CHAPTER SIX

LAW OF BANKING, INSURANCE AND NEGOTIABLE INSTRUMENTS

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6. INTRODUCTION

Dear students! The Law of Banking, Negotiable Instruments and Insurance is a vast area of Commercial Law governing various commercial transactions involving banks and their activities, negotiable instruments such as checks, promissory note, bill of exchange and insurance companies' and their activities. In this chapter, we will discuss about three interrelated issues in brief.

A bank or banker is a business organization or a person engaged in the business of accepting money, valuable things and documents on deposit, lending the money it accepted on deposit to others, depositing and managing securities, buying and selling foreign exchange and gold and silver bullions and discounting commercial instruments and transferable securities having a future maturity date.

Negotiable Instruments are documents or papers incorporating or containing various types of rights which are transferred by endorsement and delivery or by mere delivery of the document. The Ethiopian Commercial Code recognizes three types of documents as negotiable instruments,

i.e., commercial instruments /bills of exchange, promissory notes, checks, travelers' checks/, securities / shares or stocks, bonds/ and documents of title to goods / bills of lading and other types of way bills, warehouse goods' deposit certificates./

Insurance may be defined as an economic device by which a possible but uncertain risk of suffering a financial or economic loss resulting from loss or damage to property, incurring civil liability, illness or accident or death of the insured person is transferred from the person bearing it to another person, called the insurer, for consideration. So, the above mentioned issues will be discussed in brief.

Learning Objectives:

After the completion of this chapter, students will be able to:

- Explain the economic significance of banking and major banking transactions;
- Discuss the various types of banks, i.e., commercial banks and central or national banks and their functions;
- Explain the nature and purpose of negotiable instruments;
- Understand different types commercial instruments;
- Understand the definition and types of insurance;
- Explain the basic principles governing insurance contracts

6.1. Banking

What do you understand by the word bank? Give your answer on the space provided.

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Definition

The term bank refers to an institution that deals in money and its substitutes and provides other financial services. Banks accept deposits, make loans, and derive a profit from the difference in the interest rates paid and charged respectively. Some banks also have the power to create money.

The principal types of banking in the modern industrial world are commercial banking and central banking. A commercial banker is a dealer in money and in substitutes for money, such as checks or bills of exchange. The banker also provides a variety of other financial services. The basis of the banking business is borrowing from individuals, firms, and occasionally governments—i.e., receiving “deposits” from them. With these resources and with the bank's own capital, the banker makes loans or extends credit and invests in securities. The banker makes profit by borrowing at one rate of interest and lending at a higher rate and by charging commissions for services rendered.

A bank must always have cash balances on hand in order to pay its depositors upon demand or when the amounts credited to them become due. It must also keep a proportion of its assets in forms that can readily be converted into cash. Only in this way can confidence in the banking system be maintained. Another type of banking is carried on by central banks, bankers to governments and “lenders of last resort” to commercial banks and other financial institutions. They are often responsible for formulating and implementing monetary and credit policies, usually in cooperation with the government. In some cases—e.g., the U.S. Federal Reserve System—they have been established specifically to lead or regulate the banking system; in other cases—e.g., the Bank of England—they have come to perform these functions through a process of evolution.

Some institutions often called banks, such as finance companies, savings banks, investment banks, trust companies, and home-loan banks, do not perform the banking functions described above and are best classified as financial intermediaries. Their economic function is that of channeling savings from private individuals into the hands of those who will use them, in the form of loans for building purposes or for the purchase of capital assets. These financial intermediaries cannot, however, create money (i.e., credit) as the commercial banks do; they can lend no more than savers place with them.

6.2. Economic Significance of Banking

Can you give some examples that banks could play in the economic development of a country? ____
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The government has recently unveiled the five years Growth and Transformation Plan (GTP) aimed at spurring rapid growth and stirring up an economic take off. It will not achieve its growth targets and transformation goals without bolstering its source of domestic revenues and creating vibrant financial sectors. The role played by these sectors in prompting rapid growth and development is no subject to debate.

Financial sectors are intermediaries that channel the savings of individuals, businesses and governments in to loans or savings. Despite the long history of financial sectors beginning from the establishment of a bank by historically reminiscent name of Bank of Abyssinia in 1900, the sector is fairly underdeveloped. In Ethiopian, banking has dominated the sector with approximately 80% of the total financial sector assets, with insurance and microfinance sector for 10% each. They all facilitate exchange of goods and services by operating the country's payment settlement systems. It is, therefore, very difficult if not impossible, to achieve the government's goal of rapid and sustainable economic growth and development objectives that the government has planned in its GTP without having vibrant, efficient and strong financial sector which is accessible to the majority of the population, if not all.

