

Part I

INSURANCE BASICS



KEY TERMS & CONCEPTS

1

- 1 As you begin your study of Property and Casualty insurance, it is important for you to build a working vocabulary of insurance terminology. In this chapter, you will be introduced to the key terms and concepts that serve as a foundation for the balance of this text. Since these are words you will encounter over and over throughout this text, it is not necessary for you to spend hours memorizing definitions. Simply attempt to gain a basic understanding of their meaning and let the many applications which follow reinforce your understanding. On the other hand, as you work through this chapter, you must be careful to recognize the subtle (and not so subtle) differences that distinguish how these words are used in insurance as distinguished from their everyday usage.
- 2 **EXPOSURE** – The state of being subject to loss. If you own a home, a car and a business, you have multiple exposures.
- 3 **RISK** – Chance of loss; uncertainty of loss; probability that a loss will occur. For example, what is the probability (risk) that a building will burn down or that the crop will be destroyed by hail? Individuals may transfer their risk (or a portion of it) to an insurance company.
- 4 In insurance, we deal with **pure risk** situations as contrasted to **speculative risk**, which is gambling. If you place a bet at a horse race, *you can lose or you can win*. But, if you own an automobile, you can *only lose* if it is wrecked or stolen – there is no opportunity to win. With an Auto policy, the company will put you back where you were before the loss, but you still have no potential for profit.
- 5 As you can readily see, if you own anything or do anything you have a risk exposure. If you have a house, it might burn. If you have a front walk, somebody might slip and be injured.
- 6 There are several ways you can deal with risk. You might **avoid** a major risk exposure by not putting a swimming pool in your backyard. You could **reduce** risk by shoveling your walk during the winter. You could **retain** some risk by choosing a deductible when purchasing auto insurance. You can **transfer** most risks to an insurance company, and, as you will see, you are then **sharing** risk with all of the other Insureds of that company that also fit your risk profile.



chance of loss

1 **LOSS** – A **financial hurt**; the basis for a claim under an insurance policy; the amount for which the insurance company becomes liable to pay the Insured in the event of the Insured’s financial harm. If there is no financial hurt, there is no loss. And, the amount of the insurable loss will not exceed the financial hurt. Insurance companies are not inclined to underwrite *sentimental value*. Joe’s gold ring worth \$1,000 is insured for \$1,000. He cannot insure it for \$2,000 because his grandfather gave it to him.

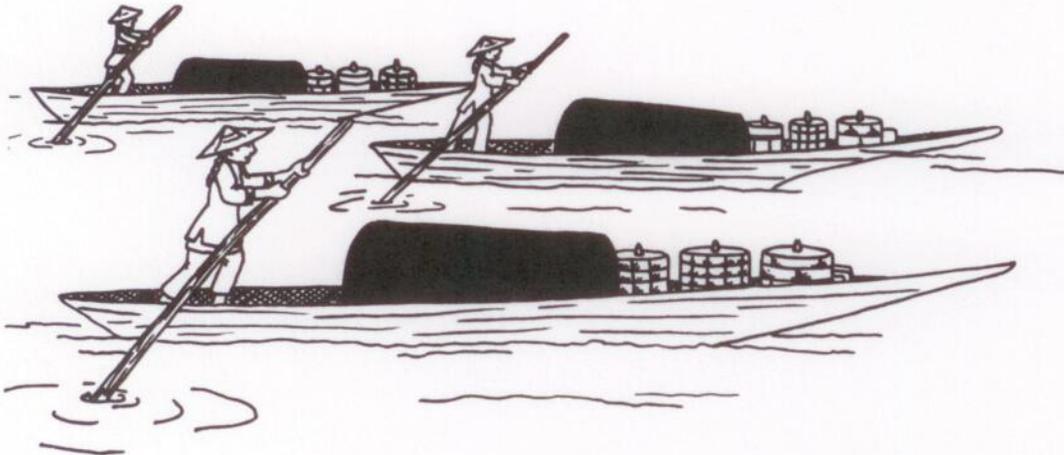
dollar value of the hurt

2 There are two types of losses: direct and indirect. A **direct loss** is the actual destruction of the insured property itself. An example of a direct loss would be the Insured’s car being crushed by a meteor. An **indirect (or consequential) loss** is any other form of financial hurt that occurs as the result of a direct loss. Indirect losses result from the **loss of use** of the insured property. An example of an indirect loss would be the Insured’s renting a replacement automobile after the meteor destroyed his car.

the stuff itself

loss of use

3 Notice that we are using the words differently than you might use them in normal conversation. In insurance, even a *chain of events* kind of loss can be a direct loss. If someone runs a stop sign, skids on the ice, and then smashes into a tree, which then topples through Joe’s roof, the damage to Joe’s house is direct. If Joe must move into a motel until his roof is repaired, his additional expenses would be considered an indirect loss. Please recognize that indirect losses are losses to your pocketbook and can only occur when there is first a direct loss.



4 The theory of insurance deals with the transfer of risk among members of society. The basic concept is not that difficult. Many insurance historians trace the basic concept of insurance back many centuries to the Chinese. In a principally agrarian society, Chinese farmers were faced with the problem of getting their crops to market. Most of them simply loaded their crops on a boat and used the rivers as transportation. Occasionally though, a boat would overturn and an entire harvest would be lost. The farmers began to transfer this risk to other farmers in a brilliant, yet simple, way. Ten farmers from one area would get together at harvest and load the boats by putting one-tenth of every farmer’s crop on each boat. If a boat sunk, each farmer lost a little, but no one lost everything.

This concept of sharing risk is the basis of all insurance products.

- 1 A modern-day policyowner trades a small known loss (premium) for the insurance company's promise to pay for a large, unknown loss should it occur. All of the policyowners lose a little, but no one has to take the risk of losing everything.

That 拍近照片步
fortune cookie was
right again!

- 2 A slightly more traditional definition would say that **insurance is a device that provides for the transfer of individual risk to a company.** In turn, the company will, for consideration, assume losses suffered by the Insured up to a predetermined limit. This is done by contracts in which an insurance company agrees, for consideration (premium and statements on the application), to indemnify or *make whole* the Insured in the event of specified losses from specified perils.

you. . .

- 3 **PROPERTY – Stuff;** belongings, possessions, assets; anything that you can acquire and own is property. Though *intellectual property*, like an idea, patent, or copyright is possible, most property is tangible – things you can see, feel, or touch. For example, your house, your furniture, your car, your dog, and your boat are your property. Property insurance is a contract to pay for damage or loss to your property caused by perils such as fire, lightning, or wind, as specified in the policy.

STUFF

- 4 Property insurance can be written on a **specific** or on a **blanket** basis. A Boatowner's policy might specify that it covers a *14 foot Tracker with a 100 horsepower Mercury outboard engine.* A Commercial Property policy might cover *all of the Business Personal Property of the Acme Furniture Company.* The blanket approach is very useful if the insured property might be located at any of several locations. If insured on a **blanket basis**, Acme would not have to be concerned if they had \$1 million of furniture in the store and \$1 million in the warehouse or if they had \$1.5 million in the store and \$500,000 in the warehouse.

property

- 5 **TWO PARTY CONTRACT** – A contract of insurance in which there are only two parties or persons involved: the **Insured** and the **insurance company.** All **property contracts are two party contracts** as the agreement only concerns two parties. If a loss occurs, the relationship between the company and the Insured becomes an adversarial relationship (tug-of-war): the Insured wants the most s/he can collect and the company wants to settle the claim equitably but not overpay.

- 6 **CASUALTY** – (Also known as **liability.**) As a member of society, you are granted certain rights, but with each of those rights come certain duties. For example, you have the right to drive your automobile but you have a corresponding duty to use care in the operation of your automobile so that you do not injure other people (called Bodily Injury or BI) or damage their property (called Property Damage or PD). Casualty insurance is designed to pay for damage you might do to someone else or their property.

*...The Other
Guy*

- 7 **THIRD PARTY CONTRACT** – A contract of insurance involving three parties: the insurance company, the Insured and an **unknown third party.** All **casualty (liability) contracts are third party contracts.** They are designed to protect the Insured(s) against lawsuits by an injured third party for BI and PD caused by a negligent Insured.

casualty

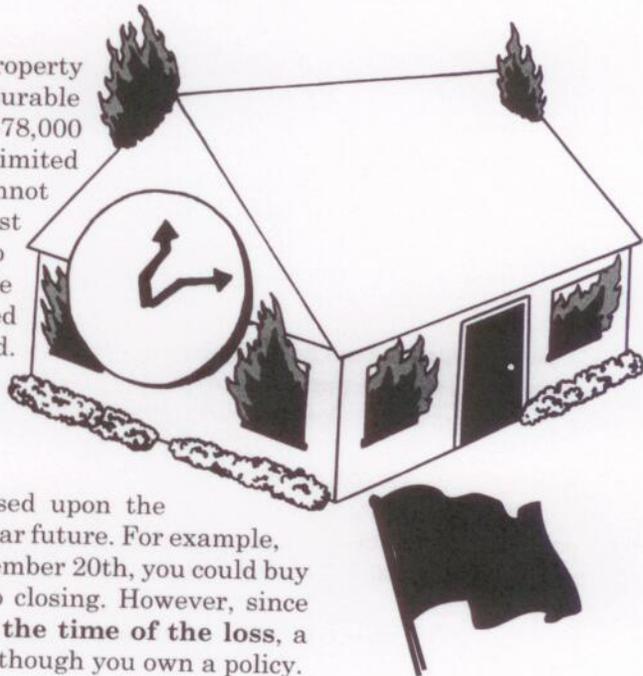
- 1 **PERSONAL LINES vs. COMMERCIAL LINES** – Insurance can be written to meet the needs of individuals or businesses. Personal lines include the property and casualty coverages that protect an individual or a family, such as Homeowners and Automobile. The Commercial lines include coverages designed for businesses, such as the Commercial Property policy, the Commercial General Liability policy and the Businessowners policy. The distinction between Commercial Lines and Personal Lines is now almost more important than the distinction between property insurance and casualty insurance, as many policies contain both property **and** casualty insurance. The distinction between Personal Lines and Commercial Lines is now so important that this book is now subdivided into those two major sections.

*Home . . .
the office*

- 2 **INSURABLE INTEREST** – In property insurance, insurable interest is any **financial interest** a person has in the property at the time of the loss. You have an insurable interest in property when its damage or destruction would result in your direct financial loss.

*what have you
got to lose*

- 3 The amount of insurance that you can purchase on property is theoretically limited to the amount of your insurable interest in that property. For example, if you only own \$78,000 worth of contents in a rented building, then you are limited to insuring just the contents for up to \$78,000. You cannot insure the building because you have no insurable interest in it. However, it is not necessary to own something to have insurable interest. A TV repair shop has insurable interest in a television in which they have invested time and materials until such time as the bill is paid. A business that leases a building has an insurable interest in betterments and improvements it makes to that building until the end of the lease.



- 4 It is also possible to purchase property insurance based upon the assumption that you will have insurable interest in the near future. For example, if you purchase a house with a closing scheduled for September 20th, you could buy the necessary Homeowners policy a week or so prior to closing. However, since benefits are only paid if you have insurable interest **at the time of the loss**, a fire on September 18th would not pay you a dime – even though you own a policy.

- 5 **INDEMNIFY** – To make an Insured **financially whole**; to restore an Insured who suffers a loss to his original financial condition . . . but **not** to make him better off than he was before the loss occurred; to compensate for what has been damaged or destroyed.

- 6 One of the fundamental principles of insurance is that the policyowner is not supposed to profit from a loss. By only agreeing to **indemnify** in the event of a loss, the insurance company removes the incentive for intentional losses.

*make whole
not rich*

- 7 **LIMIT OF LIABILITY** – Despite the name, both Property and Casualty contracts have a limit of liability that establishes the degree to which a company will indemnify following a loss. In Property insurance, suppose that I have insured my \$150,000 house for \$100,000. Further assume that I suffer a \$20,000 loss. The limit is \$100,000, the loss is \$20,000. I will collect \$20,000. The Rule of Three L's says that I will collect the **Lower of the Loss or the Limit**. Alternatively, if I suffer a total loss of my home (\$150,000), I will collect only \$100,000. In this case, the limit is lower than the loss.

Rule of 3 L's

*Lower of the
Loss or the
Limit*

1 In a Casualty contract, the Limit of Liability dictates how much the company will pay on your behalf in the event you injure someone else or their property. Of huge importance in liability insurance is the idea of **occurrence limits** and **aggregate limits**. Personal lines liability policies typically have only an occurrence limit; *we will pay up to \$100,000 for any occurrence for which you are the negligent party*. For another occurrence the following day, there is another \$100,000 and so on. This is an example of **restoration** or **nonreduction** of limits. On the other hand, Commercial liability policies normally have an aggregate limit as well, which limits the total for all occurrences within the policy period.

2 **EXCLUSIONS** – Losses that the policy specifically states are not covered by the contract. Exclusions typically fall into one of three categories:

3 **CATASTROPHIC LOSSES** – such as war, nuclear catastrophes, floods and earthquakes.

4 **LOSSES THAT ARE BETTER COVERED ELSEWHERE** – Homeowners policies, for example, exclude automobile losses because they are better covered under an Automobile policy and vice versa. Also, there are a number of very common exclusions for losses that are better covered by specialty policies, such as Equipment Breakdown, Business Income, Flood, Aircraft, Workers Compensation and Marine.

5 **PREDICTABLE LOSSES** – such as deterioration, wear and tear, rust, and mechanical breakdown. A loss must be **fortuitous** to be covered, which means it must be unexpected and unforeseen – something that happens by chance. For example, your automobile insurance policy won't pay for a new set of tires when your old ones wear out because those are predictable losses. It would pay for the same tires destroyed in a wreck because that is a fortuitous (accidental) loss.

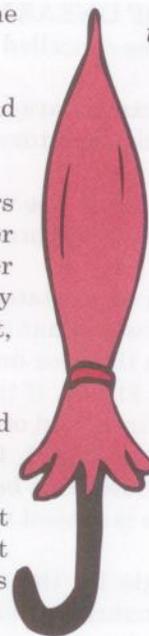
6 **INHERENT VICE** – Though most exclusions are self-explanatory (e.g. flood, war, mechanical breakdown), the words *inherent vice* are a little unfamiliar to most. Inherent vice is a property loss resulting from a latent defect natural to the property itself. For example, an auto will eventually rust – it's the nature of iron. This loss is characterized as inherent vice and is excluded by most property contracts.

7 **PRO RATA** – in proportion; share; ratio. The term *pro rata* is used frequently in property insurance such as in Pro Rata Refund, Pro Rata Coverage, and Pro Rata Liability clauses. It also shows up in liability insurance if multiple companies are involved in the same claim. Notice that pro rata does not mean equally. Suppose that you and I share a pizza. If I eat 80% of it and you eat 20%, splitting the \$10 tab pro rata dictates that I pay \$8 while you pay \$2. Sharing equally would cause us both to pay \$5. Only in the fluke circumstance where we each ate the same amount of pizza could we split the bill both proportionately and equally.



8 **LIBERALIZATION CLAUSE** – This clause simply states that if the insurance company, during your policy period, improves the terms or benefits of new policies of the same form to new Insureds for the same price, then your policy will automatically have the same improved rights and benefits as the improved policies. For example, if you owned a Commercial Property Policy and if new policies had additional coverages for the same price, then your policy would be interpreted as also having the new benefits.

things not covered



*I have to admit it's getting better...
- the Beatles*

1 **ASSIGNMENT** – In property and casualty, assignment is the legal transfer of ownership of an insurance policy from the current policyowner to a new policyowner. An assignment must be agreed to in writing by the old policyowner, the new policyowner and the insurance company. The Commercial Property Policy refers to assignment as *Transfer of Your Rights and Duties Under This Policy*.

2 **CANCELLATION/NONRENEWAL** – Cancellation is the termination of coverage during the policy period. Nonrenewal, however, is termination at the end of the policy period.

3 **REFUND OF UNEARNED PREMIUM** – By this point, it should be obvious that a policy can be cancelled midterm in two ways:

- Joe can always cancel his own policy.
- Within statutory guidelines, Joe's company can cancel the contract.

4 In either instance, Joe will be due a refund of premium for the time that coverage was paid for but not provided.

5 However, in most states and with most **Commercial policies**, the question of who cancels whom has a major bearing on the amount of the refund. To illustrate, let's assume that Joe owns a commercial building for which he pays a six month premium of \$1,000. If the company cancels Joe at the end of three months, he is due a pro rata refund of \$500. If Joe cancels the policy after three months (assume he sold the building), then most jurisdictions allow the company to pay Joe's refund on a short rate basis – he might receive \$450. The amount the company can penalize Joe is subject to state regulation but is normally around 10%.

6 The rationale for the short rate refund is fairly straightforward. The costs of issuing an insurance policy are *front-end loaded*. It is in the beginning of the policy period that the company costs of commissions, inspections, and issuing the policy are paid. If Joe cancels midterm, the company might well lose money on the policy through no fault of its own – hence the short rate refund.

