.
- ___ An electrical fire in your home.
- ___ Parking your car in a high crime area.
- ___ Driving recklessly.
- ___ Being diagnosed with cancer.

Q

1.3 Loss due to theft of his car:

- | | |
|-----------|-----------|
| A. Avoid | C. Reduce |
| B. Retain | D. Insure |

Q

1.4 Loss from fire in his rental apartment?

- | | |
|-----------|-----------|
| A. Avoid | C. Reduce |
| B. Retain | D. Insure |

Q

1.5 Danger from walking his dog?

- | | |
|-----------|-----------|
| A. Avoid | C. Reduce |
| B. Retain | D. Insure |

Q

1.6 Loss of his old laptop?

- | | |
|-----------|-----------|
| A. Avoid | C. Reduce |
| B. Retain | D. Insure |

Legal Aspects

Certain legal aspects of insurance are important to understand. Insurance is a contract and, as such, the usual elements of a contract must be present, such as an “offer and acceptance” and “legal form” (in writing for insurance contracts).

Other aspects are less obvious:

Insurable Interest

A person seeking insurance must be harmed or “at risk” in case of a loss. The concept of when an insurable interest must be present will vary depending on the type of insurance.

For property and casualty insurance, an insurable interest generally must exist to obtain coverage and, more importantly, must exist at the time of loss. If a family sells its home that is later destroyed by fire, they would no longer have an insurable interest.

For life insurance, the insurable interest need only exist at the time of contract. After a contract is issued, the owner is generally free to assign the ownership without restriction.

Consideration

A contract must involve consideration on the part of the insured and the insurer. For the insured, the obvious consideration is payment of the premium. For the insurance company, it is the promise to pay covered losses.

Competent Parties

A person must be mentally competent to enter into a valid contract. If forced into a contract under “duress or undue pressure,” it would likely be void. Importantly, contracts with minors are generally voidable by the minor when the minor reaches the age of majority (legal age of adulthood).

Representations and Warranties

When insurance is applied for, the applicant(s) make representations. In life insurance, for example, responses as to age, health, and lifestyle are representations for underwriters to consider in the decision whether to accept coverage.

If there are misrepresentations (or concealment) and if such representations are “material,” the contract is voidable by the insurance company. A material misrepresentation is one that, had the insurance company known the truth, it would not have issued the contract or would only have issued it on a less favorable status (higher premiums).

Unlike representations, warranties are commitments by the insured to take specific actions. Any breach of warranty is grounds for voiding the contract. Warranties are often part of business insurance. “We will install a sprinkler system if you will provide fire insurance for our office building.” Personal coverages (non-business) normally do not include warranties.

1.7 Select the incorrect statement.



- A. Breach of warranty makes a contract voidable.
- B. Any misrepresentation makes a contract voidable.
- C. Contracts with minors are normally voidable by the minor.
- D. Insurable interest for life insurance is necessary at the time of contract.

Insurance Contract Characteristics

Insurance contracts have specific characteristics not necessarily found in all contracts:

Indemnity – insurance is a contract of indemnity, providing for coverage of losses only, rather than providing a profit to the insured. Homeowners insurance will reimburse for fire losses as provided in the contract. Life insurance is different. The insurance company agrees to the amount of loss at the time of contract issue.

Personal – issued to an insured based upon an “insurable interest” and generally not assignable. As noted earlier, life insurance is an exception. Once issued, the owner can assign a life insurance policy without restriction (assuming no irrevocable beneficiary).

Adhesion – the insurance company writes the contract and the insured must “adhere” to the provisions or decline the contract.

Unilateral – only the insurance company is making a promise (to pay in case of a loss). The insured normally makes no promise, but is bound by the conditions of the contract (paying premiums).

Aleatory – meaning unequal dollar amounts. An individual could pay a \$1,000 annual premium for a \$500,000 term life insurance policy and be killed in an automobile accident a few months later. It will cost the company much more than premiums paid.

Some other key terms are:

Subrogation – if the insured is reimbursed by an insurer for a loss and has a claim against a third party, the insurance company has the right to “step into the insured’s shoes” to recover its payments.

Collateral Source Rule – allows an injured party to collect damages from a third party even though monies may be received from insurance coverage. A jury is not allowed to consider other sources of recovery.