Since recent times, Ethiopian banks have grown rapidly and many new banks are under establishment reflecting the improving operation environment as well as the role of banks in boosting the economy of the country. These are 15 banks that are operational of which three are owned by the government and twelve are private with total number of 673 branches as of March 2010.

Banks play a critical role in the emerging markets like Ethiopia. Firstly, banks are intermediaries between depositors and borrowers thereby promoting savings that latter result in capital formation which is the bases for economic progress in the country and a way out from abysmal poverty. Secondly, they encourage industrial progress and business expansion through funds channeled to investors. Thirdly, banks exercise considerable influence on the level of economic activity through their ability to create or manufacture money in the economy and fourthly, the

various utility functions performed by banks like accepting and discounting bill of exchange and collection of dividends and interests on behalf of customers are of great economic significance for the economy.

6.3. Types of Banks

Do you know the types of banks that we have in Ethiopia? If yes, please right them in the space below.

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1. Central Banks

It refers to an institution, such as the Bank of England, the Bank of France, or the Bank of Japan, that is entrusted with the power of regulating the size of a nation's money supply, the availability and cost of credit, and the foreign-exchange value of its currency. Regulation of the availability and cost of credit may be nonselective or may be designed to influence the distribution of credit among competing uses. The principal objectives of a modern central bank in carrying out these functions are to maintain monetary and credit conditions conducive to a high level of employment and production, a reasonably stable level of domestic prices, and an adequate level of international reserves. Under Ethiopian context, these powers are entrusted to The National Bank of Ethiopia (NBE). It is established by order No 30/1963 and reconstituted by the Monetary and Banking Proclamation No 83/1994 as an autonomous organ, which is engaged in the provision of regular banking services to the government and other banks and insurance companies'. The main purpose of the bank is to foster monetary stability financial system and such other credit and exchange conditions as are conducive to the balanced growth of the economy of Ethiopia.

2. Commercial Banks

Commercial banks are banks with the power to make loans that, at least in part, eventually become new demand deposits. Because a commercial bank is required to hold only a fraction of its deposits as reserves, it can use some of the money on deposit to extend loans. When a borrower receives a loan, his checking account is credited with the amount of the loan; total demand deposits are thus increased until the loan is repaid. As a group, then, commercial banks are able to expand or contract the money supply by creating new demand deposits.

3. Saving Banks

A savings bank is a financial institution that gathers savings and that pay interest or dividends to savers. It channels the savings of individuals who wish to consume less than their incomes to borrowers who wish to spend more. The savings deposit departments of commercial banks, mutual savings banks or trustee savings banks (banks without capital stock whose earnings accrue solely to the savers), savings and loan associations, credit unions, postal savings systems, and municipal savings banks serve this function. Except for the commercial banks, these institutions do not accept demand deposits.

4. Investment Banks

Investment bank is a firm that originates, underwrites, and distributes new security issues of corporations and government agencies. The investment-banking house operates by purchasing all of the new security issue from a corporation at one price and selling the issue in smaller units to the investing public at a price sufficiently high to cover expenses of sale and leave a profit. The major responsibility for setting the public offering price rests on the investment bank because it is in close contact with the market, is familiar with current interest rates and yields, and is best able to judge the probable demand for the issue in question.

5. Development Banks

It refers to a national or regional financial institution designed to provide medium- and long-term capital for productive investment, often accompanied by technical assistance, in less-developed areas.

6.4. Major Banking Transactions

What are the major banking transactions?

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6.4.1. Deposit of Funds

A deposit of funds is a contract whereby a person agrees to deliver and transfer the ownership of specified amount of money to a bank which agrees to repay them under the conditions agreed up-on in the contract or on the demand of the depositor. The bank, as the owner of money deposited, has right to use it in respect of its professional activities, i.e. the bank may lend it to its customers or invest it in areas which are allowed by the national bank.

6.4.2. Transfer

This transaction represents one mode of transferring money from one account to another upon the written and signed order of the transferor, and a means of performing money obligations. As a result, it is always a secondary transaction by which the debtor performs his obligations by payment of money. According to Art 903(1) of the Comm. Code, a bank transfer is a transaction whereby the bank, upon the written order of the depositor /transferor, debits the account of the transfer and credits the account of another depositor/the transferee with the amount specified in the instruction or transfer order. Transfer is still possible even if there is no account to the transferor or transferee.