7 **Memory Device:** If the company cancels Joe's Commercial policy, they are the **pros** in the transaction, and he gets a **pro rata refund**. If Joe cancels the company, he gets *short-changed* – a short rate refund.

Commercial Lines

Company cancels

– pro rata

Joe cancels

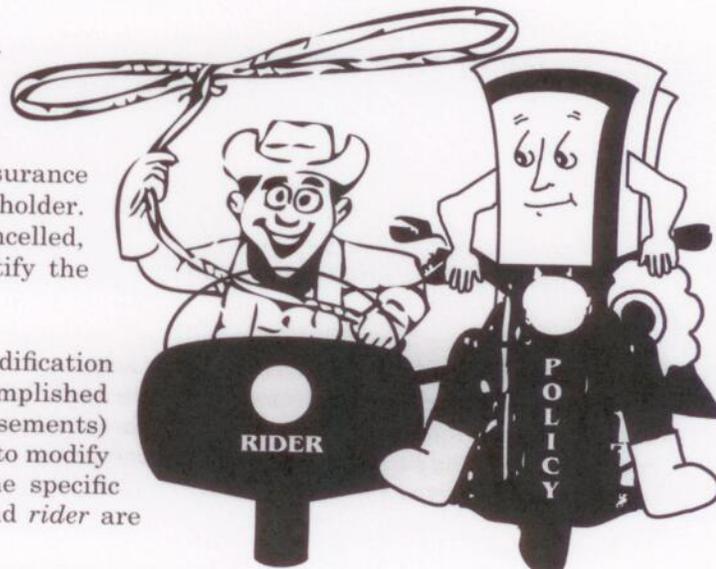
– short rate

Personal Lines

– pro rata

8 **CERTIFICATE OF INSURANCE** – Frequently in the business world contracts require one party to show the other party that they, in fact, have the insurance required by the agreement. The party requesting proof of insurance keeps the certificate and becomes the certificate holder. If the insurance shown on the certificate is cancelled, the insurance company must endeavor to notify the certificate holder of the cancellation.

9 **ENDORSEMENT** – A written modification or addition to a policy, usually accomplished by adding additional pieces of paper (called endorsements) to the policy. The purpose of an endorsement is to modify the original agreement to fit the needs of one specific policyowner. Today, the terms *endorsement* and *rider* are used interchangeably.



- 1 **NAMED INSURED** – In a personal lines contract, the Named Insured(s) have the rights and duties under the policy. While other persons may be afforded coverage under the contract, the Named Insureds maintain the contractual rights. *more than you think*
- 2 **FIRST NAMED INSURED** – The Commercial Package Policy makes a further distinction between Named Insured(s) and the **First** Named Insured. The First Named Insured is the **first entity listed** on the Declarations under the Named Insured category. This First Named Insured is the entity who has the right to cancel the policy, the right to change the policy, the duty to pay the premium, and is the individual who will be notified should the insurance company wish to cancel the policy.
- 3 **ACCIDENT** – A **sudden, unforeseen and unintended event** that happens at a **known place** and a **known time**. For example, a car rounds the bend, slides on the ice and hits a telephone pole. The driver did not foresee the ice being on the road and did not intend to slide on the ice. The event happened at a known place and a known time. Also called a **fortuitous** event. *single event*
happens by chance
- 4 **OCCURRENCE** – An accident but also including **continuous and repeated exposure** to injurious conditions that result in bodily injury or property damage. The definition of *Occurrence* is much broader than the definition of *Accident* because an occurrence includes not only sudden and swift losses, but also **losses that occur over time**. For example, the Occurrence definition would include coverage for the following kinds of losses: injury to skin as the result of the repeated use of a skin lotion; crops that are damaged by fumes escaping continuously from a manufacturing plant; paint damage to a home caused by repeated exposure to chemicals from trucks going to and from a construction site, and the injury caused by breathing asbestos particles over a long period of time. Accidental losses would be covered by a policy written on an Occurrence basis but not vice versa. *all accidents are occurrences... not all occurrences are accidents*

Conclusion

- 1 By this time your head is probably swimming with all the definitions you've been exposed to in Chapter 1. Don't worry, you'll see all the things you learned here used in context in later chapters. Let's do a quick review of some of the more important terms before moving on.
- 2 If you have anything, or do anything, you have **exposures**. If you have a car it might be stolen. If you drive the car, you might hurt someone. This chance of loss is known as **risk**. Insurance is a **pure risk** situation as you can only lose. **Speculative risk** offers the chance of gain or loss and is simply gambling.
- 3 A **loss** is a financial hurt, not a sentimental hurt. If your house burns, that is a **direct loss**. If you have to spend extra money to live in a motel while you rebuild, that is an **indirect loss**.
- 4 **Property** is stuff and insured under a **Two Party contract**. **Casualty** policies are **Third Party** contracts and pay for damage you do to the Other Guy. You buy insurance; you must have or expect to have a financial interest in the subject of the insurance. **Insurable interest** must exist at the time of loss if you are to collect under the policy.
- 5 The **Rule of three L's** says that we will pay the **lower of the loss or the limit**. Personal Lines policies have only **occurrence limits**. The policy limit applies to each separate occurrence. Commercial policies also have an **aggregate limit** which describes the total dollars available in any policy year despite the number of occurrences.
- 6 **Exclusions** spell out what the policy does not cover. Exclusions are typically **catastrophic losses**, losses **better covered elsewhere**, or **predictable losses** (like **inherent vice**).
- 7 If you want to **assign** your policy, you'll need company permission. If a company honors its policy with you this year but does not want you next year, that's **nonrenewal**. If they terminate your coverage mid-term, that's **cancellation**.
- 8 The ranking Insured in a Personal Lines policy is the **Named Insured**; in a Commercial contract it is the **First Named Insured**.
- 9 **Accidents** happen at a given time; **occurrences** can happen at a specific time or over a period of time. A train wreck is both an accident and an occurrence. Black lung disease is an occurrence but not an accident.
- 10 There are over 40 definitions in this chapter. We've hit just a few here that will give you a basic foothold on how property and casualty coverage works.



CONTRACT LAW AND UNDERWRITING

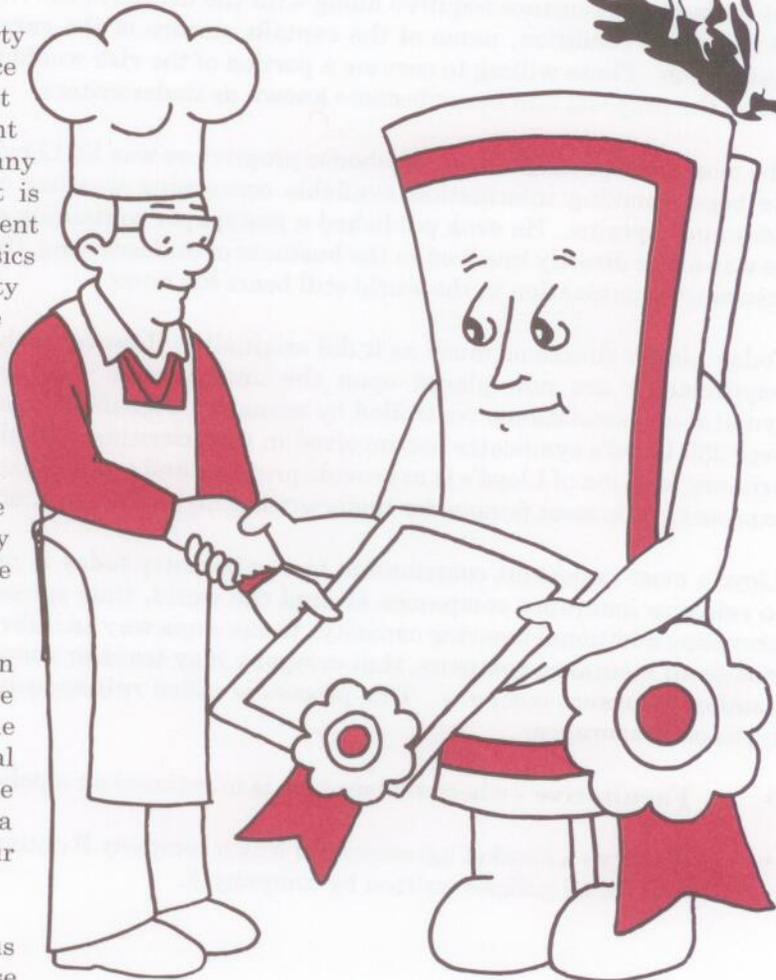
2



1 In layman's terms we say that Property and Casualty Agents sell insurance policies. In legal terms, we might say that the Agent is aiding in the establishment of a legal contract between the company and the Insured. For this reason, it is important for you as a prospective Agent to have a solid understanding of the basics of contract law. In fact, as a Property and Casualty Agent, it is even more important for you than it is for a Life and Health Agent. As a Property and Casualty Agent, you are typically given the authority by the company you represent to *bind coverage*. That is the power to start the contract and obligate the company prior to the company receiving any money or even having the opportunity to study the application.

2 Obviously, with this power you've been handed a two-edged sword. You have a great tool to help your clients and the perfect weapon to commit professional suicide. A good knowledge of the fundamentals of contract law will go a long way in assuring that you use your power beneficially.

3 From personal experience, most of us know one party to the contract because the *Policyowner R Us*. But before we look at how a contract is formed, many of us need to know just a little more about the other party to the contract – the insurance company.



TYPES OF COMPANIES

- 1 There are several ways of classifying companies within the insurance industry today. One method is by examining the corporate structure of the company.

Lloyd's of London

- 2 Probably the most startling fact about Lloyd's is that it is not an insurance company and does not issue policies. It merely provides a vehicle for associations of individuals to write insurance. The roots of this historically rich organization began in 17th century England when merchants gathered at the coffeehouses to do business and exchange ideas.

- 3 As you are aware, England has limited natural resources, and her growth depended in large measure on commerce that could be developed through shipping and trade. Her success in trade was due in part to the willingness of wealthy individuals to insure the ships and cargoes involved. An informal system slowly evolved in which the person seeking insurance would post a proposal in a coffeehouse, stating the amount of insurance required along with the details of the risk involved, such as the ship's condition, name of the captain, nature of the cargo and the ship's destination. Those willing to assume a portion of the risk would write their name under the proposal and hence became known as underwriters.

- 4 The most enterprising of the coffeehouse proprietors was Ed Lloyd of Tower Street. He began making information available concerning weather conditions, ships, tides and captains. He even published a newspaper containing such data. While he was never directly involved in the business of underwriting, the most renowned insurance organization in the world still bears his name.

- 5 Today Lloyd's functions much as it did originally. However, substantial financial requirements are now placed upon the underwriters who are organized into syndicates (associations) controlled by managing Agents. Usually several of the over 250 Lloyd's syndicates are involved in underwriting a single risk. While the primary function of Lloyd's is to provide property and casualty coverage for normal exposures, it is most famous for underwriting highly unusual, one-of-a-kind risks.

- 6 Lloyd's most important contribution to our industry today is probably its ability to reinsure insurance companies around the world, thus spreading the risk and providing additional insuring capacity. In the same way an individual can transfer risk to an insurance company, that company may transfer some of its risk to still another insurance company. This process is called **reinsurance**. There are two types of reinsurance:

- **Facultative** - where reinsurance is negotiated on a policy by policy basis.
- **Treaty** - a blanket agreement in which company B automatically reinsures 25% of all policies written by company A.

Stock Companies

1 A stock company is a corporation that is organized to conduct the business of insurance and is actually owned by its stockholders or shareholders. Shares of stock are sold to the stockholders to provide the capital (money) that the corporation needs in order to get started. This capital sustains the corporation until it makes enough money to operate from current income. Since the stockholders own the company, they are entitled to share in the company profits, which are paid to them as a dividend - a return on their capital investment. On the other hand, individuals who have purchased insurance from the company, called policyowners, do not participate in company profits and never receive dividends as they have no capital investment in the company.

For the benefit of the stockholders . . . they own it

2 In short, a stock company may be characterized by the fact that:

- It is operated for the ultimate benefit of the stockholders.
- A portion of the earnings is paid to stockholders as dividends.
- The board of directors of the company is elected by the stockholders.
- **It does not pay dividends to its policyowners.** The policyowners do not participate in company profits, and, therefore, these companies are referred to as *non-participating* companies. As you will see in the next section under mutual companies, there is another type of dividend called a "policy dividend." For the moment, remember that stock companies do not pay policy dividends.

Mutual Companies

3 The most important legal difference between a mutual company and a stock company is that a mutual has no stockholders and exists, therefore, for the benefit of the policyowners. Because it has no stockholders, a mutual must be started in a different manner. The first step for a new mutual company is to find a required number of individuals willing to purchase a minimum amount of insurance from the company. Since most people would be reluctant to apply for insurance from a company that could only be formed if enough applications are taken in advance, it is almost impossible to start a mutual today. Most mutuals are now formed by mutualizing an existing stock company. Many of the huge mutuals with which you are now familiar - Prudential, Metropolitan and Equitable of New York - were formed in this manner.

For the benefit of the policyholders . . . no one really owns it

4 Today's mutuals are technically classified as mutual legal reserve companies, which means that they meet the same capital requirements that are placed on stock companies. Most states do require mutuals to incorporate, and the policyowners control the corporation by voting for the board of directors that operates the company.

1 While the biggest legal difference between a mutual and a stock is that a mutual has no stockholders, the most visible difference is that **the mutual company pays policy dividends to policyowners** and the stock does not. It is important to note that these policy dividends are not a return on investment in the sense of the dividends paid by stock companies to stockholders. In the truest sense, policy dividends are *a return of premium overcharge*. In setting premium rates, a company makes many assumptions regarding mortality (death), anticipated earnings and expenses. Although **a policy dividend is never guaranteed**, generally company projections are quite conservative, the company does better than anticipated, and a dividend is paid. While some money must be held as surplus in the event of adverse experience in the future, the excess surplus is returned to the policyowner as a **dividend - a return of unneeded premium**. Because the policyowners participate in the profits of a mutual company, the mutual company is often called a *participating company*.

*Dividends to
policyowners*

*Dividends not
guaranteed*

2 A mutual company, then, may be distinguished from a stock company by the following:

- It is operated for the ultimate benefit of the policyowners. It has no stockholders.
- It generally pays *policy dividends*. Since the policyowners do participate in the profits of the company, it is called a *participating company*.
- There is no capital stock, so no stockholder dividends are paid.
- As there are no stockholders, the policyowners elect the board of directors of the company.

Reciprocals

3 From the viewpoint of the policyowner, a **reciprocal insurance exchange** operates like a mutual company. The biggest difference is structural. A reciprocal is an **unincorporated** entity managed by an **attorney-in-fact** generally offering homeowners or auto insurance to the public. Each Insured member is known as a **subscriber** and agrees to share in the other subscriber's insured losses as they agree to share in his. It is from this *reciprocal promise* that the name is derived.

combo

4 In most jurisdictions, these not-for-profit organizations are regulated just like mutuals and must belong to the Insurance Guaranty Associations of the states in which they do business.

Fraternals

- 1 In the late 1800's and early 1900's, waves of European immigrants began to land on the shores of this country. While they came for many reasons, they were welcomed as necessary labor in the factories of America, which were operating at full capacity throughout the period known as the Industrial Revolution.
- 2 These new city dwellers naturally grouped together in accordance with their ethnic and religious backgrounds and often formed fraternal societies to maintain their national heritage. Such religious and social fraternities began to provide small amounts of insurance, generally burial insurance, for their members.
- 3 They grew rapidly until the turn of the century. They have since declined in importance, although some very large fraternals still exist today, including the Aid Association for Lutherans, Independent Order of Foresters, Lutheran Brotherhood, Woodmen of the World, Knights of Columbus and Modern Woodmen of America.
- 4 Fraternals are not normally incorporated under state insurance laws as are insurance companies, and they are usually subject to slightly different regulations than stock or mutual companies. They do, however, closely parallel mutual companies in their organization and operation. The biggest difference is that you must join the fraternity in order to buy fraternal insurance.

*Clubs
that offer
insurance*

Self Insurers

- 5 Self insurance can appear in many forms from the very informal to the highly structured. Technically, a person who has no health insurance, for example, is self insured. If Joe Insured calculates that his family would need \$500,000 in the event of his death, he might buy only \$250,000 in coverage if he already has \$250,000 in the bank. He is self insuring for \$250,000.
- 6 Most of us self insure in automobile insurance by selecting a deductible. When our car is worth less than the gas in the tank, we drop collision damage to our own car.
- 7 Many large companies self insure their property and casualty exposures. Rather than paying an insurance company, they set aside about the same amount they would have paid in premium and pay claims out of this fund. They then buy **stop loss** coverage from a traditional company to cover losses which go beyond a specified limit.

