Direct Your Learning

9

Insurance Policies

Educational Objectives

After learning the content of this assignment, you should be able to:

- Explain the four elements of any valid contract.
- Describe the distinguishing characteristics of insurance policies.
- Explain how insurance policies can be structured using each of these alternatives:
  - Preprinted and manuscript forms
  - Self-contained and modular policies
  - Endorsements and other related documents
- Given a specific policy provision, classify it into one of the following categories:
  - Declarations
  - Definitions
  - Insuring agreements
  - Conditions
  - Exclusions
  - Miscellaneous provisions
- Explain how property policy provisions typically address each of the following:
  - Covered property
  - Covered locations
  - Covered causes of loss
  - Excluded causes of loss
  - Covered financial consequences
  - Covered parties

Outline

9

Educational Objectives, continued

- Amounts of recovery

- Explain how liability policy provisions typically address each of the following:
  - Covered activities
  - Covered types of injury or damage
  - Excluded loss exposures
  - Covered costs
  - Covered time period
  - Covered parties
  - Amounts of recovery

Insurance Policies

9

ELEMENTS OF A CONTRACT

An insurance contract, called a policy, is an agreement between the insurer and the insured. An insurance policy must meet the same requirements as any other valid contract, which is a legally enforceable agreement between two or more parties.

If a dispute arises between the parties to a contract, a court will enforce only **valid contracts**. The validity of a contract depends on four essential elements. See the exhibit "Four Essential Elements of a Contract."

Valid contract
A contract that meets all of the requirements to be enforceable.

Four Essential Elements of a Contract

- Agreement (offer and acceptance)
- Capacity to contract
- Consideration
- Legal purpose

[DA07631]

If a court cannot confirm the presence of all four elements, it will not enforce the contract.

Agreement (Offer and Acceptance)

One essential element of a contract is that the parties to the contract must be in agreement. One party must make a legitimate offer, and another party must accept the offer. In legal terms, there must be "mutual assent." In insurance, the process of achieving mutual assent generally begins when someone who wants to purchase insurance completes an insurance application—an offer to buy insurance. The details on the application describe the exposures to be insured and indicate the coverage the applicant requests.

In an uncomplicated case, an underwriter (or an agent, acting on behalf of an insurer) accepts the application and agrees to provide the coverage requested at a premium acceptable to both the insurer and the applicant. The premium is the payment by an insured to an insurer in exchange for insurance coverage. At this point, agreement exists; the insurer has accepted the applicant's offer to buy insurance.

In a more complicated case, an underwriter may not be willing to meet all the requests of the applicant. One of the underwriter's options is to accept the application with modification. The underwriter may be willing to provide coverage, but only on somewhat different terms. For example, an underwriter may insist on a higher deductible than the applicant had requested. When an underwriter communicates the proposed modifications to the applicant, these modifications constitute a counteroffer.

Several offers and counteroffers may be made before both parties agree to an exact set of terms. If the other essential elements of a contract exist, the mutual assent of the insurer and the applicant forms a contract. To be enforceable, the agreement cannot be the result of duress, coercion, fraud, or a mistake. If either party to the contract can prove any of these circumstances, a court could declare the contract to be void.

Capacity to Contract

For a contract to be enforceable, all parties must have capacity to contract. In other words, each party must have the legal capacity to make the agreement binding. Individuals are generally considered to be competent and able to enter into legally enforceable contracts, unless one or more of these characteristics applies:

- Being insane or otherwise mentally incompetent
- Being under the influence of drugs or alcohol
- Being a minor (person not yet of legal age)

However, minors are sometimes considered competent to purchase auto insurance, especially when auto insurance qualifies as a necessity. State laws vary in regard to issues involving minors.

Another aspect of legal capacity is that, in most states, an insurer must be licensed to do business in that state. If an insurer mistakenly writes an insurance policy in a state where that insurer is not licensed, the insured might later argue that the contract is not valid and demand the return of the premium. This demand would be based on the fact that the insurer did not have the legal capacity to make the agreement.

Consideration

Consideration

Something of value or bargained for and exchanged by the parties to a contract.