6.4.3. Deposit of Securities

Though the relevant provisions of the commercial code do not provide a definition of this transaction, a contract of deposit of securities may be defined as a contract whereby an owner or of securities (shares or stocks, government bonds and company bonds (debentures) or other right holder agrees to deposit the securities with a bank which agrees to provide safe custody and handle or manage them for consideration.

6.4.4. Hiring of Safes

Banks take charge of their customers' valuables like jewelry, negotiable securities, and documents of title to properties, will, and deposit them, as they can be conveniently stored. Such deposits are special in nature and thus do not fall under the general category of banks' deposit.

Banks deposit their customer's values in either of the following two ways:

1. By accepting the valuables for safe-custody or
2. By hiring out safe deposit boxes to their customers.

Facilitating safe deposit of valuables by hiring out safe boxes for their customers is the dominant service of banks in most countries of the world, including Ethiopia.

In safe deposits or hiring of safes the bank and the customer execute a contract specifying the conditions on which the safe will be hired the contract includes the customer's duty to pay rental charges and the method of payment. Sometimes, the customer may be made to open a saving account and deposit a certain amount of money from which the bank could debit the rental charges whenever they are due.

6.4.5. Discount

Discount is a contract whereby a bank agrees to pay to a holder of a commercial instrument or security having a future date of payment an amount which is lesser than its actual value, against the surrender of the instrument and the undertaking to repay the value of the instrument by the holder where payment is not made at the maturity of the instrument. A bank discounts a commercial instrument for consideration, which is the difference between the value of the instrument and the discounted amount paid by the bank to the holder. /Art 941 Comm. Code/.

6.4.6. Lending

Bank lending or credit services provided by banks are one of the most common and traditional functions of banks which, if properly used, may play a vital role in a country's economic development.

6.4.7. Documentary Credit

A documentary credit is a credit provided to persons engaged in foreign trade particularly importers who need to pay the price of goods in foreign exchange. This type of credit is required because it is only banks which are allowed to handle and deal in foreign exchange and importers

are required to pay the price of goods imported from abroad through opening letters of credits. So an importer who intends to import goods into the country has to apply to a bank to open a letter of credit in which the seller of the goods is the beneficiary. Where the bank accepts the application of the importer, it opens the letter of credit equivalent to price of the goods and transmits or communicates it to its branch (if it has a branch at the place where the seller is situated) or to a bank with which it has a correspondence. The correspondent bank, which has received the letter of credit, shall notify the seller/beneficiary of the credit. And the correspondent bank shall pay the price of the goods to the beneficiary of the credit after receiving documents representing the goods such as an invoice, a bill of lading, a packing list and an insurance policy covering risks associated with transportation (Where according to the contract of sale insurance is the obligation of the seller) and after confirming that the documents presented by the seller confirm with terms and conditions of the credit.

The correspondent bank which has paid the agreed amount to the seller or third parties to whom the right to receive payment is transferred, shall send the documents it has received from the seller to the opening bank and the opening bank will hand over these documents to the importer after receiving the amount equivalent, in Ethiopian Birr, to the amount paid to the seller, interest and service charge (commission) for the service provided.

6.5. Negotiable Instruments

What are negotiable instruments?

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6.5.1. Definition of Negotiable Instruments

The word negotiable means ‘transferable by delivery’ and the word ‘instruments’ means a written document by which a right is created in favor of a person. Thus, the term negotiable instrument literally refers to a document containing rights that can be transferred by delivery.

Similarly, Article 715(1) of Ethiopian Commercial Code of 1960 defines the term negotiable instruments as any document incorporating a right to an entitlement in such a manner that it is not possible to enforce or transfer the right separately from the instrument.

The rights that could be incorporated in negotiable instruments may be rights for payment of money arising out of various contracts such as the contract of loan, sale, lease, or any other contract performed by payment of a certain amount of money. Such rights may also arise from ownership in companies or loan made to the government or to a share company. The rights that are incorporated in negotiable instruments may be rights to receive goods under voyage or deposited in a warehouse. According to this provision, the holder of negotiable instruments can transfer the rights incorporated in the instrument by transferring the instrument. Similarly, a person who claims the rights incorporated in negotiable instruments may enforce or exercise them only if he has possession of the instrument, i.e., he should be a holder to whom the instrument is issued or transferred following the rules governing its transfer. He must also present the instrument to the person who is supposed to perform the obligations arising out of the instrument. (See also Art 716/1/). The fact that the rights incorporated in negotiable instruments may be transferred by the transfer of the instrument and the fact that a person may not exercise or enforce them unless he is in possession of the instrument are the two main features which distinguish negotiable instruments from other documents evidencing rights such as a title deeds whose transfer does not transfer the rights they establish. /Refer to Art 1185 and 1195 of the Civil Code/

Based on the purpose and rights incorporated in the instruments, Article 715(2) of the Commercial Code categorizes negotiable instruments into three main types, i.e., Commercial Instruments, [Transferable] Securities and Documents of Title to Goods.