1.8 Which is not a characteristic of an insurance contract?

- | | |
|----------------------|----------------------|
| A. Personal contract | C. Utmost good faith |
| B. Aleatory | D. Alterable |

Tort Law

A tort is a civil (not criminal) wrong other than breach of contract. Someone committing a tort is termed a tortfeasor.

Torts may be intentional or unintentional. The latter is the focus here and unintentional torts can generally be considered to be negligence.

Negligence (unintentional tort) is a result of:

- the existence of a legal duty, AND
- there was a breach of that duty, AND
- a loss occurred, AND
- the breach was the proximate (direct) cause of the loss

Liability may arise as a result of any of the following:

Negligence per se – certain actions are de facto negligent acts; violations of laws such as drunk or reckless driving would be examples.

Res Ipsa Loquitur – “the thing speaks for itself” such as the doctor left the sponge in the patient.

Attractive Nuisance – related to the extra level of care needed regarding children; example, a car knocks down a privacy fence around a swimming pool and a child drowns after entering through the unrepaired fence.

Absolute or Strict Liability – refers to being held liable without necessarily being negligent; workers compensation is an example as an employer is held absolutely or strictly liable for job-related accidents or sickness even though there was no negligence by the employer. Strict liability often applies to products; a manufacturer is held strictly liable for product defects.

Vicarious Liability – liability for actions of others; employers may be held liable for actions of employees; parents for acts of their children.

1.9 Which of the following is correct?

Q

- A. Reckless driving is an example of absolute liability.
- B. Workers compensation is an example of negligence per se.
- C. A trampoline might be an example of an attractive nuisance.
- D. Fraud is an example of an unintentional tort.

Defense to Negligence

A plaintiff is the one bringing an action for negligence against a defendant. The defendant may present certain defenses.

Assumption of Risk – the plaintiff was aware of the risks, thereby voluntarily assuming the risk.

Contributory Negligence – the plaintiff contributed to the loss (partially negligent); under the strict definition of “contributory negligence” the plaintiff gets nothing if at all proven negligent.

Comparative Negligence – under this doctrine, negligence proven on the part of the plaintiff results in a reduction of the damages on a pro-rata basis (varies by state laws).

Q

1.10 Which of the following is a true statement?

- A. Proven contributory negligence results in no damages awarded.
- B. Proven comparative negligence results in no damages awarded.
- C. Assumption of risk applies to the defendant.
- D. Pain and suffering cannot be considered in damages awarded.

Structured Settlements – A successful plaintiff may be awarded lump sum damages or damages in the form of a structured settlement (in installment payments). Compensatory damages (actual losses) are not taxable when received as a result of sickness or accident awards. Punitive damages (punishment) are taxable. Any interest received on awards would also be taxable.

Law of Agency (Insurance) – an agent works for the agency (principal) and can bind the agency. A broker represents the client (insured) and generally does not have the power to bind the agency.

An agent may have express authority, implied authority, or apparent authority. A life insurance agent's contract (appointment papers) with the company represents his express authority. He would have implied authority to solicit life insurance contracts. Even if there were not expressed or implied authority, there could be apparent authority, such as a former agent representing himself as having authority and the principal being aware and taking no action to stop him. Was there enough evidence that the authority existed for a reasonable person to have relied on it? Each of these may bind the agency.

Answers to Unit Questions

1.1 H – flammables in hot garage

P – electrical fire

H – parking in high crime area

H – driving recklessly

P – diagnosed with cancer

1.2 Answer D – Insure, car liability

1.3 Answer B – Retain, car theft

1.4 Answer D – Insure, renters insurance

1.5 Answer A – Avoid, crime area

1.6 Answer B – Retain, loss of old laptop

1.7 Answer B

For an insurance policy to be voidable, a misrepresentation must be “material.”

1.8 Answer D

Insurance contracts are not alterable; riders or endorsements can be added.

1.9 Answer C

Reckless driving is “negligence per se”; workers compensation is an example of absolute or strict liability; fraud is an intentional tort; and a trampoline could be an attractive nuisance.

1.10 Answer A

Contributory negligence results in no damages awarded.