Consideration is something of value given by each party to a contract. For example, when an auto is purchased, the buyer gives money (consideration) to the seller who, in turn, provides the car (which is also consideration). Some contracts do not involve the exchange of one tangible item for another, but instead involve performance. For example, an author may sign a contract agreeing to write a book in exchange for payment by the publisher.

Performance can also involve a promise to perform some act in the future that is dependent on a certain event occurring. In an insurance contract, the insurer's consideration is its promise to pay a claim in the future if a covered loss occurs. If no loss occurs, the insurer is still fulfilling its promise to provide financial protection even though it does not pay a claim. In insurance contracts, two types of consideration are involved:

- The insured's consideration is the payment of (or the promise to pay) the premium.
- The insurer's consideration is its promise to pay claims for covered losses.

Legal Purpose

An enforceable contract must also have a legal purpose. Courts may consider a contract to be illegal if its purpose is against the law or against public policy (as defined by the courts). For example, an agreement to pay a bribe to a government official in exchange for receiving a government job would not be enforced by the courts because such an activity is against public policy.

Although most insurance policies do not involve a question of legality, certain situations do exist that may invalidate an insurance policy. Courts will refuse to enforce any insurance policy that is illegal or that tends to injure the public welfare. Insurance contracts must involve a legal subject matter. Property insurance on illegally owned or possessed goods is invalid. For example, property insurance covering illegal drugs would be illegal and therefore unenforceable. If fireworks are illegal in a particular state, then an insurance policy covering fireworks would be unenforceable in that state.

In addition, no insurance contract will remain valid if the wrongful conduct of the insured causes the operation of the contract to violate public policy. Thus, arson by an insured would render a property insurance policy unenforceable and would preclude recovery by the insured under the policy for a building the insured intentionally burned.

Apply Your Knowledge

Sam is an insurance producer. He is having several drinks with his friend Harry at a bar. Harry decides to leave. He asks Sam whether he'll insure him for auto liability, as he thinks he might need it going home. Sam nods his head. Which of the four elements of a valid contract may be questionable at this point?

a. Agreement (offer and acceptance)

b. Capacity to contract

c. Consideration

d. Legal purpose

Feedback: a., b., and c. To be valid, agreement requires mutual assent with an offer and acceptance. The offer is vague. For example, is coverage supposed to be for a standard policy term or just until Harry reaches his house? What is the limit of liability? The acceptance of Sam nodding is also vague. Was it Sam's intent to agree to provide coverage? Capacity to contract is a concern as well. Both parties may have temporarily lost their legal capacity to contract while under the influence of alcohol. Finally, consideration is questionable. Assuming Sam did intend to provide coverage, Harry has not paid or promised to pay any premium in exchange for the promise of coverage from Sam's insurer.

DISTINGUISHING CHARACTERISTICS OF INSURANCE POLICIES

Understanding what the distinguishing characteristics of an insurance policy are and being able to recognize when they apply is essential for an insurance professional who is held responsible for enforcing the policy.

All insurance policies are contracts. However, not all contracts are insurance policies. This unique subset of contracts has the same four essential elements that all contracts have, but, because of the specialized function it serves of transferring risk from an insured to an insurer, it also has certain distinguishing characteristics. Each of these distinguishing characteristics allows the transfer of risk to occur more efficiently. See the exhibit "Distinguishing Characteristics of Insurance Policies."

Distinguishing Characteristics of Insurance Policies

- Contract of indemnity
- Contract of utmost good faith
- Contract involving fortuitous events and the exchange of unequal amounts
- Contract of adhesion
- Conditional contract
- Nontransferable contract

[DA07629]

Contract of Indemnity

The purpose of insurance is to indemnify an insured who suffers a loss. To indemnify is to restore a party who has had a loss to the same financial position that party held before the loss occurred. Most property and liability insurance policies are contracts of indemnity.

Property insurance generally pays the amount necessary to repair covered property that has been damaged or to replace it with similar property. The policy specifies the method for determining the amount of the loss. For example, most auto policies, both personal and commercial, specify that vehicles are to be valued at their actual cash value (ACV) at the time of a loss. If a covered accident occurs that causes a covered vehicle to be a total loss, the insurer will normally pay the ACV of the vehicle, less any applicable deductible.