6.5.2. Nature & Purpose of Negotiable Instruments

The main purpose of negotiable instruments is facilitation of commercial transactions. Commercial instruments are substitutes for money and are used as means of performance of money obligations. Dealing with them reduces the risk of loss or theft and the ease with which they can be transferred creates convenience which will in turn facilitate business. Transferable securities have the purpose of raising capital in the form of contributions made by purchase of

shares and bonds, which is used for starting new businesses or expansion of existing businesses thereby increasing the production of goods and services in the country. A document of title to goods, whose negotiation transfers the goods represented by them, creates convenience and facilitates transactions involving the goods. For instance, a person selling warehoused goods can do so by endorsing and transferring the certificate of deposit and without the need to actually deliver the objects. When we come to the specific purposes of commercial instruments, promissory notes can be used as means of borrowing money, buying goods and services on credit and as method of evidencing a pre-existing debt. Certificates of deposit can be used as "device for encouraging individuals to deposit funds in banks, in return the holder of the certificate has the right to receive interest. Bills of exchange on the other hand have the purpose of collecting accounts financing, the movement of goods, and transfer funds. Checks serve as "vehicles for transfer of money and also used to aid in keeping records, reduces the risk of loss and destruction and theft of currencies."

6.6.Commercial Instruments

Definition

Commercial instruments are negotiable instruments incorporating rights for payment of a specified amount of money. They are issued and negotiated on the basis and with the purpose of performing an obligation that can be performed by payment of a certain amount of money. Hence, they are used as a substitute for money.

Article 732(1) of the Commercial Code of Ethiopia defines commercial instruments as negotiable instruments setting out on entitlement consisting in the payment of a sum of money. Sub-Article (2) of the same Article provides that bills of exchange, promissory notes, checks, travelers' checks and warehouse goods deposit certificates are the types of commercial instruments recognized under the Ethiopian law. However, treating warehouse goods deposit certificates, which evidence contracts of warehousing and the right to receive the goods warehoused, as commercial instruments does not seem to be in accordance with the definition of commercial instruments, i.e., documents containing right for payment of money.

6.7. Types of Commercial Instruments

6.7.1. Bills of Exchange

Bills of exchange are negotiable instruments incorporating an unconditional order, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a certain sum in money to or to the order of a specified person.

Bills of exchange, therefore, involve an order to pay money rather than a promise to pay money. The person issuing the order is the drawer, the person ordered to pay is the drawee and the person who receives the payment is the payee.

The Commercial Code of Ethiopia does not provide a definition of bills of exchange. However, Art 735 enumerates the requirements to be fulfilled for drawing a valid bill of exchange from which one may deduce the definition of the term under Ethiopian law.

Accordingly, a bill of exchange must contain;

- The term “bill of exchange”
- An unconditional order to pay a certain sum in money
- The name of the person who is to pay (the drawee)
- The time of payment
- The place of payment
- The name of the person to whom or to whose order payment is made or an indication that it shall be payable to bearer
- The date when and the place where the bill is issued.
- The signature of the person who issues the bill (drawer)

A bill of exchange that does not contain any one of the above requirements shall not be valid and the drawer or any other party to the instrument can raise defect of form against any person who claims based on the bill. Art 717/1/ However, a bill which does not contain the time of payment is presumed to be payable at sight or on demand. A bill which does not mention the place of payment, shall be deemed to be payable at the domicile or at the address of the drawee, and a bill which does not provide place of issue, is deemed to have been drawn at the place mentioned beside the name of the drawer.

6.7.2. Promissory Notes

A promissory note is defined as a document incorporating an unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to or to the order of a specified person or to bearer. This, definition implies that promissory notes are promise to pay money and they are only two parties i.e., the maker of the promise and the payee to whom payment is affected.

Similar to the cases of bills of exchange, the Commercial Code of Ethiopia does not provide the definition of a promissory note apart from the requirements provided under Art 823 for validity of promissory notes, which are identical with the definition given above. These requirements are essential for the validity of a promissory note.