Retain risk

Risk Retention Groups

- 8 Risk retention groups generally address commercial liability exposures and simply take self insurance to another level. Suppose our buddy Joe Insured owns a restaurant where he serves liquor. If he cannot buy Liquor Liability coverage, he might decide to self insure. If he joins a risk retention group comprised of all the other bar owners in his state they have the Law of Large Numbers working on their behalf. They collect their own premiums and pay their own losses.
- 9 Risk retention groups are generally not subject to the same regulations as an insurance company and normally do not belong to the state Insurance Guaranty Association.

*Group self
insurance*

Government Insurers

- 1 In terms of dollar volume and number of policyowners, the federal government is by far the biggest insurance company on the face of the earth. Social Security and Medicare alone involve just about every U.S. citizen. In addition, programs are available for military personnel (Servicemen's Group Life) and their dependents. (Tricare).
- 2 The federal government also provides or subsidizes insurance for some catastrophic perils like flood. State government is involved in providing insurance for those who cannot buy through normal channels in the areas of medical expense, homeowners and automobile insurance. State government also plays an important role in Worker's Compensation insurance in most states.

Uncle Sam

OTHER WAYS OF CLASSIFYING COMPANIES ‡

- 3 While consumers are most likely to classify companies by structure - Stock or Mutual or Fraternal - there are several other important ways to classify companies.

BY ORIGIN (WHERE?)

- 4 In order for an insurance company to be granted a charter in a particular state it must have sufficient resources on hand to pay claims. The company anticipates that eventually enough policies will be sold to allow the Law of Large Numbers to work properly.
- 5 Some states have exceedingly high requirements and others substantially lower. Therefore, knowing the state in which a company was formed (chartered) could tell you a lot about the financial resources of a company.
- 6 A company chartered in Illinois, for example, would be considered an Illinois **domestic company**. If a company is chartered in another state, territorial possession or Washington D.C., it would be considered, in Illinois, a **foreign company**. Therefore, a company chartered in California would be a foreign company within the state of Illinois. A company chartered in another country would be viewed as an **alien company**.
- 7 Almost always, a company's home office is in the state in which it was formed - it is said to be *domiciled* there. Therefore, if we assume that we all live and work in Florida, a company domiciled in New York would be considered foreign. A company domiciled in Canada would be an alien company.

*Here =
Domestic*

*Not here,
but in U.S. =
Foreign*

*Outside U.S. =
Alien*

‡ This symbol indicates material important in Thomson Prometric test states.

BY AUTHORITY

1 A company is automatically granted the right to do business in its state of origin. If that company wants to do business in other states, it must apply to those states for approval as an **authorized (or admitted)** company. For example, a company domiciled in Indiana and authorized to do business in Kentucky, Ohio and Illinois is only an authorized (or admitted) company in those states. In any other state the same company would be an **unauthorized (or nonadmitted)** company.

*Admitted =
Authorized*

*Nonadmitted =
Unauthorized*

2 Requiring a company to be authorized before doing business in a given state gives that state's residents the assurance that their own state officials have approved the financial soundness, the method of operation and the policies sold by almost any company soliciting their business in that state.

3 The *almost* applies to a situation that rarely occurs on the life and health side of the business but transpires with some frequency in property and casualty insurance. It is possible to buy insurance from an unauthorized insurer in what is known as a **surplus lines transaction**.

4 Here's how it works. Suppose you are an Ohio resident and need an insurance policy unavailable from any Ohio authorized company.

5 If the coverage you need is available, say, from a Texas company unauthorized in Ohio, you do not have to fly to Dallas to purchase it. You could buy what you need through an Ohio-based Surplus Lines Agent. Typically, states grant this additional license only to individuals who are already Resident Agents in good standing and place some additional administrative requirements upon them.

BY FINANCIAL SOUNDNESS

6 One important task you have as an Agent is to make sure you are insuring your clients with policies from companies that are financially sound. This due diligence effort is particularly important if you are an independent Agent representing, say, 20 companies.

7 There are several independent rating services that assess the financial strength of insurance companies based upon that company's claims experience, investment earnings, level of reserves, management and other factors. The dollars set aside to pay claims are held in the insurance company's **General Reserve**. The A.M. Best Company, Moody's Investors Service, Standard and Poor's Insurance Rating services are some of the better known rating organizations. One of the easiest ways to determine the financial soundness (or unsoundness) of an insurance company is to check them against the ratings they are given by one of these services.

*General
Reserve: money
to pay claims*

8 For example, a superior company on the A.M. Best scale gets an A+. A grade of C or C- is considered marginal. A rating of D, E or F is below (or way below) minimum standards.

INSURANCE CONTRACT FORMATION

- 1 **CONTRACTS** – Insurance policies are legal contracts. A contract is simply an agreement between two or more parties. A contract has certain required elements.

- 2 **Rules of Contract Construction** - *The prime directive* for the creation of any agreement is the **Doctrine of Utmost Good Faith**. In short, no agreement, whether or not there is a written contract, will work unless the parties want it to work. Both rely on the good faith of the other.

- 3 When determining just what an insurance contract will provide, the courts will look to the **reasonable expectations** of the parties. For instance, the courts would not look favorably upon a liability insurance contract that was sold to a gas station and contained a provision excluding any injury involving petroleum products. Such a contract would not meet the reasonable expectations of the Insured.

- 4 Normally, the terms of an insurance policy are defined in one of two ways:

- Definitions found in the policy
- Everyday and ordinary meaning, for those words not defined in the policy

- 5 Insurance policies are unlike most contracts in that the parties do not bargain for terms. Insurance policies are by their very nature standardized documents. The Insured is offered the policy on a take it or leave it basis. Because of this, any part of the contract which is **ambiguous**, unclear, or subject to more than one meaning, will always be interpreted in favor of the Insured and against the company. We call such contracts **Contracts of Adhesion**.

- 6 Memory Hint: Adhesion. . . the company wrote it, now they are *stuck* with it.

- 7 Here is an example of how **adhesion** works. A property policy excludes damage caused by earth movement. The exclusion itself then lists several examples of earth movement, all of which are natural occurrences. The Insured's building is damaged by movement of the earth *which was caused by a man-made occurrence, blasting*. At least one court has found that by listing several examples of earth movement, all of which were caused by Mother Nature, that the term as it appeared in the policy was ambiguous, and that coverage for the damage should be found in this particular case.

- 8 It should also be apparent that this concept flows directly from the **Doctrine of Reasonable Expectations**. Many courts have also held that statements outside the policy itself, e.g. sales materials and even the statements of Agents are sufficient to create an ambiguity, and thus invoke the rule of Adhesion.

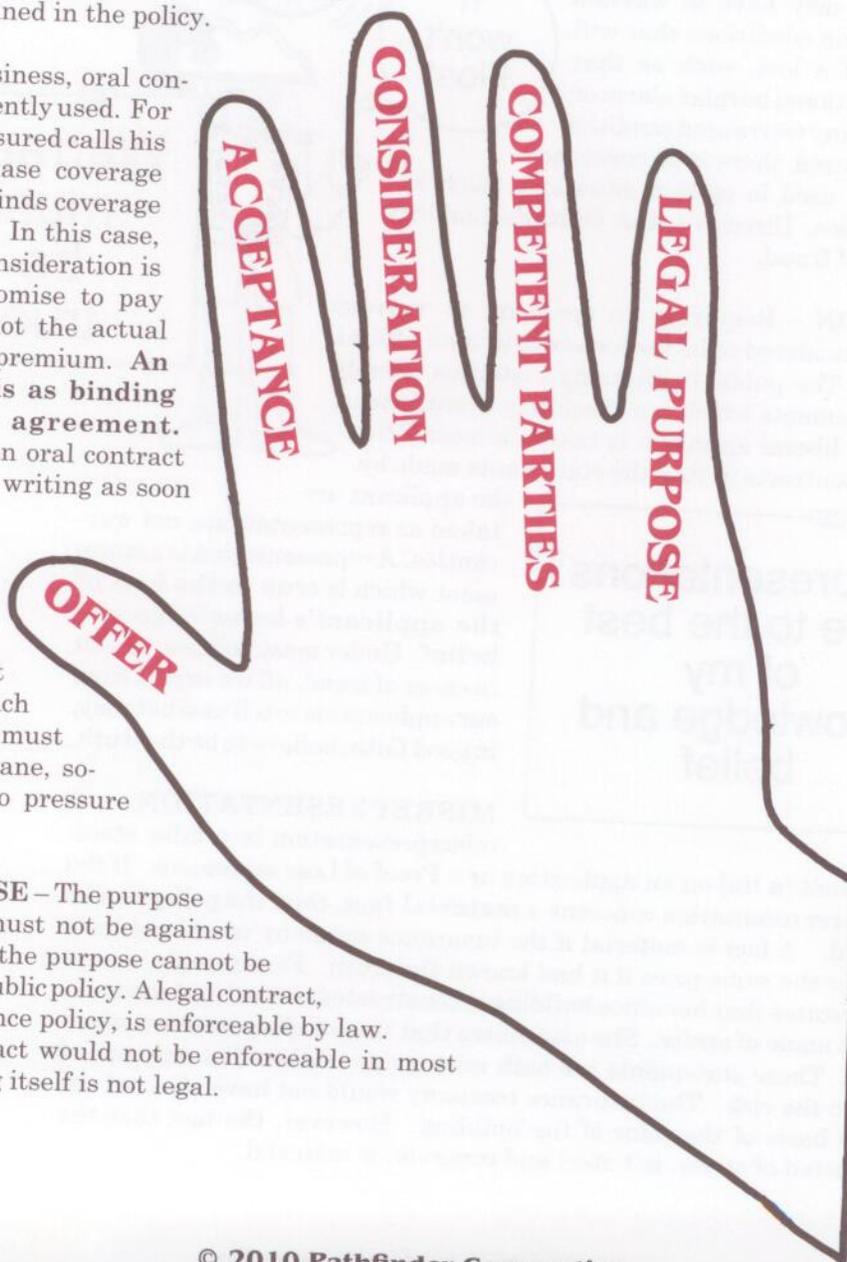
*Mutual
reliance or. . .*

*“never enter
into a contract
with anyone
who you need
a contract
with”
- My dad*

*we're stuck
with it*

REQUIRED ELEMENTS OF A CONTRACT

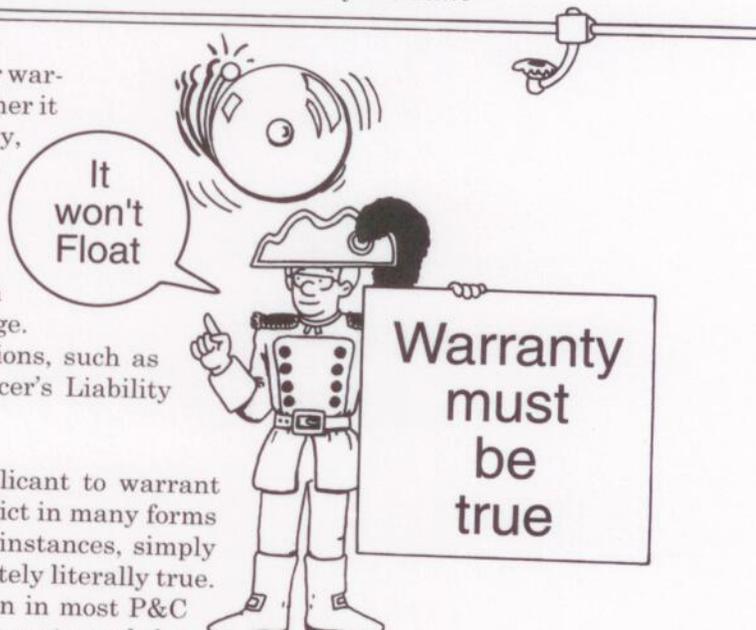
- 1 **OFFER** – One party must make an offer to the other party. In Property and Casualty insurance the company normally makes the offer by issuing a policy.
- 2 **ACCEPTANCE** – The second party must accept the first party's exact offer. The Insured normally accepts the offer by paying the premium. The combination of an offer and an acceptance is called an **agreement**.
- 3 **CONSIDERATION** – Consideration can be broadly defined as **something of value**. The parties to the contract must exchange consideration. Consideration in a property and casualty contract consists of the following: the Insured gives the company the premium for the policy and the statements made in the application for insurance; the insurance company gives the Insured the promises contained in the policy.
- 4 In the P&C business, oral contracts are frequently used. For example, the Insured calls his Agent to purchase coverage and the Agent binds coverage over the phone. In this case, the Insured's consideration is actually the promise to pay the premium, not the actual payment of the premium. An **oral contract is as binding as a written agreement**. However, such an oral contract should be put in writing as soon as possible.
- 5 **COMPETENT PARTIES** – The parties to the contract must be competent, which means that they must be of legal age, sane, sober and under no pressure or duress.
- 6 **LEGAL PURPOSE** – The purpose for the contract must not be against the law. That is, the purpose cannot be illegal or against public policy. A legal contract, such as an insurance policy, is enforceable by law. A gambling contract would not be enforceable in most states as gambling itself is not legal.



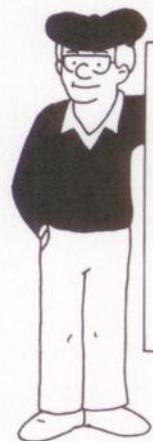
OTHER CONCERNS ABOUT CONTRACTS

1 **TRUTH** – The concern is how to define *truth*. The next five terms relate to the accuracy of the statements made by the proposed Insured when applying for a policy or when filing a Proof of Loss. As you will learn, there are varying degrees of the truth required when purchasing insurance.

2 **WARRANTY** – With regards to an application for insurance, a warranty is a statement held to be the **absolute literal truth**. A breach of warranty is sufficient to render the policy void, whether the matter warranted is material (relevant) or not, or whether it contributed to the loss. In a Property policy, the Named Insured may have to warrant the existence of certain conditions that will diminish the risk of a loss, such as that there will be an operational burglar alarm or sprinkler system. If any warranted condition is not met by the Insured, there is no coverage. Warranties are still used in certain situations, such as Ocean Marine policies, Director's and Officer's Liability policies and in case of fraud.



3 **REPRESENTATION** – Requiring an applicant to warrant his statements is considered to be far too strict in many forms of P&C insurance. The public is, in many instances, simply unable to make statements which are absolutely literally true. As a result, a more liberal approach is taken in most P&C contracts in that the statements made by



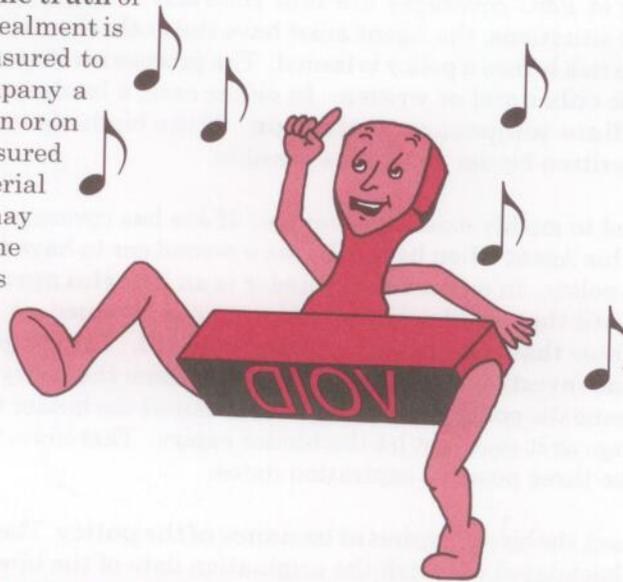
Representations true to the best of my knowledge and belief

the applicant are taken as representations, not warranties. A representation is a statement which is **true to the best of the applicant's knowledge and belief**. Under most policies, except in cases of fraud, all we expect from our applicants is to tell us what they, in good faith, believe to be the truth.

4 **MISREPRESENTATION** – A misrepresentation is a false statement (**a lie**) on an application or a Proof of Loss statement. If the misrepresentation concerns a **material fact**, then the policy can be voided. A fact is material if the insurance company would not have issued the policy for the same price if it had known the truth. For example, an applicant for a policy states that her office building is constructed of steel and concrete, when in reality it's made of straw. She also states that the building is brown when it is actually pink. These statements are both misrepresentations but only one of them is material to the risk. The insurance company would not have rejected the application on the basis of the color of the building. However, the fact that the building is constructed of straw, not steel and concrete, is material.

TRUTH
bending the truth

- 1 **CONCEALMENT** – **hiding the truth or telling a partial truth.** Concealment is the failure of the applicant/Insured to disclose to the insurance company a **material fact** on an application or on a proof of loss. The applicant/Insured has the duty to reveal all material information. Failure to do so may void the contract. The Doctrine of Utmost Good Faith requires the proposed Insured to tell the truth, *the whole truth*, and nothing but the truth.



*hiding
the truth*

THE MATERIAL AND INTENTIONAL TWO-STEP

- 2 **FRAUD** – Fraud is an intentional act of deception or cheating in order to financially benefit yourself at the expense of another. An example of fraud would be an Insured claiming a loss that never occurred in order to collect. Fraud will release the insurance company from its obligation to pay the claim. Fraud may be perpetrated by an Insured, an insurance company or an Agent.