Liability insurance generally pays to a third-party claimant, on behalf of the insured, any amounts (up to the policy limit) that the insured becomes legally obligated to pay as damages because of a covered liability claim, as well as the legal costs associated with that claim. For example, if an insured with a liability limit of $300,000 is ordered by a court to pay $100,000 for bodily injury incurred by the claimant in a covered accident, the insurer will pay $100,000 to the claimant and will also pay the cost to defend the insured in court.

A contract of indemnity does not necessarily pay the full amount necessary to restore an insured who has suffered a covered loss to the same financial position. However, the amount the insurer pays is directly related to the amount of the insured's loss. Most policies contain a policy limit that specifies the maximum amount the insurer will pay for a single claim. Many policies also contain limitations and other provisions that could reduce the amount of recovery. For example, a homeowners policy is not designed to cover large amounts of cash. Therefore, most homeowners policies contain a special limit, such as $200, for any covered loss to money owned by the insured. In that instance, if a covered fire destroys $1,000 in cash belonging to the insured, the homeowners insurer will pay only $200 for the money that was destroyed.

Insurance policies usually include certain provisions that reinforce the **principle of indemnity**. According to the principle of indemnity, the insured should not profit from a covered loss. Insurance policies contain various provisions to clarify that the insured cannot collect more than the amount of the loss. For example, policies generally contain an "other insurance" provision to prevent an insured from receiving full payment from two different insurance policies for the same claim.

Principle of indemnity
The principle that insurance policies should provide a benefit no greater than the loss suffered by an insured.

Similarly, insurance contracts usually contain subrogation provisions, which allow the insurer, after paying a covered loss, to assume the insured's rights of recovery against other parties who are legally responsible for causing the loss. For example, following an auto accident in which the insurer compensates its insured when the other driver is at fault, the subrogation provision stipulates that the insured's right to recover damages from the responsible party is transferred (subrogated) to the insurer. The insured cannot collect from both the insurer and the responsible party. If the insured is not fully indemnified by the insurer's loss payment, for example, because of a deductible, the laws of many states require the insurer to pay, out of its subrogation recovery, the additional amount needed to indemnify the insured. The insurer is entitled to keep the rest of the subrogation recovery.

Another factor enforcing the principle of indemnity is that a person usually cannot buy insurance unless that person is in a position to suffer a financial loss. In other words, the insured must have an insurable interest in the subject of the insurance. For example, property insurance contracts cover losses only to the extent of the insured's insurable interest in the property. This restriction prevents an insured from collecting more from the insurance than the amount of the loss he or she suffered.

A person cannot buy life insurance on the life of a stranger, hoping to gain if the stranger dies. Insurers normally sell life insurance when there is a reasonable expectation of a financial loss from the death of the insured person, such as the loss of an insured's future income that the insured's dependents would face. Insurable interest is not an issue in liability insurance because a liability claim against an insured results in a financial loss if the insured is legally responsible. Even if the insured is not responsible, the insured could incur defense costs.

Valued policy

A policy in which the insurer pays a stated amount in the event of a specified loss (usually a total loss), regardless of the actual value of the loss.

Some insurance contracts are not contracts of indemnity but valued policies. When a specified loss occurs, a **valued policy** pays a stated amount, regardless of the actual value of the loss. For example, a fine arts policy may specify that it will pay $250,000 for loss of a particular painting or sculpture. The actual market value of the painting or sculpture may be much smaller or much greater than $250,000, but the policy will pay $250,000 in either case. In most valued policies, the insurer and the insured agree on a limit that approximates the current market value of the insured property.

Contract of Utmost Good Faith

Because insurance involves a promise, it requires complete honesty and disclosure of all relevant facts from both parties. For this reason, insurance contracts are considered contracts of utmost good faith. Both parties to an insurance contract—the insurer and the insured—are expected to be ethical in their dealings with each other.

Concealment

An intentional failure to disclose a material fact.

Misrepresentation

A false statement of a material fact on which a party relies.

Material fact

In insurance, a fact that would affect the insurer's decision to provide or maintain insurance or to settle a claim.

The insured has a right to rely on the insurer to fulfill its promises. Therefore, the insurer is expected to treat the insured with utmost good faith. An insurer that acts in bad faith, such as denying coverage for a claim that is clearly covered, could face serious penalties under the law.