Thus, a promissory note must contain;

- The term “promissory note”
- An unconditional promise to pay a sum certain in money
- The time of payment
- The place of payment
- The name of the person to whom or to whose order payment is to be made or a statement that the note is payable to bearer
- The date when and the place where the note is issued
- The signature of the person who issues the instrument

These requirements should be observed for promissory note to be negotiable instrument. Failure to comply with these requirements results in the invalidity of the instrument except in the cases provided by Art 824, which fills gaps in case of absence of time of payment, place of payment and the place of issuance. Accordingly, a promissory note which does not specify time of payment, shall be deemed to be payable at sight or on demand, a promissory note which fails to indicate the place of payment is presumed payable at the address of the maker of the promise and note which does not indicate the place of issuance deemed to have been drawn at the place indicated beside the name of the maker.

It is important to note the following distinctions between bills of exchange and promissory notes, i.e. a promissory note contains promise to pay whereas a bill of exchange contains an order to

pay. The maker of promissory note is always primarily liable and its liability is the same as the acceptor of a bill of exchange, but in case of drawer of bill of exchange once the bill is accepted he is only liable as surety in the event of dishonoring of bill of exchange. The concept of acceptance is not applicable to promissory notes unlike bills of exchange that may be accepted. Finally, promissory notes involve two parties only as opposed to bills of exchange that under normal circumstances involve three parties.

6.7.3. Checks

A check is the most widely used form of commercial instrument. It is bill of exchange drawn on a bank and payable on demand. The English Bills of Exchange Act of 1882 defines a check under Art 73 as a bill of exchange drawn on a banker payable on demand. Therefore, since check is defined by reference to a bill of exchange, most provision governing bills of exchange are applicable to check. The check is an unconditional order in writing, addressed by one person, the drawer, to a banker, signed by the drawer, requiring the bank to pay, on demand, a sum certain in money to or to the order of specified person or to bearer.

The following are the main differences between checks and bills of exchange. A check is always drawn on a banker and is always payable on demand while a bill of exchange may be drawn on any one and may be made payable on demand or at fixed or a determinable future time and a check can be crossed in several ways but bills cannot be crossed. Acceptance is not necessary for a check since it is payable on demand as opposed to bills of exchange which may be made payable at fixed or determinable future time presentment for acceptance may be necessary.

It is also important to note that a drawer of a bill of exchange and a check or the maker of a promissory note may antedate or postdate it, provided that he has not committed a fraud. In other words, unless the drawer or maker intended to jeopardize the interest of the payee by causing the rights contained in the instrument to lapse, the mere fact of antedating or post dating an instrument does not make it invalid.

Crossed Checks and Checks Payable into Account

A crossed check is a check containing two parallel lines drawn across its face by the drawer or holder. A check may be crossed generally or specially.

A check is crossed generally where it bears the two parallel lines only or where the word “bank’ or ‘banker’ is inserted between the lines. The crossing shall be special where the name of a specific bank is inserted between the lines. A check crossed generally can only be paid to a bank, which is the banker of the payee or holder, or to a person who is the customer of the drawee. A check crossed specially can only be paid to the bank specified in the crossing. Such bank may have the check collected by another bank. Where the bank whose name appears in a special crossing is the drawee itself, the check may be paid to a person who is the customer of the drawee. However, a bank may not collect crossed checks on behalf of persons other than their customers or other banks. Art 864

The whole purpose of crossing checks is to make sure that the check is paid to the intended person by preventing payment to other persons into whose hands the check might fall. It also helps to avoid or at least minimize risks associated with loss or theft of checks i.e. to trace and identify the person who actually received payment for the purpose of recovery., because crossed checks are paid to either banks or customer of banks whose addresses are known and traceable.

However, the fact that a check is crossed does not mean that it cannot be negotiated as open checks. Negotiation of crossed checks shall have the same effect as the negotiation of open checks and the person to whom such check is transferred shall have the status of a holder in due course if the requirements are fulfilled. However, the drawer or holder may prohibit negotiation by inserting words such as ‘not negotiable’ or 'not transferable’ in the same manner as the drawer or endorser of an open check. A person to whom a crossed check containing such a provision is transferred shall not acquire a status of a holder in due course and does not acquire a better title than the transferor/ Art 865. / See also Art 842, which provides for the effect of transfer a non negotiable open check.

A bank, which violates the provisions of Art 864 and pays the check to a person who is not entitled to receive payment, shall be liable to pay compensation to the drawer or holder which does not exceed the value of the check. /866/1//

However, a drawee which paid a check in which a crossing has been altered, struck out or modified contrary to the law, in good faith, and without negligence- believing that it is paying to the appropriate person- shall not be liable under Art 866(1). A bank which receives payment on

crossed checks on behalf of its customers shall be liable for damages to the drawer or the holder to the extent of the value of the check, where it is shown that the customer on whose behalf it collected the crossed check has no right to the instrument or that his rights is defective and subject to personal defenses.