*the result
of a lie*

- 3 **FIDUCIARY** – A fiduciary is an individual who has a responsibility for the financial affairs of another. As an insurance Agent, you have a fiduciary responsibility to your clients for the safekeeping of their premiums and a limited responsibility for their financial affairs. You are, therefore, forbidden from using your policyowners' money for your own purposes.

*holding
somebody
else's money*

- 4 **WAIVER** – A waiver is the intentional and voluntary relinquishment of a legal right. For example, when buying Auto insurance, Joe might be offered a coverage called Uninsured Motorists. If he declines the coverage, he might do so by signing a *waiver*. Joe is knowingly giving up the right to pursue Uninsured Motorists' claims with the company.

- 5 Another example concerns the completion of an application for insurance. Suppose that Joe does not answer all of the questions on the application, but the company issues the policy anyway. The company is said to have **waived its rights** to receive an answer to those questions.

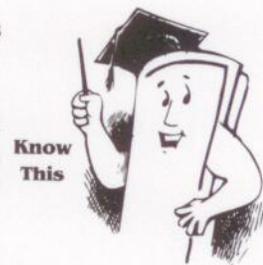
- 6 **ESTOPPEL** – Estoppel is little more than the legal consequences of a waiver. Under this doctrine, one party to a contract may be estopped (stopped) by his past words or actions from asserting a right granted him in the contract.

- 7 In the above example, the company had waived their right to receive answers to certain questions on the app. If they tried to cancel the contract or deny a claim on this basis, they would be estopped from doing so.

1 **BINDER** – Many types of P&C coverages are *oral contracts* – applied for and activated orally. In these situations, the Agent must have the authority to bind the insurance company to the risk before a policy is issued. The process involves the use of a binder, which may be either oral or written. In either case, a binder provides the Insured with **immediate temporary protection**. If the binder is verbal, it should be followed by a written binder as soon as possible.

2 A binder may also be used to modify existing coverage. If Joe has coverage for one auto, he may simply call his Agent when he purchases a second car to have the new car added to his existing policy. In either case, a binder is an **interim agreement** that provides coverage until the actual policy or endorsement is issued. A binder, however, does not guarantee that a policy will, in fact, be issued. The company, as a result of its research and investigation, may decide not to issue the policy. If the company decides not to issue the policy, then it may either cancel the binder in order to discontinue the coverage or it may just let the binder expire. Therefore, binders in most jurisdictions have three possible expiration dates:

- If the policy is issued, the binder expires **at issuance of the policy**. The policy's effective date is backdated to match the origination date of the binder.
- If the insurance company declines to issue the policy and no formal cancellation is given, then the binder remains in effect until its **expiration date**. Binders are normally issued for a limited period of time, such as 30 or 60 days.
- If the insurance company declines to issue the policy and sends out a formal cancellation of the binder, then the binder expires **on the day after receipt of the notice of cancellation**.



3 **COUNTERSIGNATURE** – Many states have laws requiring that newly issued policies sold by a nonresident Agent be countersigned (signed a second time) by a licensed *resident* Agent of that state before delivery to the policyowner.

DISTINCT CHARACTERISTICS OF AN INSURANCE CONTRACT

4 **PERSONAL CONTRACT** – Property and Casualty contracts are personal in nature. Most people assume that the policies insure the property, but actually, they do not. They insure a person's **insurable interest** in the property. Since P&C contracts are personal in nature, they are not assignable to another without the prior written consent of the insurance company.

5 **CONDITIONAL** – Insurance policies are conditional in nature because certain future conditions or acts must occur before any claims can be paid. For example, the Insured must pay the required premiums, suffer a loss, notify the company of the loss and provide adequate proof to support the claim. The company will verify the accuracy of the claim before paying it. Conditional statements are **“If . . . then . . .”** in nature. “If there is a loss, then the company is obligated to pay.”

6 **UNILATERAL** – Insurance contracts are unilateral in nature because **only one party, the insurance company, makes any legally enforceable promises**. The policyowner promises nothing, not even to pay the premiums. If Joe Insured fails to pay the premium, the policy will simply lapse.

- 1 **ALEATORY** – Aleatory contracts are contracts in which both parties realize that one party may obtain far greater value than the other party under the agreement, and in which payment depends upon fortuitous (unforeseen and unexpected) future events. There is an element of chance involved. For instance, Joe might pay \$1,000 a year for 50 years for Homeowners insurance and never suffers a loss. His neighbor, Joe Kool, had paid only one year's premium when his house burned to the ground and his company paid \$156,000 on the claim. The Law of Large Numbers tells us that insurance will never come out even for each individual - it works out as predicted only for the group.
- 2 **ADHESION** - As we have pointed out, insurance contracts are contracts of adhesion - the company wrote it; they're stuck with it.
- 3 **PARTS OF A POLICY** – P&C insurance policies are made up of four sections: (Remember the acronym **DICE**.)
- 4 **D** **Declarations** – The Declarations Sheet is usually the first page of any policy and contains the following basic information: the Named Insured(s) and the property which is to be protected, its description, the policy period and the premium. This is the “**Who, What, When, Where and How Much**” section – the fill-in-the-blanks section.
- 5 **I** **Insuring Agreement / Coverages** – The Insuring Clause / Coverages section contains the insurance company's promises. It is the “heart” of the contract. It establishes the obligation of the company to provide the insurance coverages as stated in the policy.
- 6 **C** **Conditions** – The Conditions section of the policy spells out the procedures that enable the parties to function effectively under the contract. They establish the rules of conduct between the parties of the contract, such as: how to report a loss, appraisal provisions, time and manner of paying a loss, subrogation, cancellation, assignment rights and definitions of terms. The policy Conditions are the bulk of the policy.
- 7 **E** **Exclusions** – These are the perils or types of losses that are not covered, such as intentional acts, losses due to war or catastrophic losses. The Exclusions are particularly important in “All Risk” policies.

*“W’s” -
like limits*

promises

ground rules

no's



UNDERWRITING ‡

1 Underwriting is the process of selecting, classifying, pricing and insuring a risk. Once a group with a similar risk level is identified, the next step in estimating premium cost is to estimate the cost of claims for that group.

2 While it is impossible to predict if Joe Insured's house will ever suffer a loss, the probability of loss for a large group of Joes with similar houses in similar neighborhoods with similar fire departments at similar distances is **very predictable**. This device, known as the **Law of Large Numbers**, is at the heart of all insurance underwriting.

3 **INSURABLE RISK ELEMENTS** – Not all risks are insurable. Those that are share the following characteristics:

- There must be a large number of homogeneous (similar) risks for the **Law of Large Numbers** to work.
- **Uncertainty** is insurable where intentional losses are typically excluded.
- The loss must be **economically significant to the applicant**. You would not insure a disposable lighter because it is economically insignificant. You could not insure a stranger's house; his house would be economically significant to his family, but not to you.
- Losses must be **measurable in dollars**. Each Insured must contribute premium in accordance with the amount of risk that he or she wishes to transfer.
- **Catastrophic losses** that impact many Insureds simultaneously are excluded in most forms of insurance. If the Martians declare war and invade your neighborhood, your house and car would not be covered.

4 **SOURCES OF UNDERWRITING INFO** – The underwriting process is 100% dependent upon valid information. With it, good underwriting decisions are made; without it, underwriting becomes a nightmare. In most cases, the majority of the important information will be obtained through one of the following sources:

- the application itself
- physical inspections
- consumer credit reports

5 While the first two sources require little explanation, there are several important concerns about consumer credit reports. The credit report is helpful to underwriters as it gives information concerning the applicant's finances, background and reputation.

6 However, the insurance company must adhere to the requirements of the **Fair Credit Reporting Act** while collecting this and any other consumer report. Specifically, the Act requires that the applicant must be **notified in writing** that an investigative report is being ordered. The applicant has the right to question the validity and source of any information retained on file. If the validity of the info is questioned by the consumer, the credit reporting agency must reinvestigate the case. Not only must any inaccurate info in the file itself be corrected, but also any reports transmitted in the last six months containing the error must be retransmitted with the correction.

Federal Law

*Advice and
Consent*

*Right to
question 7
years*



*The Agent is
the company's
eyes and ears*

1 The Act provides many additional rights to the consumer regarding credit information, but the central intent of the law is to give consumers the right to review their credit report and have any incorrect data reviewed and corrected. The Act, furthermore, limits the retention of credit data to **seven years** except for bankruptcy, which can be retained for **ten years**.

2 **FIELD UNDERWRITING** – While the amount of work an Agent must do before submitting an application to his/her company varies from company to company, the Agent is often an important additional source of information. Your responsibilities will certainly include helping the proposed Insured to accurately complete the application. You may also be required to conduct a drive-by or initial inspection of the property. You could be required to photograph the proposed risk or summarize your impression of the exposure involved.

3 Obviously, it is to your benefit to take your field underwriting responsibilities seriously. If you consistently submit unacceptable risks to your company, you waste everyone's time and seriously jeopardize your relationship between you and your clients and between you and your company.

RATING CONCEPTS ‡

4 Insurance premiums are computed by the use of insurance rates. A **rate** is the price for each unit of exposure. For instance, a **rate of \$2.00** per square foot would necessitate a premium of \$2,000 for a 1,000 square foot premise. A good rating system should generate premiums that reasonably cover the anticipated losses, pay the expenses, allow a reasonable underwriting profit and allow the company to remain competitive. Both competition in the marketplace and regulatory authorities tend to encourage sound rating approaches as the insurance laws of most states prohibit rates that are **excessive, inadequate or unfairly discriminatory**.

5 While this text is not designed to teach you how to rate an exposure, you should be familiar with the various rating approaches in use in today's marketplace.

6 **Class rates** apply to all members of a large group of rather homogeneous exposures. If listed in a rating manual, the rates are known as **manual rates**. The advantage here is simplicity and the disadvantage is the lack of flexibility. Rarely, if ever, would all of the exposure units be truly homogeneous. Therefore, some risks are being undercharged and others overcharged to create the simplicity of average or **class rates**.

7 **Individual rates** are utilized when there are not enough similar exposures to mathematically justify a class rate. Here, an underwriter might start with a class rate and then modify it by lowering it for positive factors like brick construction and raising it for negative factors like a poorly rated fire department. At the end, we have a rate that is unique to one Insured. This approach is perfectly legal as long as the modifications are consistently applied from one Insured to the next.

8 **Merit rates** are again a modification of class rates based upon the likelihood of losses. Under **schedule rating**, additions or reductions are applied to reflect specific characteristics of the risk - like the use of sprinklers. With **experience rating**, additions or reductions are made to reflect the actual loss experience of the risk in previous years. With **retrospective rating**, the premium for a specific year is adjusted for losses in the same policy year.

9 **Judgment rates** are rates based exclusively or (more likely) partially on the judgment of the underwriter.

*A "fire resistant
structure" is
defined as
"concrete and
masonry which
will resist fire
for at least two
hours."*

RATE FILINGS

- 1 In most states the rates charged by insurance companies must be filed with the Department of Insurance. Some states are **prior approval** states, which require that the rate plan be approved before use in that state. Others are **file and use** states which only require that the rates be filed before they are used. Certainly, if the rates are ever **disapproved**, companies may not continue their use.
- 2 **Rating Bureaus** save Property and Casualty companies millions of dollars in the rate-making and filing process. Even a small P&C company might offer several hundred products to the public in 10 different states. If each company took on the responsibility of creating and filing rating plans for all of its policies in all jurisdictions in which it does business, the costs would be prohibitive.
- 3 A Rating Bureau calculates rates for specific types of insurance and files them with the states within their jurisdiction. Many rating bureaus also write the policies and endorsements for which the rates were developed. Companies who subscribe to a particular rating bureau may use the rates and state filings of their bureau. They are then only responsible for filing any **deviations** they make to the policy to differentiate their product.
- 4 By far, the largest rating bureau in the country is the Insurance Services Office (ISO), which makes rates and prepares policies for most property and casualty product lines. The *standard* policies referred to in this text are ISO contracts.

ASSESSING UNDERWRITING ACCURACY

- 5 Though much of the insurance business is about predicting the future, all we really have to go on is a clear understanding of the past. **Loss and expense ratio** data is used to decide about account renewal, the continuation of agency contracts and whether or not to tighten underwriting standards for a particular product line.
- 6 Loss and expense ratios can be calculated for a specific account (Ford Motor Company), a line of insurance (personal auto), an agency (the Walker Agency) or an entire company. A **loss ratio** is calculated by dividing the losses for a particular period (say, \$400,000) by the total premium received for the same period (say, \$1 million). $\$400,000 \div \$1 \text{ million} = 40\%$. If expenses for the same period were \$500,000, then the **expense ratio** is $\$500,000 \div \1 million , or 50%. The **loss and expense ratio** would be $\$900,000 \div \1 million , or 90%. For the company involved, these figures would show an **underwriting profit** of 10%.

INSURANCE DISTRIBUTION SYSTEMS

- 7 Within the Property and Casualty insurance arena there are four basic ways in which our products are distributed to the public:
 - Exclusive Agencies
 - Direct Writers
 - Direct Response Companies
 - Independent Agencies
- 8 In an **exclusive** or **captive agency** arrangement, the insurance company contracts with an agency (an independent business) to market insurance exclusively for that one company.

- 1 **Direct writers** are exclusive Agents or employees of the one company that they represent.
- 2 Companies who utilize **direct response** marketing do not use agencies in the traditional sense. They advertise for customer inquiries, and insurance is then sold by telemarketers who hold whatever licenses are required.
- 3 **Independent agencies** sell the policies of numerous insurance companies with whom the agency has contracted on a nonexclusive basis.

POWERS OF AGENCY

- 4 Any of the basic distribution systems of the insurance industry fit nicely under the general laws of agency. The insurance company is the **principal** and it appoints legal representatives - **Agents** - to act in its place. As the Agent, you must clearly understand your powers, duties and responsibilities to avoid confusion, delay and loss to your company, your customers or to yourself.

**Principal =
Company**

Agent = You

- 5 **THE AGENT** - As an Agent, you are the legal representative of your insurance company. Your legal obligation is to serve your company. However, you are morally obligated to serve the interest of your clients as well. As an Agent, you solicit insurance business on behalf of your insurance company. Your words or acts are binding on the company, because legally you are the company in that you have been authorized to act on its behalf and are subject to certain rules.

- A **captive Agent** has signed an agency contract with a company which demands that the Agent represent that one company exclusively.
- An **independent Agent** has contracted with multiple companies whose agency agreements do not demand exclusivity.

- 6 **NOTE:** The laws in some states refer to Agents as *producers* or *intermediaries*. In this text, we will refer to anyone who sells insurance as an Agent.

- 7 **AGENCY AGREEMENT OR AGENCY CONTRACT** - You and your company will enter into a contract, called an agency agreement, which will tell you specifically what you can and cannot do, and how you will be compensated. For example, the agreement might state that you can bind coverage for personal lines policies, but that you cannot bind coverage for commercial lines policies. Your relationship with your company will be framed by this agreement, so study it carefully.

- 8 **AN AGENT CAN EXTEND THE COMPANY'S LIABILITY** - Your actions as an Agent may extend the company's liability if you act outside the authority specifically granted to you in the agency agreement. Your words and actions are the company's. If you say or do something beyond the scope of your authority, the company is bound by your actions. For example, if you exceed your authority to bind coverage, your company will be bound by your actions.

- 9 **AGENTS KNOWLEDGE** - Your knowledge as an Agent is deemed to be the knowledge of the company because legally you are the company. Therefore, be certain to pass along all of the relevant information given to you by your clients.

- 10 **SOLICITORS** - Some states license an individual as a solicitor who contracts with an Agent to represent that Agent's product line to the public. Normally, a solicitor is not empowered to obligate the company in any way.

1 **BROKERS** - The term "broker" is one of the most misused and misunderstood terms in the insurance industry. You will hear broker used in many different ways such as, "He brokered the business to another Agent," or "She is a licensed broker." In each example, the word "broker" has a different meaning. While, in time, you should learn all the different ways that the term can be used in insurance jargon, first learn the legal definition of a broker.

2 You know that, **as an Agent, you are the legal representative of the company.** On the other hand, if you are an insurance broker, your legal responsibility is just the opposite. **As a broker, you are the legal representative of the client.** A broker determines the client's needs and then seeks to find the best product offered on the market by the numerous insurance companies that provide such products. As a broker, your legal obligation is to your client, not to the companies providing the products.

3 As an Agent you have an agency agreement with the company that you represent. Legally, you can represent more than one company, but for each company that you represent, you will have a separate agency agreement. On the other hand, as a broker, *you would not have an agency agreement* with any company. There is a significant legal difference. As a broker, your words and actions are not legally binding on the company.

4 Because of the confusing terms and the difficulty in establishing legal responsibility, there is currently a trend in most states to no longer issue brokers licenses.

