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## Understanding the Life Insurance Contract

### A. Introducing the Life Insurance Contract

Understanding life insurance **contract** provisions is important, since the insurance company will perform its obligations based on these provisions. The insurer is bound to performance as long as the premiums are paid when required. The contract may cease if the **policyowner** does not pay the premium or if the contract is surrendered for cash.

Some of the **contract** provisions are designed to protect the life insurance company from being defrauded by people who lie about medical problems or contemplate suicide. Many provisions, however, protect the owner, insured, and beneficiaries from the insurer acting differently than agreed to in the contract.

The policy date is used in reference to the date shown on the policy schedule from which policy years, policy months, policy anniversaries, and the premium intervals will be determined. The policy date is usually the original **effective date**. It is treated as an anniversary date and used to determine premium due dates and other important dates. The **due date** is simply the date on which all premium payments after the first payment become due. If a policy takes effect on May 8 of the current year, and that is the policy date, then May 8 will be the anniversary date for the policy.

If premiums are payable annually, then they will be due on May 8 of each year. If premiums are payable monthly, they will be due on the 8th of each month. So, the **due date** means that each premium after the first is due at the end of the period for which the preceding premium was paid. **Proceeds** are the amount payable as a **death benefit**.

If a policy has an original **face amount** of \$100,000 and dividends have been used to buy \$5,000 of additional insurance, then the proceeds (death benefit) will equal \$105,000 at that point. The **payee** is the person entitled to benefit payments under the policy. Usually, this is a designated **beneficiary**. The **owner** of the policy is the person who makes the **contract** with the insurance company. The owner has various rights and obligations, such as designating a beneficiary and making premium payments.

#### 1. Four Contract Requirements

Before a life insurance **contract** becomes effective or is said to be in force, 4 requirements must be met:

1. The contract must be for a lawful purpose.
2. The contract must have legally competent parties.
3. The contract must have involved an agreement (offer and acceptance).

4. The contract must have **consideration** (something of value that each party gives to the other).

The contract must be an exchange of value, called **consideration**.

The **offer and acceptance rule** in life insurance is that the **applicant** makes an offer, and it is up to the insurance company to accept the offer. The life insurance agent is soliciting an offer when the sales presentation is made. Only when the life insurance company accepts can there be a valid insurance **contract**. Therefore, life insurance agents cannot bind or start the life insurance contract immediately. That said, an agent may be granted the authority to issue a **conditional receipt**, which is a written acknowledgement that a completed **application** and initial premium have been received by the agent. Coverage is provided until the company issues a policy or until the application is declined. If the applicant should die before the policy is issued or declined, the company has to pay, unless there is a basis that would have allowed the company to deny coverage.

**Consideration** (money) must be exchanged before any life insurance **contract** takes effect. This exchange usually consists of paying the first premium. It does not have to be for the annual amount but can be based on a monthly or quarterly payment schedule. Because the process of offer and acceptance may take time, problems can arise in determining whether a contract existed at the time of death, even though money was sent to the insurer with the **application**.



If money is sent with the **application**, the policy normally becomes effective when the life insurance company accepts it. However, other **conditions** may be required by the company, such as delivery to a healthy insured. In the case where the premium is paid before the policy is delivered, the applicant's estate would argue that the insurer should pay the death **claim** because money had changed hands and the life insurance company would have accepted the policy.

## B. The Contract Application

Life insurance companies receive initial information about an individual through statements in the **application**. The application is usually filled out by the life insurance agent and/or the insured and allows the company to determine whether the **applicant** is insurable and, if so, to determine the premium. The types of underwriting information typically requested include the following:

- Age;
- Sex;
- Amount and type of insurance requested;
- Beneficiaries;
- Information about any other life insurance in force or applied for;
- Occupation; and
- Information about any medical **conditions** or treatment.

The second part of the **application** is usually the medical report, which commonly is completed by a physician. Life insurance also is sold on a nonmedical basis, meaning that the only medical information needed for underwriting purposes is the information supplied in the application. Applications asking for very little medical information probably will be more expensive for the individual, because the pool of insureds will be in below-average health.

## C. Parties to the Contract

A life **insurance policy** is a legally enforceable contract issued by the insurer in **consideration** of the application and the payment of premiums. There are usually 4 parties identified in life insurance contracts:

1. The insurer;
2. The insured;
3. The applicant/policyowner (if different from the insured); and
4. The **beneficiary**.