Where the drawer or holder of a check writes transversally across the face of the check words such as 'payable in account' or any similar expression, the drawee may not pay the check in cash to a person who is not its customer. Such check can only be settled by means of crediting an account, by transferring from one account to another, set off …Art 867(1). The bank that violates this provision and pays the check in cash at the counter shall have the liability to pay damages provided under Art 866.

Certificates of Deposit

A certificate of deposit is a form of commercial instrument issued by a bank. It is an instrument containing an acknowledgement by a bank that it has received a sum of money on deposit and a promise to repay the sum of money. When a person deposits money in a bank he will be given the document showing the deposit of money which could be withdrawn by the depositor or the holder of the certificate. Under our law, a certificate of deposit is not considered as a commercial instrument. It is not even mentioned in our law but in common law countries, it is treated as a commercial instrument because it serves as means of payment of money similar to other type of commercial papers.

Agreements as to Payment of Interest

According to Art 739 and 825 bills of exchange and promissory notes payable at sight or at a fixed period after sight may contain a provision regarding payment of interest. It also clearly prohibits agreements as to the interest made in relation to bills and notes payable at a fixed period after date and those payable on a fixed future date.

Opposition, Payment and Discharge

The drawer or an endorser of a bill of exchange may oppose the payment of the value of the bill at any time before payment on the grounds of the bankruptcy of the holder.

Similarly, the holder of a bill may oppose payment of a bill on the ground of loss or theft of bill before payment is made. /Art 779. / Opposition on these grounds may be made by notifying, in writing or orally, the drawee of the grounds of the opposition.

However, payment of a check may be stopped by the instruction of the drawer at any time before payment without the need to prove the existence of a valid ground to do so. / Art 857. /

The drawer who pays a bill at maturity or a check is validly discharged and cannot be held liable unless he has violated the opposition of payment or 'stop payment' order respectively. /Art 776 and Art 861/ The drawer must verify the signature of the drawer but not the signature of endorsers, as it does not have the specimen of signatures of all the potential endorser of the bill or check . /Art 776(3) and Art 860/

Acceptance of Commercial Instruments

Acceptance of commercial instruments refers to the agreement of the drawee to pay the value of the instrument to the holder at its maturity. Acceptance shall be made on the instrument and may be expressed by words such as 'accepted' 'agreed' or any other similar expression implying agreement of the drawee and signed by the latter. A mere signature of the drawee on the bill shall also constitute acceptance. Acceptance should also indicate the date when it is given, particularly in cases where the instrument is required by the drawer to be presented for acceptance within the time specified in the bill of exchange and in cases where a bill is payable at a fixed period after sight. This is because, in the first type bill, the date when acceptance is given is essential, as failure to present the instrument for acceptance within the period stipulated might result in the loss of right of the holder. In the second type of bills, such date is important to determine the maturity of the bill. Where the date of acceptance is not shown on these types of bills, the holder must authenticate the omission of the date of acceptance by protest drawn within the period provided for drawing up of a protest.

The concept of acceptance applies to bills of exchange and not to promissory notes and checks because of the following reasons. A promissory note shall not be accepted as it does not involve a drawee whose agreement constitutes acceptance and the maker of a promissory note is considered as an acceptor of a bill of exchange who has already expressed his agreement to pay the agreed amount on a future date. On the other hand, a check cannot be accepted because it is

always payable at sight or on demand and the drawee shall pay the value of the check on presentment. Note that acceptance is applicable to bills with a future date of payment.

Acceptance for Honor

Acceptance for honor represents a guarantee to pay the value of commercial instruments by any person who may even be a signatory of the instrument. A person may guarantee the payment of the whole or part of the value of a commercial instrument on its maturity by accepting it for the honor of any one of the parties liable to the holder. That means the person who accepts a commercial instrument shall be liable on the instrument in the same manner as the person for whom he has become a guarantor.

6.8.Definition of Insurance

What do you understand by the word insurance?

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Insurance may be defined in various ways. Firstly, from the point view of an individual it may be defined as a risk transfer mechanism or an economic device whereby a person, called the insured/assured transfers a risk of a possible financial loss resulting from unforeseeable events affecting property, life or body to a person called the insurer for consideration.

Secondly, from the point of view of the insurer, insurance may be defined as a mechanism through which a risk is distributed among the group of persons who are exposed to the same type of risk, i.e., persons who bear the risk of suffering a financial loss as a result of events affecting property, life or body.