5 **AGENT AUTHORITY** - As we have discussed, your authority as an Agent is specifically stated in your Agency Agreement. As we have mentioned, your actions outside this agreement can extend your company's liability. As an Agent, you have three types of power or authority. They are Expressed, Implied and Apparent.

- **Express Authority** - Express Authority is *specifically granted* to you in your Agency Agreement, such as the power to bind coverage. You must strive to operate within the scope of your Express Authority.
- **Implied Authority** - The Agency Agreement cannot cover every last detail of your duties. Implied Authority covers the powers that are not specifically given to you in your Agency Agreement, but *they are the powers that you can imply or assume that you must have* in order to do your job. For example, physical inspections are a necessary prerequisite to many property and casualty policies. Therefore, you can imply that you have the authority to schedule physical inspections.
- **Apparent Authority** - The two types of authority discussed above concern the relationship between you and your company. Apparent Authority concerns the relationship between you, *your customers*, and your company. As long as you act within your contractual powers (your Agency Agreement), you will have no problem. But, if you should say or do something you are not authorized to do, and the public could logically assume that an insurance Agent might have such powers, then your company will be bound by your actions. Even though you did not have the authority to bind coverage on a commercial risk, your company could be liable for the risk because your word is the company's word. The company would, however, have a valid cause of action against you. You can avoid these problems by operating within the scope of your Agency Agreement.

Conclusion

- 1 This chapter revolves around you, the Agent. In it, you learned about the kind of company organization for which you work. We examined the policies you offer from the viewpoint of contract law, and you were given a brief introduction to underwriting. Finally, you were shown what powers you have and don't have as an Agent.

Types of Companies

- **Lloyds Associations** – Individuals grouped in syndicates acting as companies. The individuals comprising the syndicates are personally liable for losses.
- **Stock Company** – Run for the benefit of stockholders, no dividend to policyowners.
- **Mutual Company** – No stockholders, run for the benefit of policyowners, can pay a policy dividend to policyowners.
- **Reciprocal** – Operates like a mutual, managed by an attorney-in-fact.
- **Fraternal** – Operates like a mutual, but you must join the club to buy the policy.
- **Risk Retention Groups** – Self insurance on a group basis.

Classifying Companies

By Origin

- **Domestic...** formed in this state
- **Foreign...** formed in another state
- **Alien...** formed in another country

By Authority

- **Authorized or Admitted...** approved to do business in this state
- **Unauthorized or Nonadmitted...** not approved to do business in this state. . . but the policies can be sold in this state under certain conditions by a **Surplus Lines Agent**

By Financial Soundness

- A+... Good
- F... Awful

Contract Law

- 2 To form a legal contract there must be an **offer** and an **acceptance**. There must be an exchange of **consideration**. A proposed Insured's consideration is payment of the premium and the statements made in the application. The company's consideration is the promises contained in the policy. The contract must be formed between **legally competent parties** and it must serve a **legal purpose**.

- 1 Statements in the application that must be the absolute truth are **warranties**. Statements that must be true to the best of your knowledge are **representations**. A **misrepresentation** is a lie, and a **concealment** is the failure to disclose the whole truth.
- 2 A **binder** is used to provide immediate, temporary protection. It may be written or oral. There is no guarantee that a policy will be written simply because a binder was issued.
- 3 Insurance contracts are **personal** in nature; we are insuring your **interest in the property**, not the property itself. These contracts are **conditional** – if a loss occurs, then we will pay. Insurance policies are **unilateral**. . . only one entity makes an enforceable promise – the company. They are also **aleatory**; there is not, necessarily, an equal exchange of value. And, insurance policies are **contracts of adhesion** . . . the company wrote it, they're stuck with it.
- 4 The four parts of the policy include: the **Declarations**, the **Insuring Clause**, the **Conditions**, and the **Exclusions**.
- 5 **Underwriting** is the process of selecting and classifying risk. **Rating** is the process of pricing an acceptable risk.
- 6 An **Agent** is the legal representative of the company. The Agent's authority, which is spelled out in the **Agency Agreement**, is called **Express Authority**. Powers not spelled out in the agreement but presumed therein are called **Implied Authority**. The authority the public believes an Agent possesses is known as **Apparent Authority**. A **broker** is the legal representative of the client. A **solicitor** is the legal representative of an Agent. Since brokers and solicitors are not legal representatives of the company, they could not legally bind the company.

RISK MANAGEMENT ‡

- 1 In recent years, it has become fashionable to apply the term Risk Management to what was once called Insurance Management. In many circles, this is only a matter of semantics. However, the trend is for agencies to become true Risk Managers for their clients.
- 2 True Risk Management is not simply obtaining the broadest and least expensive coverage for the premium dollar. Risk Management seeks to protect the assets and income of the household or business it is serving. Insurance is viewed simply as one of many approaches for minimizing risks that the client faces.
- 3 The Risk Management process involves four specific steps:
 - Identification and evaluation of the risks
 - Consideration of alternatives to manage these risks
 - Choosing the best alternative and implementing
 - Evaluating and reviewing
- 4 In most households and in most businesses, many risks are obvious while others are easily overlooked. Therefore, most Risk Managers use some systematic approach in the task of risk identifications. Commonly used tools could include physical inspection, questionnaires, checklists and analysis of financial statements.
- 5 In evaluating the risks uncovered, there must be some measurement of the potential severity of the loss as well as the likelihood that the loss might occur. Many Risk Managers then place the risks identified into one of three piles:
 - Those that would bankrupt the household or the business
 - Those that would require substantial borrowing to avoid bankruptcy
 - Those whose losses could be offset with existing income or assets.
- 6 The alternatives for addressing the subject risks boil down to four - avoidance, reduction, retention and transfer. However, the specific form that each of those devices can assume vary greatly. A homeowner might **avoid risk** by choosing not to own a pit bull or a trampoline. A business might **reduce risk** with a sprinkler system or a burglar alarm. **Risk transfer** could involve insurance or the subcontracting of certain operations. In making a decision, the Risk Manager must evaluate the benefits and the costs of each alternative.
- 7 Once the decision is made and implemented, monitoring the Risk Management program is absolutely critical. Invariably, risks will be overlooked or mistakes will be made in conducting the program. Careful monitoring may identify these problems before they become too costly. Furthermore, change is inevitable. New concerns arise and old ones diminish. Resources may grow or shrink, and new policies or new technology may immerge. Risk Management is a dynamic process not a static one.

Insurance Agent's Errors and Omissions Loss Prevention ‡

- 1 One of an insurance agency's biggest exposure to loss is the potential lawsuit that could result from an Agent's error or omission. An Agent owes a duty to perform as a professional insurance Agent to both their customer and their principal, the insurer. Customers of an insurance Agent expect the Agent to give proper risk management/insurance advice to the customer. The customer also expects the Agent to follow the customer's instructions, place the customer's order for policies, endorsements, and provide other services promised by the Agent. The Agent's principal, the insurer, also has expectations of the Agent. The insurer expects the Agent to be the eyes and the ears of the insurer. The Agent has a duty to provide the insurer with complete, honest, non-biased information about the risks that the Agent has placed with the insurer.
- 2 Sadly, there are many situations where an Agent fails to meet their duty owed to their customer and to their principal, the insurer. Agents can breach the duty owed to their customers in many ways. Some of the major areas of customer and insurer errors and omissions claims exposure are misrepresentations; delays in processing coverage; cancellations errors; agency agreement violations; policy change errors; and inadequate coverage claims. When an agency is named in an errors and omissions lawsuit, it is likely that the agency personnel involved in the transaction will also be named in the suit.
- 3 There are many positive steps that an agency can take to eliminate 90% of their errors and omissions claims exposure. Every agency should have **policies and procedures** in place for every type of transaction handled by the agency. These **policies and procedures** should be **communicated to everyone** in the operation. And **everyone** in the operations should follow the **same policies and procedures**. Probably the single most important step that an agency can take is to get everyone in the habit of **documenting all transactions, conversations, requests . . . bottom line - DOCUMENT, DOCUMENT, DOCUMENT!** Many times an Agent does everything the right way but fails to write it down. With no evidence, other than the Agent's memory, the E&O claim is almost a sure loser for the Agent.
- 4 An agency that has established policies and procedures in place that are followed by everyone in the operation has gone a long way to control error and omissions losses. Even the best run agency cannot totally eliminate the potential errors and omissions claims exposure and so a good risk management tool is to purchase Insurance Agent's Errors and Omission coverage.



BASICS OF TWO PARTY COVERAGE

3



PROPERTY ROOTS

1 At one time in the long history of the human species it was really true that if you wanted something done, you did it yourself. If you wanted to eat, you hunted or planted crops. If you wanted shelter, you found a cave or built a cabin. Modern civilization began when some amongst us developed *excess capacity*. For instance, suppose I was a truly fantastic farmer with an abundance of land. Year after year I could regularly produce more food than my family could consume. Now, further suppose that you can't even grow dandelions, but you are a great salesman. Between the talents of us both we could create the seventeenth century version of a Farmer's Market. In so doing, you have been relieved of the responsibility of growing food to feed your family.

In the beginning . . .

2 One immediate result of our alliance is that you no longer need to live on a farm. In fact, it is to your advantage to put your seventeenth century Kroger's in the middle of the biggest population you can find – a city or town populated by other non-farmers like yourself. Even in a country as young as the United States, major cities like New York, Boston and Philadelphia had begun to grow exponentially by the early 1700's. However, the growth of the cities magnified the effects of problems like fire. When we were all farmers, a fire at my house did not affect you. But if we are both Philadelphia merchants with our businesses next door to one another, my fire could definitely jeopardize your business or your home and your future.

"... but, there's no evidence that Mrs. O'Leary named you as a beneficiary."



FIRE INSURANCE COMPANIES

1 While most of us learned in elementary school that Ben Franklin established several fire departments in the 1730's, we were not taught that in 1752 he also helped to found one of the first fire insurance companies in North America. People bought fire insurance (as Property insurance was called in those days) for one of two reasons:

- They wanted to buy
- They had to buy

2 The first reason is self-evident. If Joe's great-great-great grandfather owned a thriving restaurant in the 1750's, his entire livelihood was probably tied up in that business. If he was in the middle of a big city, surrounded by several hundred thousand people in wooden structures lit by candlelight and heated by fireplaces, he would not have to be a rocket scientist to realize that his business and his home are at risk. The fact that the local fire department is a bucket brigade augmented by a horse-drawn fire truck only helps to further dramatize the risk.

3 However, there are always a few hardheads who don't recognize that they need to insure their property but are placed in situations where they must do so. If great grandpa Joe wanted to expand his restaurant or buy a new house, he might seek money from an investor or a bank. And even in the 1700's, he would have been no more successful at borrowing money on uninsured property than you and I would be today. In many respects the growth of commerce and industry that has led to the standard of living that we enjoy today can be attributed to the mechanism of insurance. Providing capital for expansion is already a risky business. The additional risk of fire rendering the borrower unable to repay his debt could easily nullify the entire transaction. Without fire insurance, the growth of modern civilization could have been slowed to a snail's pace.

PROPERTY RULED THE ROOST

4 While today's purchasers of either commercial lines or personal lines insurance may well be focused on the Casualty coverages, for at least 200 years Property insurance was the major interest of most buyers... and fire was the principal peril of most Property policies. For the first 100 years, most Property companies were small, local arrangements much like the one Ben Franklin started, and the policy issued by one company bore little resemblance to those issued by any other. This changed dramatically following the near disastrous New York City Fire of 1835. Though not as well known by most Americans as the Great Chicago Fire (mostly because the New York fire lacked Ms. O'Leary, the cow, the lantern and the song), the New York fire had a much greater impact on the Property insurance business. What we learned is fairly obvious in retrospect. If a community is insured through one company, and if that company only insures one community, both the company and the community are in deep soot if half the town burns to the ground. For the insurance mechanism to work properly, the risks of any one company must be spread over many cities and towns, and the collective risk of any one community must be spread throughout hundreds of companies.



CALLING FOR STANDARDIZATION

1 By the 1850's, it was not unusual for dozens of fire insurance companies to be selling policies in one community. As a result, Great Grandpa Joe could be insured by Flamethrower Mutual one year and by Firecracker State the next. Since the two policies probably did not at all resemble one another, a great deal of pressure was placed on property carriers by the public, the courts and even the more thoughtful corners of the industry itself to standardize the Property Insurance Contract.

2 A rather famous court case (Delancy v. Rockingham Farmers Mutual) in 1873 was the straw that broke the camel's back. In examining what must have been a real gem of a policy, the court had this to say:

3 *This compound (meaning the policy), if read by an ordinary man, would be an inexplicable riddle, a mere flood of darkness and confusion...should some extremely eccentric person attempt to examine the involved and intricate net in which he was to be entangled, he would find that it is printed in such small type and in lines so long and so crowded as to make the perusal of the document physically difficult, painful and possibly injurious.*

4 There were several early attempts at standardization. The State of Massachusetts proposed a standard policy form in 1873 and this was followed by the State of New York in 1887 and again in 1918. While the early twentieth century policies did not contain the night and day differences of their predecessors, it was not until the New York Standard Fire Policy of 1943 was approved for use in practically all jurisdictions that we found a policy that met with the approval of most consumers, companies and state regulating agencies.

THE STANDARD FIRE POLICY (SFP)

5 Since 1943, the 165 contract lines of the Standard Fire Policy have governed the Property (and to an extent) the Casualty coverages contained in policies issued in this country. While the conditions of the modern Businessowner's Policy or the modern Homeowners Policy may be more generous, the basic, guiding principles of these policies regarding concealment, exclusions, written endorsements, requirements in the event of a loss, appraisal, subrogation, and much, much more all stem from the Standard Fire Policy.

*... gee whiz,
it only took
us a century
and a half*

6 Until the mid 1980's, the influence of the Standard Fire Policy was obvious. Most states required that the Standard Fire Policy be a part of every policy that contained property insurance – which was almost every contract. If a policyowner was so inclined, he or she could peel back all the pages of the contract and find, at the bottom of the stack, a Standard Fire Policy.

1 In one sense the Standard Fire Policy was a fantastically flexible contract. It could be used to insure almost any property in which you had the necessary insurable interest. You could use this contract to insure a house, a commercial building, or the property contained in either. It could fit the needs of a homeowner, the landlord, the tenant, the business owner who owns his building or the business owner who leases his premises. The genius of this policy was that it was general enough in context to apply to almost all Property insurance needs. However, this same attribute was also its greatest weakness. The needs of the consuming public went far beyond the limited definitions and coverages of the Standard Fire Policy. This contract was always sold with endorsements used to *customize* it to fit the needs of a particular Insured. If you insured a business, you might purchase a fire policy with a General Property Building and Contents form attached. If you were a homeowner, you bought it with a Dwelling form or Homeowners form attached.

USING THE STRUCTURE OF THE STANDARD FIRE POLICY AS AN EXAMPLE

2 The Standard Fire Policy is a two page document composed of four main parts (DICE):

- D eclarations
- I nsuring Clause
- C onditions
- E xclusions

DECLARATIONS

3 The top two-thirds of page one of the Standard Fire Policy is called the Declarations section. It is the **Who, What, When, Where, Which and How Much** of the policy. It is the only section of the policy containing fill-in-the-blanks. Your job as the Agent is to fill in the blanks.

"W's"

THE INSURING CLAUSE

4 The Insuring Clause is the heart of any property insurance policy. It is a **statement by the insurance company that summarizes the promises contained in the policy**, the coverages provided and the conditions and limitations of the coverage in general terms. The Insuring Clause contains the following statements:

promises

- *For the premium listed above (in the Declarations section), the company listed above,*
- *for the policy period listed above,*
- *starting at 12:01 p.m. Standard Time at the location of the property on the date listed above,*
- *insures the property listed above,*
- *to the amount not exceeding the amount listed above,*
- *insures the Named Insured(s) listed above,*

*every other
policy starts at
12:01 a.m.*



- or their legal representatives (such as their executors, administrators, or guardians),
- up to the Actual Cash Value (ACV) of the property at the time of the loss,
- but not exceeding the amount that it would cost the company to repair or replace the property with material of a similar kind and quality,
- and without regard to any increases in costs of repair or reconstruction as the result of any building ordinances that govern construction or repair,
- and without regard for the indirect loss of the interruption of business,
- nor in any event for more than the insurable interest of the Insured,
- does insure the property against the perils of
 - Fire
 - Lightning
 - Removal
- at the location specified above (in the Declarations), or if salvaged from its normal place following a peril, for up to **five days** at its new storage place.

“whew, that’s one sentence”

1 Notice that the Standard Fire Policy was only intended for property at a fixed location. This is true for most property contracts today – especially in commercial lines.

2 **Assignment** – The next sentence states that the Named Insured cannot assign the policy to another party without the written consent of the insurance company.

3 The last sentence in the Insuring Clause states that other provisions, conditions, additions or endorsements can be added to the Standard Fire Policy in writing and made part of the contract.