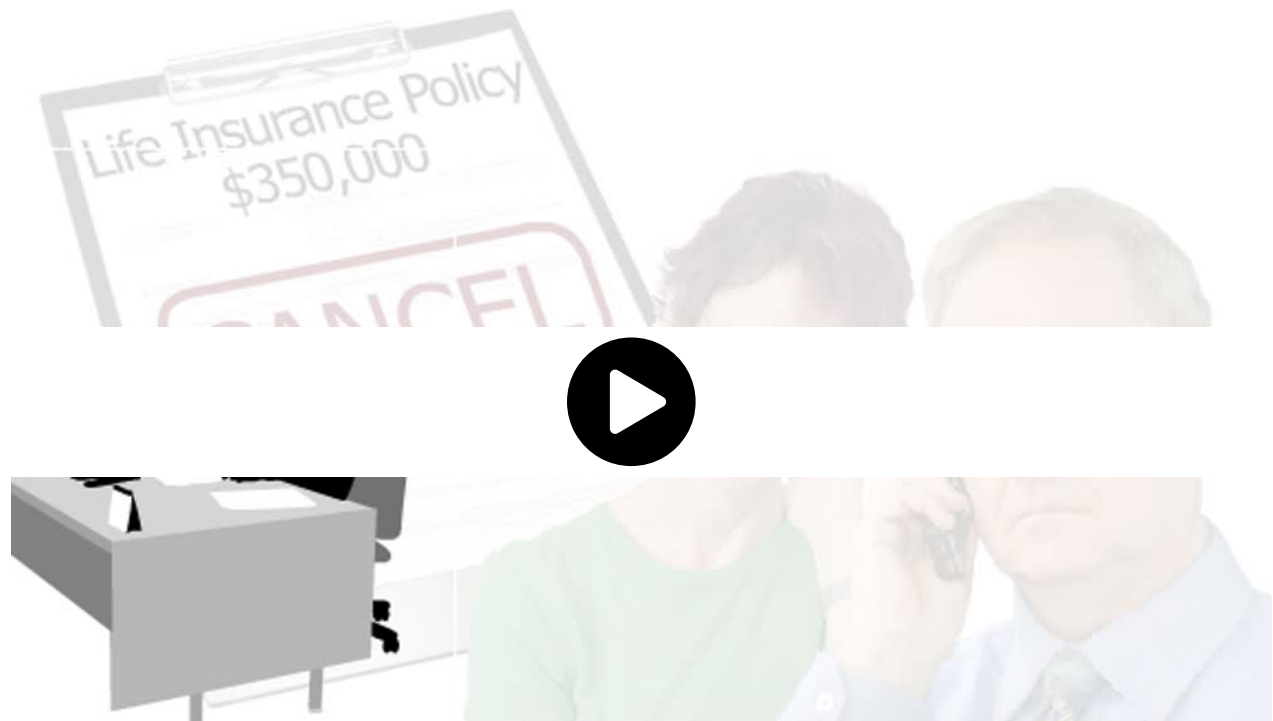
The first party, the insurer, is almost always a corporation and must be licensed in each state in which it does business. The second party is the insured, and can be any person who meets underwriting requirements. The third party is the applicant/policyowner, who often is the same individual as the insured. This individual applies for and owns the **contract** that has been made with the insurer. The applicant/policyowner can be an individual or an entity, such as a corporation, partnership, or sole proprietorship.

The fourth party is the **beneficiary**. Although beneficiaries do not sign the **application** for insurance and may not even be aware of the existence of the insurance, the beneficiary may have rights to sue the insurer after the insured's death to collect the policy proceeds, because the **contract** was intended for their benefit.

## D. Nature of Insurance Contracts

### 1. Unilateral Contracts

**Unilateral** contracts explain that the insurance company is the only party to the contract, which makes a legally enforceable promise. The policyowner's payment of premiums is technically a "condition precedent" to the insurer's liability. The insurer promises to pay a specific dollar amount if the insured dies while the policy is in force. The policyowner makes no promise to continue paying premiums.



## 2. Aleatory Contracts

**Aleatory contracts** are those in which the performance of one or both parties is contingent upon the occurrence of a particular event, and in the case of insurance may provide more in benefits than premiums paid. *For example*, after only one premium payment on a life policy a **beneficiary** may receive hundreds of thousands of dollars of death benefit; or an insurance company can collect more in premiums than it ever pays out in benefits, as in a life **insurance policy** that matures or endows at age 100 because the insured is still alive.

Aleatory contracts are of two kinds:

1. When one of the parties exposes himself or herself to lose something that will be a profit to the other, in **consideration** of a sum of money, which the latter pays for the risk. Such is the contract of insurance. In other words, the insurer takes all the risk, and the insured pays a premium to the insurer for the risk.
2. When each party runs a risk that is the consideration of the engagement of the other. *For example*, when a person buys an annuity, he or she runs the risk of losing the consideration in case of death. But the person may live and receive three times the amount of the purchase price.



### 3. Contract of Adhesion

Insurance contracts are also considered **contracts of adhesion**, meaning they are prepared by one of the parties (insurer) and accepted or rejected by the other party (insured). Insurance policies are not drawn up through negotiations, and an insured has little to say about its provisions. In other words, insurance contracts are offered on a "take-it-or-leave-it" basis by an insurer.

Since the insured does not have an opportunity to negotiate the wording in a contract of adhesion, any ambiguities in the contract are usually interpreted in favor of the insured.

### 4. Conditional Contract

As the name implies, a **conditional contract** requires that certain **conditions** be met by the **policyowner** and the company in order for the contract to be executed and before each party fulfills its obligations. *For example*, the insured must pay the premium and provide **proof of loss** in order for the insurer to cover a **claim**.

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