6.8.1. Definition and Nature of Contracts of Insurance

A contract of insurance is a contract whereby one party undertakes, in return for a consideration called a premium, to pay to the other party a sum of money on the happening of a certain event (death or attainment of a certain age, or injury) or to indemnify the other party against a financial loss arising from the loss or damage to property or from incurring civil liability.

The party which promises to pay a certain amount of money to, or to indemnify, the other party is called the insurer. The document containing the terms and conditions of the contract of insurance is called the policy, and the insured is therefore, also referred to as a policyholder.

According to Art 654 of the Commercial Code, insurance is a contract between two or more persons in which one person called the insurer, agrees to pay the agreed amount of money or compensation to another person, called the insured, or the beneficiary where the insured property is lost or destroyed (in cases of property insurance), or where the insured person incurs civil liability (in cases of liability insurance) or where the insured person dies or suffers bodily injury or falls ill (in case of insurance of persons). The insurer undertakes this obligation for consideration, called premium payable by the insured person.

6.8.2. Significance of Insurance

Can you mention some of the roles that insurance could play in the society?

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Insurance as a mechanism of transfer of risk has great economic and social benefits to the individual insured, his family and the country in general. The following are some of the major benefits.

Indemnification for Losses

Payment of compensation by the insurer for losses permits individuals and their families to be restored to their original financial position after a loss has occurred. As a result, they can maintain their financial security. Since they are restored either in part or in whole after a loss occurs, they are less likely to seek financial assistance from relatives and friends. It also allows businesses to remain in business and employees to keep their jobs, suppliers will continue to receive orders, and customers can still purchase the goods and services they desire.

Reduction of Worry and Fear

Another benefit of insurance is that it reduces worry and fear, both before and after loss. For instance, if family heads have life insurance for adequate amount to cover the future needs of their families, they are less likely to worry about the financial security of their dependents in the event of their premature death.

Means of Loss Control

Although the main function of insurance is not to reduce loss but merely to spread/distribute losses among members of the insured group, insurers are nevertheless vitally interested in keeping losses at a minimum.

Enhancing Credit

Insurance enhances a person's credit, i.e., it makes the borrower/debtor a better credit risk because it guarantees the value of the borrower's collateral/mortgage or pledge/, and gives the creditor /lender greater assurance that the loan will be repaid.

6.9.Basic Principles of Insurance

What are the basic principles in order to establish a valid contract of insurance?

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a) **Principle of Utmost Good Faith**

It is the inherent duty of both parties to a contract of insurance to make full and fair disclosure of all material facts relating to the subject matter of the proposed insurance. It is so because insurance shifts risk from one party to another. A material fact for this purpose is a fact, which would affect the judgment of a prudent insurer in considering whether he would enter into a contract at all or enter into it at one premium rate or another. There should not be any false statement or half-truths or any silence on a material fact. This applies to all material facts whether considered by him as material or not and whether known to him or not.

b) **Principle of Indemnity**

The second fundamental principle is that all contracts of insurance are contracts of indemnity, except those of life and personal accident insurances where no money payment can indemnify for loss of life or bodily injury. If there is no loss under the policy, the insurer is under no obligation to indemnify the insured. The purpose of indemnity is to place the insured, after a loss, in the same position he occupied immediately before the event.

c) Proximate Cause

The next principle of insurance is that the insurer is liable only for those losses which have been proximately caused by the peril insured against. In other words, in order to make the insurer liable for a loss, the nearest, immediate, or the last cause has to be looked into, and if it is the peril insured against, the insured can recover.

d) Insurable Interest

Consistent with the concept of insurance as a means of indemnifying an insured against a loss, is the corollary that insurance should not provide an insured with the means of showing a net profit from the event insured against. Insurable interest means some proprietary or pecuniary interest. The object of insurance is to protect the pecuniary interest of the insured in the subject matter of the insurance and not the material property as such. A person is said to have an insurable interest in the subject matter insured where he will derive pecuniary benefit from its existence or will suffer pecuniary loss from its destruction. Insurable interest is thus a financial interest in the preservation of the subject matter of insurance.

e) Doctrine of Subrogation

The doctrine of subrogation is a corollary to the principle of indemnity and as such, it applies only to property insurances. According to the principle of indemnity, the insured can recover only the actual amount of loss caused by the peril insured against and is not allowed to benefit more than the loss he suffered.