The insurer also has a right to expect that the insured will act in good faith. An insurance buyer who intentionally conceals certain information or misrepresents certain facts does not act in good faith. Because an insurance contract requires utmost good faith from both parties, an insurer could be released from a contract because of **concealment** or **misrepresentation** by the insured regarding a **material fact**.

Contract Involving Fortuitous Events and the Exchange of Unequal Amounts

While noninsurance contracts involve an exchange of money for a certain event, such as the provision of goods or services, insurance contracts involve an exchange of money for protection upon the occurrence of uncertain, or fortuitous, events. Insurance contracts involve an exchange of unequal amounts. Often, there are few or no losses, and the premium paid by the insured for a particular policy is more than the amount paid by the insurer to, or on behalf of, the insured. If a large loss occurs, however, the insurer's claim payment might be much more than the premium paid by the insured. It is the possibility that the insurer's obligation might be much greater than the insured's that makes the insurance transaction a fair trade.

For example, assume an insurer charges a $1,000 annual premium to provide auto physical damage coverage on a car valued at $20,000. The following three situations may occur:

- If the car is not damaged while the policy is in force, the insurer pays nothing.
- If the car is partially damaged, the insurer pays the cost of repairs, after subtracting a deductible.
- If the car is a total loss, the insurer pays $20,000 (minus any deductible).

Unless, by chance, the insurer's obligations in a minor accident total exactly $1,000, unequal amounts are involved in all three of these cases. However, it does not follow that insureds who have no losses—or only very minor losses—do not get their money's worth or that insureds involved in major accidents profit from the insurance.

The premium for a particular policy should reflect the insured's share of estimated losses that the insurer must pay. Many insureds have no losses, but some have very large losses. The policy premium reflects the insured's proportionate share of the total amount the insurer expects to pay to honor its agreements with all insureds having similar policies.

Contract of Adhesion

The wording in insurance contracts is usually drafted by the insurer (or an insurance advisory organization), enabling the insurer to use preprinted forms for many different insureds. Because the insurer determines the exact wording of the policy, the insured has little choice but to "take it or leave it." That is, the insured must adhere to the contract drafted by the insurer. Therefore, insurance policies are considered to be contracts of adhesion, which means one party (the insured) must adhere to the agreement as written by the other party (the insurer). This characteristic significantly influences the enforcement of insurance policies.

If a dispute arises between the insurer and the insured about the meaning of certain words or phrases in the policy, the insured and the insurer are not on an equal basis. The insurer either drafted the policy or used standard forms of its own choice; in contrast, the insured did not have any say in the policy wording. For that reason, if the policy wording is ambiguous, a court will generally apply the interpretation that favors the insured.

Reality Check

An Example of Applying Contract of Adhesion

The Court of Appeals of Kentucky refused to enforce an exclusion that would have resulted in an insured not having coverage for a severe auto accident. The court based its decision in part on the fact that motor vehicle policies are largely contracts of adhesion and, therefore, there was no practical method by which the insured, as a member of a class of excluded persons, could have avoided the risk of not having coverage.

Hodgkiss-Warrick v. State Farm Mutual Automobile Insurance Company," Leagle, April 8, 2011, www.leagle.com/xmlResult.aspx?page=5&xmldoc=In KYCO 20110408270.xml&docbase=CSLWAR3-2007-CURR&SizeDisp=7 (accessed April 27, 2011). [DA07630]

Conditional Contract

Conditional contract

A contract that one or more parties must perform only under certain conditions.

An insurance policy is a **conditional contract** because the parties have to perform only under certain conditions. Whether the insurer pays a claim depends on whether a covered loss has occurred. In addition, the insured must fulfill certain duties before a claim is paid, such as giving prompt notice to the insurer after a loss has occurred.

A covered loss might not occur during a particular policy period, but that fact does not mean the insurance policy for that period has been worthless. In buying an insurance policy, the insured acquires a valuable promise—the promise of the insurer to make payments if a covered loss occurs. The promise exists, even if the insurer's performance is not required during the policy period.

Nontransferable Contract

The identities of the persons or organizations insured are important to the insurer, because it has the right to select those applicants with whom it is willing to enter into contractual agreements. After an insurance policy is in effect, an insured may not freely transfer the policy to some other party (a practice called "assignment"). If such a transfer were allowed to take place, the insurer would be legally bound to a contract with a party it may not wish to insure. Most insurance policies contain a provision that requires the insurer's written permission before an insured can transfer a policy to another party.