4 **Summary of the Insuring Clause:** The Insuring Clause is a statement made by the insurance company to the Insured which contains the promise that the insurance company will insure the designated property against the designated perils subject to all the provisions, conditions, extensions, limitations, endorsements and exclusions contained in the rest of the policy.

ground rules

CONDITIONS

5 Page two of the Standard Fire Policy contains the policy **Conditions**. The Conditions spell out the **terms and stipulations** of the agreement such as cancellation of the policy, the mortgagee’s rights, how and when claims will be paid and the policyowner’s right to sue.

EXCLUSIONS

6 No insurance policy covers everything. There are always some losses that will not be covered – called Exclusions.

STANDARD FIRE INSURANCE POLICY

Standard Fire Insurance Policy for Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Tennessee, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin and Wyoming.

No.

RENEWAL OF NUMBER

CAPITAL STOCK COMPANY



SPACE FOR COMPANY NAME, INSIGNIA, AND LOCATION

Insured's Name and Mailing Address

NERO FIDDLER
711 Appian Way
Rome, New York 13440

SPACE FOR PRODUCER'S NAME AND MAILING ADDRESS

July 1, 1969 July 1, 1970
Inception (Mo. Day Yr.) Expiration (Mo. Day Yr.)

1
Years

It is important that the written portions of all policies covering the same property read exactly alike. If they do not, they should be made uniform at once. INSURANCE IS PROVIDED AGAINST ONLY THOSE PERILS AND FOR ONLY THOSE COVERAGES INDICATED BELOW BY A PREMIUM CHARGE AND AGAINST OTHER PERILS AND FOR OTHER COVERAGES ONLY WHEN ENDORSED HEREON OR ADDED HERETO.

AMOUNT	RATE	PREPAID TERM PREMIUM DUE AT INCEPTION	ANNUAL PAYMENT DUE UNDER DEF. PREM. PAY. PLAN	PERIL(S) Insured Against and Coverage(s) Provided (Insert Name of Each)
\$ 37,500	\$.22 Dwg; \$.30 Conts	92.50	\$	FIRE AND LIGHTNING EXTENDED COVERAGE
xxxxxxx	\$.13	\$ 48.75	\$	
\$		\$	\$	
\$		\$	\$	
\$ 141.	TOTAL PREMIUM FOR POLICY TERM UNDER D. P. P.	TOTAL(S) \$141.25	\$	

Item No.	Amount Fire or Fire and Extended Coverage, or Other Peril	Per Cent of Co-insurance Applicable	DESCRIPTION AND LOCATION OF PROPERTY COVERED <small>Show construction, type of roof and occupancy of building(s) covered or containing the property covered. If occupied as a dwelling state number of families.</small>
1.	\$ 25,000.	-	Brick, tile roof, two family dwelling, situate 711 Appian Way, Rome New York;
	12,500.		Contents usual to Dwelling described above

Subject to Form No(s). 49D (1-64)

Mortgage Clause: Subject to the provisions of the mortgage clause attached hereto, loss, if any, on building items, shall be payable to: **Augustus Savings and Loan Association, Pontine Marshes, Rome, N.Y.** attached hereto.

AGENCY ADDRESS: Augustus Savings and Loan Association, Pontine Marshes, Rome, N.Y. Agency at

Countersignature Date

Agent

IN CONSIDERATION OF THE PROVISIONS AND STIPULATIONS HEREIN OR ADDED HERETO AND OF the premium above specified, this Company, for the term of years specified above from inception date shown above At Noon (Standard Time) AND OF the expiration date shown above At Noon (Standard Time) at location of property involved, to an amount not exceeding the amount(s) above specified, does insure the insured named above and legal representatives, to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair, and without compensation for loss resulting from interruption of business or manufacture, nor in any event for more than the interest of the insured, against all DIRECT LOSS BY FIRE, LIGHTNING AND BY REMOVAL FROM PREMISES ENDANGERED BY THE PERILS INSURED AGAINST IN THIS POLICY, EXCEPT AS HEREINAFTER PROVIDED, to the property described herein while located or contained as described in this policy, or pro rata for five days at each proper place to which any of the property shall necessarily be removed for preservation from the perils insured against in this policy, but not elsewhere.

Assignment of this policy shall not be valid except with the written consent of this Company.

This policy is made and accepted subject to the foregoing provisions and stipulations and those hereinafter stated, which are hereby made a part of this policy, together with such other provisions, stipulations and agreements as may be added hereto, as provided in this policy.

1 **Concealment,** This entire policy shall be void if, whether
2 **fraud.** before or after a loss, the insured has wil-
3 fully concealed or misrepresented any ma-
4 **terial fact or circumstance** concerning this insurance or the
5 **subject thereof,** or the interest of the insured therein, or in case
6 **of any fraud or false swearing** by the insured relating thereto.
7 **Uninsurable** This policy shall not cover accounts, bills,
8 **and** currency, deeds, evidences of debt, money or
9 **excepted property.** securities; nor, unless specifically named
10 hereon in writing, bullion or manuscripts.
11 **Perils not** This Company shall not be liable for loss by
12 **included.** fire or other perils insured against in this
13 policy caused, directly or indirectly, by: (a)
14 enemy attack by armed forces, including action taken by mili-
15 tary, naval or air forces in resisting an actual or an immediately
16 impending enemy attack; (b) invasion; (c) insurrection; (d)
17 rebellion; (e) revolution; (f) civil war; (g) usurped power; (h)
18 order of any civil authority except acts of destruction at the time
19 of and for the purpose of preventing the spread of fire, provided
20 that such fire did not originate from any of the perils excluded
21 by this policy; (i) neglect of the insured to use all reasonable
22 means to save and preserve the property at and after a loss, or
23 when the property is endangered by fire in neighboring prem-
24 ises; (j) nor shall this Company be liable for loss by theft.
25 **Other insurance.** Other insurance may be prohibited or the
26 amount of insurance may be limited by en-
27 dorsement attached hereto.
28 **Conditions suspending or restricting insurance.** Unless other-
29 wise provided in writing added hereto this Company shall not
30 be liable for loss occurring
31 (a) while the hazard is increased by any means within the con-
32 trol or knowledge of the insured; or
33 (b) while a described building, whether intended for occupancy
34 by owner or tenant, is vacant or unoccupied beyond a period of
35 sixty consecutive days; or
36 (c) as a result of explosion or riot, unless fire ensue, and in
37 that event for loss by fire only.
38 **Other perils** Any other peril to be insured against or sub-
39 **or subjects.** ject of insurance to be covered in this policy
40 shall be by endorsement in writing hereon or
41 added hereto.
42 **Added provisions.** The extent of the application of insurance
43 under this policy and of the contribution to
44 be made by this Company in case of loss, and any other pro-
45 vision or agreement not inconsistent with the provisions of this
46 policy, may be provided for in writing added hereto, but no pro-
47 vision may be waived except such as by the terms of this policy
48 is subject to change.
49 **Waiver** No permission affecting this insurance shall
50 **provisions.** exist, or waiver of any provision be valid,
51 unless granted herein or expressed in writing
52 added hereto. No provision, stipulation or forfeiture shall be
53 held to be waived by any requirement or proceeding on the part
54 of this Company relating to appraisal or to any examination
55 provided for herein.
56 **Cancellation** This policy shall be cancelled at any time
57 **of policy.** at the request of the insured, in which case
58 this Company shall, upon demand and sur-
59 render of this policy, refund the excess of paid premium above
60 the customary short rates for the expired time. This pol-
61 icy may be cancelled at any time by this Company by giving
62 to the insured a five days' written notice of cancellation with
63 or without tender of the excess of paid premium above the pro-
64 rata premium for the expired time, which excess, if not ten-
65 dered, shall be refunded on demand. Notice of cancellation shall
66 state that said excess premium (if not tendered) will be re-
67 funded on demand.
68 **Mortgagee** If loss hereunder is made payable, in whole
69 **interests and** or in part, to a designated mortgagee not
70 **obligations.** named herein as the insured, such interest in
71 this policy may be cancelled by giving to such
72 mortgagee a ten days' written notice of can-
73 cellation.
74 If the insured fails to render proof of loss such mortgagee, upon
75 notice, shall render proof of loss in the form herein specified
76 within sixty (60) days thereafter and shall be subject to the pro-
77 visions hereof relating to appraisal and time of payment and of
78 bringing suit. If this Company shall claim that no liability ex-
79 isted as to the mortgagor or owner, it shall, to the extent of pay-
80 ment of loss to the mortgagee, be subrogated to all the mort-
81 gagee's rights of recovery, but without impairing mortgagee's
82 right to sue; or it may pay off the mortgage debt and require
83 an assignment thereof and of the mortgage. Other provisions

IN WITNESS WHEREOF, this Company has executed and attested these presents; but this policy shall not be valid unless countersigned by the duly authorized Agent of this Company at the agency hereinbefore mentioned.

84 relating to the interests and obligations of such mortgagee may
85 be added hereto by agreement in writing.
86 **Pro rata liability.** This Company shall not be liable for a greater
87 proportion of any loss than the amount
88 hereby insured shall bear to the whole insurance covering the
89 property against the peril involved, whether collectible or not.
90 **Requirements in** The insured shall give immediate written
91 **case loss occurs.** notice to this Company of any loss, protect
92 the property from further damage, forthwith
93 separate the damaged and undamaged personal property, put
94 it in the best possible order, furnish a complete inventory of
95 the destroyed, damaged and undamaged property, showing in
96 detail quantities, costs, actual cash value and amount of loss
97 claimed; and within sixty days after the loss, unless such time
98 is extended in writing by this Company, the insured shall render
99 to this Company a proof of loss, signed and sworn to by the
100 insured, stating the knowledge and belief of the insured as to
101 the following: the time and origin of the loss, the interest of the
102 insured and of all others in the property, the actual cash value of
103 each item thereof and the amount of loss thereto, all encum-
104 brances thereon, all other contracts of insurance, whether valid
105 or not, covering any of said property, any changes in the title,
106 use, occupation, location, possession or exposures of said prop-
107 erty since the issuing of this policy, by whom and for what
108 purpose any building herein described and the several parts
109 thereof were occupied at the time of loss and whether or not it
110 then stood on leased ground, and shall furnish a copy of all the
111 descriptions and schedules in all policies and, if required, verified
112 plans and specifications of any building, fixtures or machinery
113 destroyed or damaged. The insured, as often as may be reason-
114 ably required, shall exhibit to any person designated by this
115 Company all that remains of any property herein described, and
116 submit to examinations under oath by any person named by this
117 Company, and subscribe the same; and, as often as may be
118 reasonably required, shall produce for examination all books of
119 account, bills, invoices and other vouchers, or certified copies
120 thereof if originals be lost, at such reasonable time and place as
121 may be designated by this Company or its representative, and
122 shall permit extracts and copies thereof to be made.
123 **Appraisal.** In case the insured and this Company shall
124 fail to agree as to the actual cash value of
125 the amount of loss, then, on the written demand of either, each
126 shall select a competent and disinterested appraiser and notify
127 the other of the appraiser selected within twenty days of such
128 demand. The appraisers shall first select a competent and dis-
129 interested umpire; and failing for fifteen days to agree upon
130 such umpire, then, on request of the insured or this Company,
131 such umpire shall be selected by a judge of a court of record in
132 the state in which the property covered is located. The ap-
133 praisers shall then appraise the loss, stating separately actual
134 cash value and loss to each item; and, failing to agree, shall
135 submit their differences, only, to the umpire. An award in writ-
136 ing, so itemized, of any two when filed with this Company shall
137 determine the amount of actual cash value and loss. Each
138 appraiser shall be paid by the party selecting him and the ex-
139 penses of appraisal and umpire shall be paid by the parties
140 equally.
141 **Company's** It shall be optional with this Company to
142 **options.** take all, or any part, of the property at the
143 agreed or appraised value, and also to re-
144 pair, rebuild or replace the property destroyed or damaged with
145 other of like kind and quality within a reasonable time, on giv-
146 ing notice of its intention so to do within thirty days after the
147 receipt of the proof of loss herein required.
148 **Abandonment.** There can be no abandonment to this Com-
149 pany of any property.
150 **When loss** The amount of loss for which this Company
151 **payable.** may be liable shall be payable sixty days
152 after proof of loss, as herein provided, is
153 received by this Company and ascertainment of the loss is made
154 either by agreement between the insured and this Company ex-
155 pressed in writing or by the filing with this Company of an
156 award as herein provided.
157 **Suit.** No suit or action on this policy for the recov-
158 ery of any claim shall be sustainable in any
159 court of law or equity unless all the requirements of this policy
160 shall have been complied with, and unless commenced within
161 twelve months next after inception of the loss.
162 **Subrogation.** This Company may require from the insured
163 an assignment of all right of recovery against
164 any party for loss to the extent that payment therefor is made
165 by this Company.

DRAMATIC CHANGES

- 1 By the late 1970's in the personal lines arena and by the mid 1980's in commercial lines, change began to occur. No longer did it make sense to issue a very narrow coverage contract with a dozen or more liberalizing endorsements. It seemed more user friendly to write a Homeowner's Policy for homeowners, a Businessowner's Policy for a business and so on. However, even though most states do not require a Standard Fire Policy at the bottom of the stack any longer, the influence of the Fire policy is visible on every sheet of paper still found in the stack. The Standard Fire Policy may be a dinosaur in the sense that you may never sell one, but practically everything you learn about this contract will surface again and again in your study of modern Commercial Property contracts and Homeowners policies.

PROPERTY FORMAT

- 2 In protecting an Insured's property, there are two questions which must be answered:
1. What property do you want to insure?
 2. From what causes of loss do you want to insure it?
- 3 The answers to these two questions can allow us to insure a modest home or a business as big and complex as IBM.

What's covered?
What's it covered from?

WHAT?

- 4 **BUILDING AND CONTENTS** – In a general sense, Property policies are designed to insure buildings (and other structures) as well as the contents of those buildings at a fixed location. It is also possible to insure *betterments* and *improvements* made by the Insured to rented premises. In Commercial Lines Property policies, there is even the opportunity for a businessowner to insure his responsibility for other people's property – e.g. a TV Repair Shop which is responsible for my television. This is a *bailee's-like coverage*. It is further possible for the TV Shop owner to insure his investment of time and materials in his customer's property. If the TV repairman invests \$200 in parts and labor into a TV that is destroyed before it is retrieved and the bill is paid, the policy could pay.

DICE

- 5 Regardless of the simplicity or complexity of a given Property risk, the types of property exposures covered by a specific contract will be spelled out on the Dec sheet of that policy.

- 6 **SPECIFIC VS. BLANKET COVERAGE** – An Inland Marine contract might cover a 1.5 carat diamond in a gold setting as **specific coverage** – that ring and nothing else. A Homeowners policy, on the other hand, might cover up to \$50,000 of your personal property on a **blanket basis**. There is no list of personal property required at contract formation. Blanket coverage is also a plus if the insured items could be at any of several locations. . . store #1, store #2 or at the warehouse.

FROM WHAT?

- 1 **PERIL/CAUSE OF LOSS** – The specific event that caused the loss. Fire, lightning, windstorm, smoke, hail, falling objects, vandalism, robbery, theft, and flood are examples of perils. In life insurance, the peril is death; in health insurance, the perils are accident and sickness.
- 2 **NAMED PERIL POLICY** – Property policies can be written in one of two ways: on a Named Peril or an Open Perils (“All Risk”) basis. As the name implies, in a Named Peril policy, **each of the covered perils is literally named in the policy.** Example: The company agrees to pay for loss or damage due to Fire, Lightning, Explosion, Windstorm or Hail.
- 3 You should note that with a Named Peril policy, the *burden of proof* is on the Insured. The fact that Joe’s house is destroyed is irrelevant unless it is destroyed by one of the named perils.
- 4 **OPEN PERILS (ALL RISK) POLICY** – The second way to write policies is on an Open Perils basis. This means that the policy does not list the covered perils but, rather, states that the policy will pay for every conceivable peril (even an unusual one) that causes a loss **except for those specifically excluded** in the policy. An Open Perils policy, therefore, provides better coverage (at a higher price) than a Named Peril policy.
- 5 In most cases, the word **Special** indicates Open Perils (All Risk) Coverage.
- 6 Under an Open Perils policy, the *burden of proof* shifts to the company. If Joe’s house is destroyed, the company must pay unless it can show that the cause of Joe’s loss is an exclusion under the policy.
- 7 **NOTE:** Blanket Coverage is to All Risk...as Specific Coverage is to Named Peril.
- 8 **HAZARD** – A hazard is any factor or situation that increases or contributes to the probability that a peril will occur. For instance, faulty wiring is a hazard that increases the likelihood that the peril of fire will occur. In the broadest sense, almost any activity of life or business can be viewed as a hazard. Owning a home with a swing set and a swimming pool is a hazard. Owning and operating a motor vehicle is a hazard. Inviting the public into your restaurant or grocery store is a hazard. Manufacturing a product or publishing a periodical is a hazard. Obviously, the only way to avoid hazards altogether is to not own anything and not do anything.