In case the loss has arisen out of tort or fault of a third party, the insured becomes entitled to proceed against both the insurer as well as the wrongdoer. However, since a contract of insurance is a contract of indemnity, the insured cannot be allowed to recover from both and thereby make a profit from his insurance claim. He can make a claim against either the insurer or the wrong doer. If the insured chooses to be indemnified by the insurer, the doctrine of subrogation comes into play and as a result, the insurer shall be subrogated to all the rights and remedies of the insured against third parties in respect of the property destroyed or damaged.

f) Mitigation of Loss

When the event insured against occurs, for example, in the case of a fire insurance policy when the fire occurs, it is the duty of the policyholder to take steps to mitigate or minimize the loss as

if he were uninsured and must do his best for safeguarding the remaining property. Otherwise, the insurer can avoid the payment for loss attributable to the negligence of the policyholder.

7. Doctrine of Contribution

The doctrine of contribution states that ‘in case of double insurance all insurers must share the burden of payment in proportion to the amount assured by each. If an insurer pays more than his ratable proportion of the loss, he has a right to recover the excess from his co-insurers, who have paid less than their retable proportion.’ Thus, the essential conditions required for the application of the doctrine of contribution are:

1. There must be double insurance

2. There must be either over-insurance or only partial loss

8. Reinsurance

An insurer assuming larger risk from the direct insurance business may arrange with another insurer to off load the excess of the undertaken risk over his retention capacity. Such arrangement between two insurers is termed as ‘reinsurance.’ Thus, by the device of reinsurance the original insurer transfers part of the risk to the reinsurer. Payment made by the ceding insurer (called original insurer or reinsured) to accepting insurer (called reinsurer) for the assumption of the risk by the latter is termed ‘reinsurance premium.’

Summery

In this chapter, you have studied the concepts and legal rules regulating negotiable instruments, banking and insurance. You studied rules of the Commercial Code governing: bill of exchange, promissory note and cheque. Negotiable instruments are devices that may be used in substitute of money. Commercial instruments facilitate commercial and serving as a means of payment and medium of exchange. Credit sale may easily be arranged by exchange or by a promissory note. Similarly, where the buyer is not in immediate to possession of money he may write a cheque to the seller and the seller may withdraw the stated amount in the cheque or transfer the cheque to the other creditors.

The documents are said to be negotiable because they may be easily transferred from one person to other by mere negotiation. Negotiation may be effected through endorsement and delivery of the instruments. Negotiable instruments to serve the function of money shall satisfy all the

requirements demand the Commercial Code. As a business student you should know all the procedures and requirement validity of a negotiable instrument. The other area of law that has been discussed in this chapter is insurance. Insurance is a means of distributing money. The insurance companies collect money from the insured parties and compensates whenever an insured peril materializes. This commercial institution avoids the fear of loss and encourages business person to engage in business freely.

It is a wise decision to get the property and other insurable interests should be insured for it compensates risk. The insured must perform his obligations once he concludes an insurance contract. These obligations are the duty to pay premium and a duty to disclose all the material information to the insurer.

The person who needs to make a contract of insurance must identify what kind of insurance he wants. This is because there are many kinds of insurance contracts, like property insurance, liability insurance, and personal insurance. Finally if the insured property gets damaged, then the insured party has to inform the insurance companies regarding the materialization of the peril.

Activity 1

1. What is bank and banking activities?

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2. What is the economic significance of banks?

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3. What is the nature and purpose of insurance?

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4. Explain the different types of commercial instruments?

5. Draw the difference and similarities between bill of exchange, promissory note and cheque.

6. Discuss the basic tenets governing insurance contract?

7. Discuss the application of insurable interest and doctrine of subrogation in life insurance by supporting provisions from the commercial code, if any.

Case Type Questions

Case 1

W/ro Hiwot has interred in to life insurance. In the insurance policy made with the Company, the insured has specified the beneficiaries to be ‘A’, ‘B’, and ‘C’ who are her children while excluding two of her children from the insurance benefits.

On the process, ‘A’ has killed his mother to get the benefits of insurance.

a. Can the excluded children claim against their exclusion from the benefits of insurance.

b. What will happen as to the policy if ‘A’ is criminally convicted for homicide?

c. Can ‘A’ get the benefits if he killed his mother negligently?

Case 2

Ato Wasihun has entered in to fire insurance for his house. He has paid all the premiums as per their agreement until the property is assigned to Ato Getachew. However, they have agreed in the contract that the Company is not obliged to make payment of compensation if the house is assigned to another person.

Unfortunately, the house is damaged due to fire covered in the policy on Sep. 1 2002 E.C. within one month after the house has been assigned to Ato Getachew. So, the Company is requested to make payment of compensation but refused.

Q^n.

a. Had you been a legal adviser to this case, what will be your decision? Why?
b. Ato Getachew claims payment of compensation on Sep. 21, 2004 E. C. Had you been the legal adviser of the Company, what will be your legal defense?