Apply Your Knowledge

Evelyn's health had worsened to the point she no longer felt capable of driving and decided to sell her car. John agreed to buy it from her as long as she would assign her auto policy to him, as his poor driving record prevented him from buying auto insurance for an amount he determined to be reasonable. Before purchasing Evelyn's car, John took it for a test drive and collided with a wall, totaling the vehicle. John demanded Evelyn's insurer pay him for the value of the car. Which two distinguishing characteristics of Evelyn's insurance policy did John's demand fail to consider?

a. Contract of indemnity
b. Contract of utmost good faith
c. Contract involving fortuitous events and the exchange of unequal amounts
d. Contract of adhesion
e. Conditional contract
f. Nontransferable contract

Feedback: a. and f. John's demand failed to consider that Evelyn's insurance policy has the distinguishing characteristics of being a contract of indemnity and a nontransferable contract. The contract of indemnity characteristic requires John to have an insurable interest in the vehicle. That is, he must have an interest in the car that is not unduly remote and that would cause John to suffer financial loss when the collision occurred. Because John had not yet purchased the vehicle, he could simply apply the funds he would have paid Evelyn to purchase a vehicle from someone else. The nontransferable contract characteristic prevents Evelyn from assigning or transferring her policy to John without her insurer's written consent.

INSURANCE POLICY STRUCTURE

An insurance policy is a carefully written contract that describes the agreement between the insured individual or organization and the insurer. Insurers use different types of policy structure to meet insureds' particular needs.

Insurance policy structure can vary, depending on customer coverage needs. Most policies are issued using **preprinted forms**, but **manuscript forms** may be used when an insured has coverage needs that preprinted forms do not adequately address. Moreover, all policies can be classified as being either self-contained policies or modular policies. Another important aspect of policy

Preprinted form
An insurance form that meets the needs of many policyholders and is therefore printed in bulk for future use.

Manuscript form
An insurance form that is drafted according to terms negotiated between a specific insured (or group of insureds) and an insurer.

structure is the incorporation of endorsements or other documents into the policy.

Preprinted and Manuscript Forms

Depending on whether the insurer can use a form already created or must create a new form for a customer, the policy can be either a preprinted form or a manuscript form.

Most insurers use standard preprinted policy forms, because it is not necessary to negotiate new contractual terms for each policy purchased. Insurance advisory organizations, such as Insurance Services Office, Inc. (ISO) and the American Association of Insurance Services (AAIS), develop industry-wide standardized forms for different types of property-casualty insurance, and many insurers use these standard forms. Alternatively, an insurer may develop its own nonstandard, preprinted forms. For example, a person buying auto insurance may find that three small insurers are using the same ISO standard policy form but that one large insurer is using its own nonstandard, preprinted policy form for auto coverage.

When an insurer's preprinted forms do not provide the terms of coverage needed by a particular insured or a small group of insureds, the insurer (or in some cases the insured's broker) may draft a manuscript form to meet the customers' needs. For example, an insurer might develop a manuscript form to cover the unique liability exposures of a highly specialized profession. Because of the limited number of professionals requiring this coverage, insurers typically would not have preprinted forms available for that class of insureds.

Self-Contained and Modular Policies

Depending on the type and variety of coverages a customer seeks, a policy can be a single document (self-contained), or it may require a combination of documents to include all the agreements between the insured and the insurer (modular).