DICE

menu

everything but...

makes it worse

1 On the other hand, certain hazards can be controlled. Joe can scrape and salt his restaurant parking lot in the winter to reduce the likelihood of a trip-and-fall injury. Within the insurance industry, there are normally considered to be three types of manageable hazards: physical, moral, and morale.

2 A **PHYSICAL hazard** is a visible or tangible condition of the premises that increases the chances of a peril occurring, such as faulty wiring, slippery floors, congested traffic, icy roads, unguarded premises, uninspected boilers, gasoline cans, explosives, and loose items hanging from the ceiling.

3 A **MORAL hazard** concerns the Insured's attempting to defraud the insurance company through **intentional and deliberate destruction** of the insured property. This may occur either by the Insured's intentionally setting fire to his property or hiring an arsonist. The company seeks to determine the probability of a moral hazard by reviewing the proposed Insured's reputation, financial record and past tendency to take advantage of others in business.

4 A **MORALE hazard** has to do with the Insured's indifference, carelessness, laziness, disorderliness, or lack of concern for the insured property. Examples of morale hazards include leaving your keys in your car, smoking in bed, or exceeding the speed limit.

HOW MUCH?

5 **CLAIMS SETTLEMENT OPTIONS** – While claims are most frequently settled with a check from the insurance company, most policies give the company the option to *repair or replace with like kind or quality*. This is the company's option, and they will do what is in their best interest.

6 **VALUATION** - It may surprise you, however, that the value to which an Insured will be indemnified can be defined in several different ways. Some, like Actual Cash Value, strictly adhere to the principle of indemnity, and others, like Replacement Cost, can be much more generous. They all *roughly* fit the concept of indemnity, but several (like Replacement Cost) severely test the limits.

7 Obviously, the more generously we define value in the event of a loss, the more expensive the policy. Just as obviously, each policy must specify how value will be defined under that particular contract.

8 **ACTUAL CASH VALUE (ACV)** – ACV is a formula used to determine the amount the insurance company will pay for a loss.

$$\text{Replacement Cost} - \text{Depreciation} = \text{ACV}$$

9 ACV is the most basic method used to determine how much a policy will pay for a loss and is certainly the method for determining value which most rigidly adheres to the principle of indemnity.

DICE

KNOW THIS:
 $RC - D = ACV$

- 1 Under ACV, value is defined as the **replacement cost** of the destroyed property **at the time of the loss** less an amount that reflects what was used up before the loss (depreciation). **Depreciation** is the decrease in value of property over time as the result of deterioration, or wear and tear. To indemnify a loss on an ACV basis takes into account that the damaged property was partially worn out when the loss occurred. Under an ACV coverage, the insurance company will not pay for the depreciation of the lost or destroyed property, i.e., it will **not pay new for old**. However, some policies will pay *new for old*; they are called Replacement Cost policies.

*can't collect
what's already
used*

- 2 **REPLACEMENT COST** – Policies written on this basis will pay the amount it costs to replace the destroyed property. This means that the insurance company will pay to replace the old property with new property of a like kind or quality **without deducting depreciation**. Though you fare better following a loss with a Replacement Cost contract than you would under ACV, a couple of points should be made.

new for old

- 3 First of all, you paid more premium to get this more generous method of settlement. And, most Replacement Cost contracts have built-in safeguards to keep you from pocketing any profit you might seem to have made. For instance, if your couch has a Replacement Cost of \$1,000 and an ACV of \$600, most Replacement cost policies would immediately pay \$600. When you actually replaced the couch for \$1,000, you would be paid the \$400 difference. While it would appear that you profited \$400 on the loss, you were not able to put the money in your wallet.

- 4 **FUNCTIONAL REPLACEMENT COST** – Sometimes called **Repair Cost**. Certain buildings, furniture, fixtures, machinery, and equipment are impossible to duplicate or replace. For example, ornate woodwork would require an inordinate amount of labor to reproduce. Obviously, the cost of writing replacement cost coverage for such decorative and expensive work would be prohibitive.

*not
stained glass
...glass*

- 5 In order to alleviate this problem of expense and still provide a replacement cost-type policy, the Functional Replacement Cost concept was introduced. When the policy is written, the Insured agrees to have the irreplaceable materials replaced with **functionally equivalent** materials, although the decorativeness may be substantially less. While the property will not be exactly replaced, the Insured can obtain replacement cost coverage at a reasonable price, and he will receive materials that are functionally the same as what was destroyed.

- 6 **STATED VALUE** - Most Property and Casualty policies are written on a Stated Value basis. The Insured tells the company the value of the item and insurance is written for that amount. **Following a loss**, the company can challenge value. If the item can be repaired or replaced for a lesser amount, the company can settle the loss for less than the amount of insurance.

*value decided
at time of loss*

- 7 **AGREED VALUE** – Another method by which insurance companies can pay losses is on an Agreed Value basis. Under an Agreed Value contract, the insurance company and the Insured agree to a **specific price** for each piece of property **before** the contract is written. The values are *scheduled* on the back of the policy. If there is a loss, the company pays the Agreed Value as specified on the schedule with no regard for depreciation or for the replacement cost of the item. Agreed Value works best for items whose value does not fluxuate greatly. Antiques and artwork – yes; gold and silver – no.

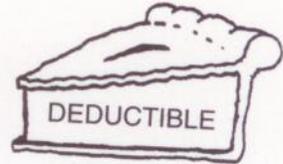
*value decided
up front*

1 **FAIR MARKET VALUE** – What somebody else will give you in cash for the property at this moment. Fair Market Value is very rarely used in determining property insurance limits because it reflects the value of real estate (land and location) and not just the cost of rebuilding the property itself.

2 In property insurance, what is of importance is the replacement cost of the building and the contents, not the value of the land, because land is not destroyed by most insured perils. Also, the land itself is usually not insured.

COST CONTAINMENT TOOLS IN PROPERTY POLICIES

3 **DEDUCTIBLE** – The deductible is the policyowner's piece of the claim pie. The policyowner always pays the deductible. In property insurance (such as Homeowners and Automobile policies), the deductible is almost always a flat dollar amount, such as \$250. In other contracts, it can be a percentage deductible.



4 The primary reason for deductibles is to **stop the overutilization of the policy** (i.e., to control risk by keeping the Insured from using the policy unless there is a substantial loss).

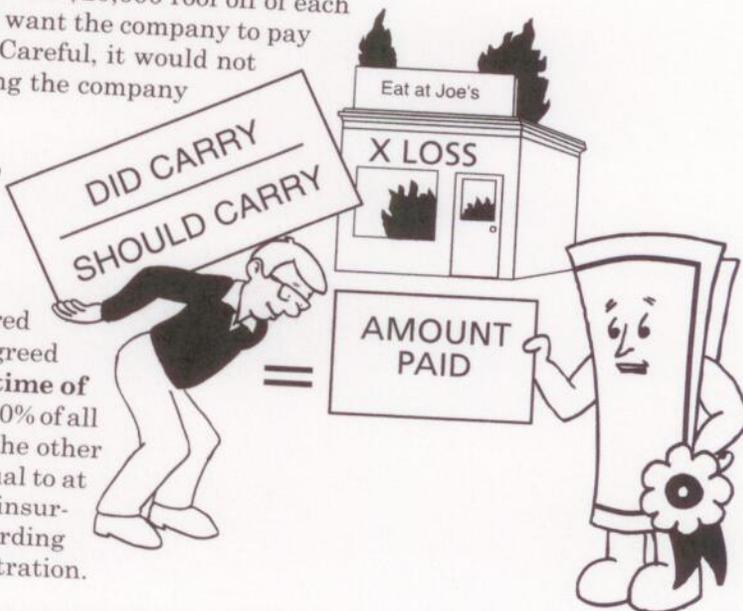
5 **COINSURANCE CLAUSE** – The Coinsurance Clause found in most property policies is designed to encourage the policyowner to insure the property for an amount (at least) approaching the real value of the building. At first glance, a cheapskate policyowner who insures his \$100,000 building for only \$20,000 would appear to already have an incentive to raise those limits to something more closely reflecting the value of the building. In the event of a total loss, the cheapskate would lose \$80,000.

*insure to value
not total loss*

6 However, what you probably do not know is that the vast majority of property losses are less than 20% of total value. With this in mind, let's structure an example to show why coinsurance is necessary. Suppose Buildings A and B sit side by side. Each is worth \$100,000. Joe Cheap insures Building A on a replacement cost basis for only \$20,000. Joe Careful insures Building B for \$100,000 on a replacement cost basis. A windstorm blows the \$20,000 roof off of each building. While Joe Cheap would certainly want the company to pay him the same \$20,000 that it will pay Joe Careful, it would not make sense to do so as Joe Careful is paying the company five times as much premium.

7 The purpose of the Coinsurance Clause is to reward the Insureds who purchase adequate levels of insurance and penalize those who do not.

8 The Coinsurance Clause states that if the Insured will agree to insure the property for an agreed percentage of its value (typically 80% **at the time of loss**), then the insurance company will pay 100% of all partial losses, up to the policy limits. If, on the other hand, the Insured fails to carry insurance equal to at least 80% of the value of the property, then the insurance company will penalize the Insured according to an agreed-to formula in the following illustration.



- 1 The recommended procedure for calculating coinsurance is for you to answer the following questions:

1. **Is it a partial loss?**

If **no** (i.e., it is a total loss), pay the full claim.

If **yes**, go to #2 below.

2. **Did the Insured meet the coinsurance requirement?**

If **yes**, pay the entire partial loss.

If **no**, then calculate Coinsurance.

*“co”-insure –
Joe pays part
of the claim*

2 Example 1:

Coinsurance Requirement	80%
Building Value	\$100,000
Amount of insurance in force	\$ 60,000
Amount of loss	\$ 20,000

- 3 The first step is to ask whether this is a partial or a total loss. It was obviously a partial loss because the amount of the loss was \$20,000 and the building value was \$100,000. So go to step number two.

- 4 The second step is to ask yourself, “Did the Insured meet the coinsurance requirement at the time of the loss?” The coinsurance requirement is 80% of \$100,000, or \$80,000. The amount of insurance carried was \$60,000. Therefore, the Insured did not meet the coinsurance requirement. The formula for determining the amount paid on the loss therefore would be:

$$\frac{\$60,000 \text{ carried}}{\$80,000 \text{ required}} \times \$20,000 \text{ loss} = \text{amount paid}$$

$$\frac{\$60,000}{\$80,000} \text{ reduces to } \frac{3}{4}, \text{ so}$$

$$\frac{3}{4} \times \$20,000 = \$15,000 \text{ which is the amount paid}$$

5 Now try one yourself.

Example 2:

Coinsurance Requirement	80%
Building Value	\$200,000
Amount of insurance in force	\$ 80,000
Amount of the loss	\$ 30,000

Amount paid ?

1 The application of the Coinsurance Clause is simple. As long as the Insured carries insurance equal to or greater than the required percentage, the insurance company will pay all partial losses up to the policy limits. However, if the Insured does not maintain the required percentage, then the insurance company will penalize the Insured by only paying a percentage of the Insured's loss according to the coinsurance formula.

2 The theory is that since the property was only partially insured, the company should only pay part of the loss. The purpose of the Coinsurance Clause is to **encourage the policyowner to insure the property to value.**

(The answer is \$15,000.)

3 We might summarize coinsurance by saying that it is a mechanism by which the company cheats the policyowner on a claim to the same degree that the policyowner cheated the company when purchasing the insurance in the first place. And while this is a gross oversimplification, it does make the point.

COMMON PROPERTY PROVISIONS

4 **PROOF OF LOSS** – A Proof of Loss is a sworn statement concerning a loss under a Property policy. It must only be submitted when requested by the company, and most claims are settled without one.

sworn

5 **APPRAISAL** – In most property policies there is a provision for appraisal. In situations where the company has acknowledged that a loss is covered by the contract and simply cannot agree with the Insured on a settlement amount, each side hires (and pays for) an appraiser. The two appraisers select an umpire (for whom the two sides split the cost). When two of the three are in agreement as to value, their decision is binding.

*only dollars...
...not coverage*

6 **RIGHT OF SALVAGE** – When the insurance company pays in full to replace an item, the company gains ownership of the destroyed item. If Joe's auto is totaled, the company has the right to salvage what remains of Joe's car after paying him book value.

*company's
right*

7 **ABANDONMENT** – On the other hand, Joe has no right to abandon his property to the company. After a minor *fender bender*, Joe cannot hand his car keys to the company and demand full book value.

8 **ADDITIONAL COVERAGES AND EXTENSIONS OF COVERAGES** – Most property policies have three or four major coverages and then a list of additional coverages and a list of coverage extensions. Some of these actually add dollars to the total amount payable for a loss, and others merely allow for limited amounts to be paid from the major coverages in circumstances that would otherwise be excluded. Additional coverages are normally **automatic** and the extensions must typically be **earned** by maintaining insurance equal to **eighty** percent of the value of the Insured property.

*There's more
than meets
the eye*

Notes

*unoccupancy-
nobody's home**vacancy-
they took the
furniture with
them*

- 1 **VACANCY/UNOCCUPANCY** – While these two words are basically synonymous in normal usage, in insurance-ese there is a big difference.

- 2 Unoccupancy means that no **people** are there. Most homes and businesses are, therefore, unoccupied for some period every day. Vacancy, on the other hand, means no people are present **and** no furniture, furnishings, or equipment are in place. Obviously, the potential for arson, vandalism, and any number of other perils is greatly increased in a vacant building.

COMMON PROPERTY CONDITIONS

Concealment, Misrepresentation or Fraud

- 3 Your property coverage is void if you intentionally conceal or misrepresent a material fact concerning this coverage.

DICE
*you lie, you're
on your own*

Control of Property

- 4 The negligence of any person beyond your direction or control will not affect your insurance. In fact, even if you violate the terms of this coverage part, it will only affect your coverage at the location involved. Coverage will continue for other locations.

*we pay, then
chase*

Insurance Under Two or More Coverages

- 5 If you have insured your property under two or more policies, you will not be paid more than the actual loss.

whole not rich

Legal Action Against Us

- 6 You may not sue the insurance company unless you are in full compliance with your responsibilities and have started the lawsuit within a time limit specified by state law.

Liberalization

- 7 If the company should revise its policy to broaden coverage in any way without additional premium, those policies already outstanding will be interpreted as if the more liberal provision were included.

No Benefit to Bailee

- 8 Property policies are two party coverages, and are not designed to protect *Bailee's* obligations.

*let him get his
own coverage*

Other Insurance

Notes

1 If you have a piece of property insured by two Property policies that are identical in peril power (concurrent), each company will pay its share of the claim in the same proportion as its policy limits bear to the total. For example:

pro rata - coverage to claim

	Insurance Limits	
Company A	\$ 70,000	Pro Rata Share
Company B	<u>30,000</u>	70%
Total	\$100,000	<u>30%</u>
		100%

2 If there is a \$10,000 loss, Company A would pay \$7000 and Company B would pay \$3000 and each would apply its deductible.

3 However, if we change the example so that the peril power of Company A's policy does not match Company B's (**nonconcurrency**), things could turn out much differently.

	Peril Power	Insurance Limits
Company A	Basic	\$70,000
Company B	Basic + Earthquake	30,000

DICE

4 If there is a \$10,000 earthquake loss, Company A pays zero. Company B would only pay its share, \$3000. Remember, Company B is only receiving about one-third of the premium and therefore should not be forced to cover 100% of the loss.

5 NOTE: It would be extremely rare today for a risk to be covered by two separate property policies. It might happen if a building were too expensive for any one company to handle the entire risk. However, **if two property policies do cover the same piece of property, they must be concurrent - the peril power must match.** The major reason that this clause still appears on modern policies is to keep the policyowner from profiting in the event of a loss. Suppose I own a \$100,00 building and it is insured with Company A for \$100,000 and with Company B for \$100,000. I may not be an arsonist, but I am certainly planning to profit if lightning ever does strike. If it does, each would pay its proportionate share of the loss. Company A would pay \$50,000 minus a deductible and likewise Company B. In a total loss, I would collect only the \$100,000 I lost minus the deductibles.

never more than pro rata

Policy Period and Coverage Territory

6 Obviously, the insurance company only covers losses that occur during the policy period. The coverage territory is defined in the contract.

Subrogation

1 (Latin, for *going in place of*) Subrogation is the legal process by which your insurance company, once it reimburses you for a loss caused by someone else, **assumes your legal right to sue the responsible third party**. For example, your next-door neighbor causes damage to your house and is liable for it. You collect from your own insurance company for the loss because it is easier than suing your neighbor. Your insurance company then subrogates against your neighbor in order to recover the money it paid to you. This is legally possible because you transferred your right to sue your neighbor to your insurance company when you accepted payment of the claim.

now, the fun really begins

Transfer of Rights

2 Subrogation upholds the principle of indemnity (no profit) by preventing you from collecting twice for the loss (once from your insurance company and once from your neighbor).