Coverage part

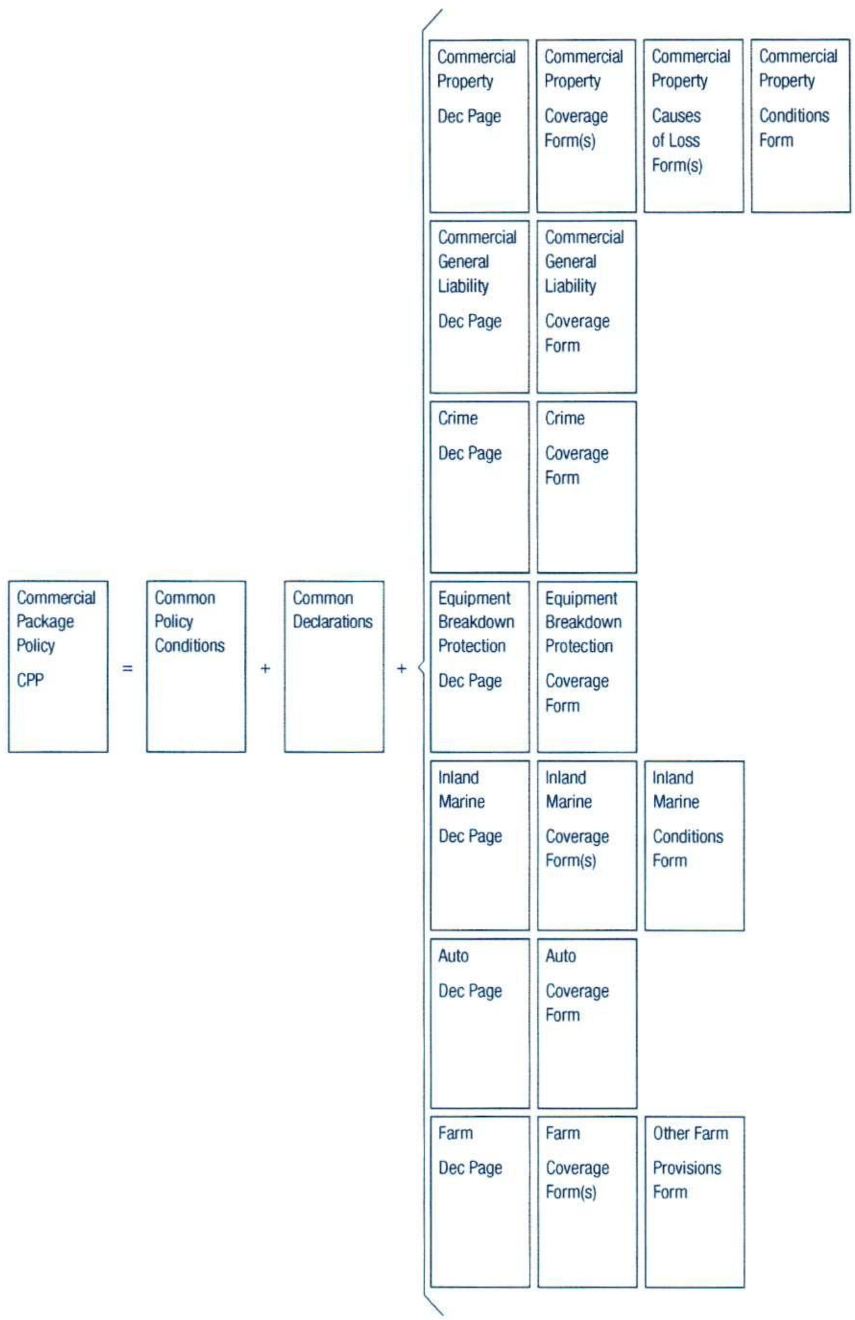
A component of a CPP or a monoline policy that contains the policy provisions relating to a particular line of business, such as commercial property or commercial general liability; consists of the coverage part's declarations page, one or more coverage forms, applicable endorsements, and in some cases a general provisions form.

If the customer seeks coverage that is common to a large number of insureds, the insurer may choose to offer a self-contained policy. A personal auto policy is an example of a self-contained policy. Because most drivers have very similar auto insurance needs, a self-contained personal auto policy serves the needs of most insureds.

Conversely, if the customer seeks a variety of coverages that may not be common to a large number of insureds, the insurer may choose to offer a modular policy to tailor a policy to an insured's specific needs.

The ISO commercial package policy (CPP) is an example of a modular policy because it combines different **coverage parts** to meet the insured's particular needs. Commercial insureds' needs can vary, depending on the type of business insured. For example, some businesses may need commercial auto coverage, and others may not. See the exhibit "Components of the ISO Commercial Package Policy."

Components of the ISO Commercial Package Policy



[DA00427]

Each ISO-type CPP begins with two component documents: a set of common policy conditions and common declarations. Adding the necessary forms to make up the coverage parts that meet the insured's needs completes the policy. In most cases, a separate **declarations page** is included for each coverage part contained in the CPP.