3 The commercial policies refer to Subrogation as **Transfer of Rights of Recovery Against Others To The Insurer**.



YOUR DUTIES IN THE EVENT OF A LOSS

- Notify the police if a law has been broken.
- Notify the insurance company promptly.
- Give the company a description of the loss.
- Protect the property from further damage.
- If the company requests, complete an inventory of the damaged and undamaged property.
- Allow the company to inspect the damage and your records substantiating the loss.
- If requested, permit the company to question you under oath.
- At the company's request, complete the Proof of Loss forms provided by the company, including your sworn signature.
- Cooperate with the company in the settlement of the claim.

DICE

LOSS PAYMENT

Notes

- 1 In the event of a covered loss, the company will do one of the following:
 - Pay the value of the loss and take the damaged property as salvage.
 - Pay the cost to repair or replace the damaged items.
 - Repair or replace it with property of like kind and quality.
- 2 The company will not pay you more than your insurable interest in the damaged property.

*company's
choice*

- 3 **VALUATION** – As we have seen, value to which an Insured will be indemnified can be defined in several different ways. Some, like Actual Cash Value, strictly adhere to the principle of indemnity, and others, like Replacement Cost, can be much more generous. Obviously, the more generously we define value in the event of a loss, the more expensive the policy. Just as obviously, each policy must specify how value will be defined under that particular contract.

RECOVERED PROPERTY

- 4 If either party recovers insured property after payment of a loss, the other party must be notified. It is then your option to return either the dollars or the property to the company.

DICE

MORTGAGE HOLDERS

- 5 The mortgage holder or mortgagee is **the bank** holding an interest in your property as described on the Dec Sheet. The purpose of this section is to protect the banker's rights.
- 6 In essence, **the bank never loses**. Even if we catch you burning down the building, we still pay the bank.
- 7 In fact, if the insurance company pays the bank an amount equal to the entire mortgage, the mortgage note is transferred to the insurance company and the insurance company is now your mortgagee. You can pay the company from whatever federal penitentiary you are residing in while you are serving time for arson.
- 8 Basically, you can view the bank as the shadow of the policyowner. Any rights or obligations that you fail to exercise become the bank's. If you do not pay the premium, then the bank can (while it simultaneously forecloses on your mortgage). If you don't submit proof of loss within 60 days, then the company will give the bank 60 days to render proof of loss.
- 9 The Standard Mortgage Clause also protects the mortgagee by requiring that the insurance company give the mortgagee notice in the event of policy cancellation.

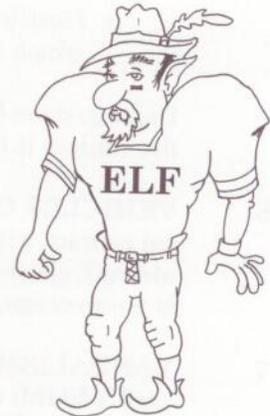
*bankers
never lose*

THE CAUSE OF LOSS FORMS: BASIC, BROAD, & SPECIAL

- 1 As we have discussed, the FROM WHAT? question can be answered with either a list of perils under a Named Peril contract or with an Open Perils (All Risk) contract, which essentially covers anything not excluded.
- 2 In both Personal Lines and Commercial Lines there are two groups of Named Perils that are nearly identical. They are known as the Basic Perils and the Broad Form Perils. The Basic Perils in Personal Lines contracts are nine in number. In Commercial Lines, the Basic Perils include the same nine plus two more, **for a total of 11 perils**. The Broad Form in each case adds three perils to the appropriate list of Basic Perils.
- 3 **Memory Hint:** As you look at the Basic Perils in the order presented, you will notice that the first letter of each peril would create a list as follows:

WR ELF VVV SSS

- 4 Most football fans recognize WR as an abbreviation for Wide Receiver. Therefore, we have a Wide Receiver whose name is ELF, plus three V's and three S's. In Personal Lines, we have the same Wide Receiver ELF plus three V's and only one S. As you move from Dwelling policies to Homeowners to Commercial Property, you will find relatively few other differences, once you have committed this list to memory.



BASIC Cause of Loss Form

1. **WINDSTORM OR HAIL** covers windstorm (hurricanes, tornadoes, etc.) or hail damage to your building. The interior or contents is not covered for damage by rain, snow, sand or dust driven by the wind unless the building first sustains wind or hail damage that allows the rain, snow, sand or dust to enter. Simply put:
 - If you let Mother Nature in, no coverage.
 - If Mother Nature lets herself in, you're covered.
2. **RIOT OR CIVIL COMMOTION** covers acts of striking employees and looting (theft) which occurs during a riot.
3. **EXPLOSION** includes the explosion of gases within a furnace or any fired vessel. It does not include the rupture or bursting of pressurized vessels, like steam boilers. (That's covered elsewhere – Boiler & Machinery / Mechanical Breakdown.)
4. **LIGHTNING** covers the discharge of natural electricity.



*Economy
model*

11 perils

let herself in

not war

*Purdue
exclusion*

*not man's
electricity*

5. **FIRE** is the oldest and still the biggest risk in property insurance. Actually, this peril is *Fire Plus* because it also covers the results of a fire:

- firefighter damage
- water damage
- smoke damage

more than just fire

Fire can be divided into two subcategories:

- **Friendly Fire** – a fire you start intentionally to do a job that is in its intended area (like a fire in a fireplace, on a stove, or in a water heater).
- **Hostile Fire** – a fire you did not start intentionally, or a friendly fire which is no longer doing what it was intended to do.

good...

...bad...

...ugly

Damage done by a hostile fire is covered but not damage done by a friendly fire (unless it has become hostile).

somebody else's

6. **VEHICLES OR AIRCRAFT** provides coverage only for the direct physical contact with insured property by an aircraft, an object falling from an aircraft, spacecraft, missile, vehicle or object thrown up by a vehicle. There is no coverage, however, for damage caused by vehicles you own or operate.

7. **VANDALISM** is often called *Vandalism and Malicious Mischief* (abbreviated V&MM) and covers damage done by vandals, but **it does not cover theft**. COVERED IF THEY BREAK IT, BUT NOT IF THEY TAKE IT. Vandalism will cover burglar damage.

break it – yes

take it – no

8. **VOLCANIC ACTION** covers the **above ground** damage of a volcano, such as damage from the blast or shock waves, ash, dust or lava flow.

“A”

9. **SMOKE** damage is covered as long as it is sudden and accidental. Prolonged exposures are not covered.

Note: Smoke from a hostile fire on your premises is already covered under the peril of fire. Smoke coverage is necessary for smoke damage caused either by someone else's fire or by smoke damage where there was no hostile fire (like due to an overheated stove or furnace).

*sudden...
...accidental*

10. **SPRINKLER LEAKAGE** is covered because we want you to have sprinklers.

NOTE: The only *water coverages* of the Basic form are firefighter water and sprinkler water – water that is there to put out a fire.

2 Commercial Perils

11. **SINKHOLE COLLAPSE** is the loss caused by the sinking or collapse of land into underground spaces created by the action of water, limestone or dolomite. This does **not** cover the collapse of land into man-made underground cavities, like a coal mine.



Florida

BROAD Cause of Loss Form

Family sedan

14 perils

through the roof



1 This form adds three more perils to the Basic form. It also adds the additional coverage of collapse

12. **FALLING OBJECTS** – like a boulder tumbling down a mountainside. Coverage is generally limited to damage of the insured buildings. Contents coverage is only provided if the exterior damage to the building allowed the contents damage to occur.

13. **WEIGHT OF SNOW, ICE OR SLEET** provides coverage for a building that is damaged by the weight of snow, ice or sleet.



14. **WATER DAMAGE** broadens the coverage of the Basic form. Before we look at the modifications of the Broad form specifically, let's review the entire picture of water damage in the Commercial Property contracts.

NOTE: Water damage coverage can be readily understood and remembered if you keep the following three points in mind:

- Firefighter water (and sprinkler water in Commercial policies) is **always** covered.
- Mother Nature's water in the form of a flood is **never** covered. (Hence the need for Flood insurance.)
- The Broad and Special forms cover losses due to **intentional water**. That is, water that you bring into the building intentionally in pipes, water heaters, etc. . . . in other words, **plumbing**.

always...

...never...

...broad and beyond

2 Therefore, the Broad form (and the Special form) provides coverage for the damage caused by the **leaking and freezing** of pipes, appliances or systems which contain water. Of course, this only applies if you have done your best to maintain heat in the building. Further, coverage is provided for leakage that is sudden and accidental. Coverage is NOT provided for the appliance or system from which the water escaped.

Additional Coverage: COLLAPSE

Notes

1 The Broad Cause of Loss form provides for the additional coverage of collapse. It is not listed as a peril because there are many perils which can cause a building to collapse. Primarily, **this section provides coverage if any of the Broad form perils damages a building which ultimately collapses.** For example, if fire damages a building and it collapses later, there is coverage. In addition, collapse due to any of the following is covered:

- Hidden decay
- **Hidden insect or vermin damage**
- Weight of people or personal property
- Weight of rain
- Defective materials or methods of construction if the collapse takes place during the construction or remodeling.

2 Collapse does not cover outdoor items such as antennas, awnings or guttering, nor does it cover items on the ground such as fences, piers, walkways or roadways. Further, collapse does not cover damage due to settling, cracking, bulging or expansion.

SPECIAL Cause of Loss Form

3 The Special form covers everything covered by the Broad form and more. It is the *All Risk* or Open Perils form. It covers everything except that which is specifically excluded. There are probably two valid questions that can be raised about this and any other all risk coverage:

1. What am I covered for now that I wasn't before?
2. What's excluded?

4 In answer to the first question, the best answers tend to fall into the category of "Weird stuff that happens to me and no one else on earth."

- A bear walks into your kitchen and destroys it. *Wild animals* appear on no list of perils, so no named policy would provide coverage. However, since *wild animal damage* is not excluded under an All Risk contract, it would provide coverage.
- You cut yourself at the kitchen sink and bleed on your wall-to-wall carpeting on the way to the bathroom. Not excluded, therefore covered under Open Perils.
- You are preparing to paint the dining room. You have an open 5-gallon can of paint with the electric mixer sitting in it. Your 5-year old turns on the mixer, which creates a splatter pattern worthy of Jackson Pollack – covered under All Risk.

5 The second question is terribly important because an Open Perils contract normally does not list the perils covered. Simply, you are covered for anything not excluded. While it sounds backwards, you can determine the extent of coverage in your All Risk policy by reading the exclusions. Most will fall into the three categories we established earlier:

- Catastrophic losses
- Losses better covered elsewhere
- Predictable losses

mostly this...

but also...

bugs...

people...

...defects...

"everything but"



Luxury

DICE

CAUSE OF LOSS	BASIC	BROAD	SPECIAL	Remember
1. WIND OR HAIL	X	X	X	...let herself in
2. RIOT OR CIVIL COMMOTION	X	X	X	not war
3. EXPLOSION	X	X	X	Purdue Exclusion
4. LIGHTNING	X	X	X	Mother Nature's Electricity
5. FIRE	X	X	X	fire, smoke, water, & firemen
6. VEHICLES OR AIRCRAFT	X	X	X	somebody else's
7. VANDALISM	X	X	X	break it, but don't take it
8. VOLCANIC ACTION	X	X	X	Action, Air Ash, Above
9. SMOKE	X	X	X	sudden ... accidental
10. SPRINKLER LEAKAGE	X	X	X	good guys
11. SINKHOLE COLLAPSE	X	X	X	Florida
12. FALLING OBJECTS		X	X	through the roof
13. WEIGHT OF SNOW, ICE, OR SLEET		X	X	weight
14. PLUMBING		X	X	14 days
15. COLLAPSE: ADDITIONAL COVERAGE		X	X	vermin, people, and more
16. EARTHQUAKE: OPTIONAL COVERAGE	X	X	X	plug in by endorsement
17. OPEN PERILS: "ALL RISK"			X	everything but ...

BASIC

BROAD

CRIME LOSSES

Notes

- 1 Please note that the following are insurance definitions as they relate to crime coverages. They bear little, if any, resemblance to the criminal law definitions.
- 2 **Robbery** – The taking of property by violence or threat of violence **from a person**. *Robbery...
Violence/person*
- 3 **Burglary** – The taking of property **from a premises** that is closed and locked tight and leaving marks of forced entry or exit. There must be visible evidence of force at the point of entry or exit. *Burglary...
Violence/building*
- 4 **Theft** – Any act of stealing. Theft is a broad term and includes robbery and burglary, as well as other forms of stealing, such as shoplifting and embezzlement.
- 5 **Safe Burglary** – The taking of property from a locked safe or vault, or the taking of the safe itself. As with burglary, there must be visible marks of force. Cash registers, cash drawers and cash boxes are not safes.
- 6 **Disappearance** – Insured property is simply gone. There is no evidence, or even a probability, of theft. Disappearance is covered only in “All Risk” policies. *It was here...
...now it's gone*

Conclusion

- 1 In this chapter, you have been introduced to a number of terms and concepts related to Property (two party) contracts. A good group of these fundamentals will be of tremendous value as you begin to examine the specific policies that contain property coverage.
- 2 The great-great-granddad of all property insurance is the New York Standard Fire policy of 1943. It standardized the fire policies that had been sold in this country for about 150 years prior to its arrival. The SFP did not do much by today's standards. It covered only three perils – fire, lightning, and removal. And, the coverages it provided were greatly limited by the definitions, provisions and exclusions within the contract. Specific forms and endorsements were developed to *customize* and broaden the coverage for the various subjects of property coverage (business building, homes, contents, etc.). Today, we no longer modify a Standard Fire policy with a stack of endorsements; the major property exposures each have policies written exclusively for use in that area. However, the basic property vocabulary originally developed for the Standard Fire policy is liberally sprinkled throughout these modern policies.
- 3 All Property policies must define **what** property is insured and **from** which perils. Since Property contracts are essentially designed to cover property at specific locations, **buildings** are the perfect subject of a Property policy. On-premises coverage is available for the **contents** of a building. Property coverage can be **specific** – your 1.5 carat diamond ring, or it can be written on a **blanket** basis – all the stuff in your house.
- 4 The *from what* question can be answered with a **Named Peril** policy that lists each cause of loss that is covered, or an **Open Perils** contract that covers everything not specifically excluded. A **peril** is an event that causes a loss – fire, lightning, wind and hail. A **hazard** is a factor that increases the likelihood of a peril – oily rags, improper storage of flammable materials, faulty wiring.
- 5 To settle a covered loss, the policies can specify any of several ways of establishing the value of that loss. **Actual Cash Value** is the replacement cost at the time of loss minus the depreciation of the insured item. **Replacement Cost** policies do not depreciate the cost of replacement – essentially this is *new for old* settlement. **Functional Replacement Cost** is the amount required to replace damaged property with functionally equivalent materials – plexiglass for stained glass. **Stated Value** is what you say something is worth, but **Agreed Value** is what both you and the insurance company agree that it is worth. **Fair Market Value** is what the property would sell for today. Since Fair Market Value includes the price of the land under the building, this determination of value is seldom used for insurance purposes.
- 6 To control costs, Property policies contain **deductibles** – first you pay and then the company will pay. Deductibles reduce the overutilization of the policy. Another cost containment tool is **coinsurance**. It is designed to encourage the policyowner to *insure to value*. There is a reward for those who do and a penalty for those who do not. The penalty can be expressed by the formula

$$\frac{\text{DID CARRY}}{\text{SHOULD CARRY}} \times \text{LOSS} = \text{AMOUNT PAID}$$

- 1 Common Property provisions and conditions include some of the following:
 - **Appraisal** – two appraiser, one umpire
 - **Salvage** – the company keeps the leftovers
 - **Abandonment** – you have no right to abandon
 - **Unoccupied** – no people
 - **Vacant** – no people, no stuff
 - **Multiple policies** – covering the same property, pay proportionately if concurrent
 - **Subrogation** – company pays you and then sues the at-fault party

- 2 The list of Named Perils known as the Basic Perils for Commercial risks include WR ELF VVV and SSS. For Personal Lines the Basic Perils are almost identical – WR ELF VVV and S.
 - Windstorm or hail
 - Riot or civil commotion

 - Explosion
 - Lightning
 - Fire

 - Vehicles or aircraft
 - Vandalism
 - Volcanic Action

 - Smoke
 - Sprinkler leakage
 - Sinkhole collapse

- 3 The Broad Form adds three perils to the Basic Perils for both Commercial and Personal Lines contracts.
 - **Falling objects**
 - **Weight of ice and snow**
 - **Water damage (plumbing)**

- 4 Also, the Broad Form adds the Additional Coverage of **Collapse**.

- 5 Finally, this chapter defines the important terms of Crime insurance. They include:
 - **Robbery** – taking of insured property by violence or threat **from a person**.
 - **Burglary** – taking of insured property **from a premises** that is closed and locked tight.
 - **Theft** – any act of stealing; includes burglary, robbery and other forms of stealing that are neither burglary nor robbery.