Declarations page (declarations, or dec.)

An insurance policy information page or pages providing specific details about the insured and the subject of the insurance.

Endorsements and Other Related Documents

Documents other than insurance forms can become part of a policy either by being physically attached to, or by being referenced within, the policy. Documents that can become part of a policy are the completed application, endorsements, the insurer's bylaws, and relevant statutory terms or provisions. See the exhibit "Related Insurance Policy Documents."

Related Insurance Policy Documents

Related document	Description	Example
Application	Documented request for coverage, containing information about insured and loss exposures	Personal auto policy application containing relevant insured information pertinent to driving and vehicle(s)
Endorsements	Documents modifying basic policy form	Homeowners policy endorsement for home business coverage
Insurer's bylaws	Insurer's corporate bylaws	Attachment to policy issued by mutual insurer giving insureds corporate rights
Relevant statutory terms	Incorporation of statute by reference in policy	Workers compensation or no-fault auto insurance statutes

[DA00429]

An insurance application, the documented request for coverage, contains information about the insured and the loss exposures presented to the insurer. The insurer usually keeps the completed application in order to preserve the insured's representations. In some cases, misleading or false representations in an application can be grounds for denying a claim. Some state statutes require that any written application become part of the policy for some types of insurance.

Endorsement

A document that amends an insurance policy.

An **endorsement** adds to or modifies an insurance policy. An endorsement may be a few words handwritten into a policy, or it may be a separate document of one or more pages—preprinted, computer-printed, typewritten, or handwritten—that is attached to the policy.

An endorsement's provisions may conflict with the provisions of the policy to which the endorsement is attached. For example, a preprinted policy form may contain an exclusion, and an endorsement attached to the policy may delete the exclusion. If the policy and the endorsement contain conflicting terms, the endorsement takes precedence. Agreements between an insurer and insured, particularly handwritten alterations, tend to reflect true intent more accurately than do other, preprinted policy terms.

Some insurance contracts incorporate the insurer's bylaws or pertinent statutory provisions. For example, mutual and reciprocal insurance policyholders typically have rights and duties associated with managing the insurer's operations; the policy specifies these rights and duties by incorporating corporate documents.

Policies providing workers compensation insurance or auto no-fault insurance are among those that provide benefits required by state statutes. The insurance policy usually does not contain the relevant statutes but incorporates them by reference. For example, a standard workers compensation policy issued by the National Council on Compensation Insurance (NCCI) contains the following statement instead of detailing the types and amounts of benefits payable:

> We will pay promptly when due the benefits required of you by the workers compensation law.

Apply Your Knowledge

BNY Company has unique property and liability loss exposures that are not adequately insured under standard property-casualty insurance policies. What type of property-casualty policy would be the best solution for BNY?

a. Self-contained policy
b. Modular policy
c. Manuscript policy
d. Preprinted policy

Feedback: c. Because BNY Company has unique loss exposures, a manuscript policy would enable the insurer to draft a one-of-a-kind policy to address BNY's insurance needs.

POLICY PROVISIONS

Policy provisions are insurance policy statements communicating the terms of the insurer's and insured's coverage agreements. They describe and clarify the insurance policy's coverage, the types of losses the policy does not cover, and the parties' contractual responsibilities.

Policy provisions
Any phrase or clause in an insurance policy that describes the policy's coverages, exclusions, limits, conditions, or other features.

Each **policy provision** typically fits within one of six categories, depending on the provision's purpose. Some policy provisions appear in policy sections matching the provision's category, such as a definition located in the policy's definitions section. Other policy provisions may be interspersed throughout the policy.

Common policy provisions fall within these six categories:

- Declarations
- Definitions
- Insuring agreements
- Conditions
- Exclusions
- Miscellaneous provisions

Declarations

An insurance policy first must identify the parties to the contract. Information specific to the policy, such as the insurer's and insured's names and locations and the subject of insurance, usually appear on the policy's first page, typically called the declarations page, or simply the declarations. See the exhibit "Categories of Property-Casualty Insurance Policy Provisions."

The purpose of the declarations is to personalize a policy and tailor it to fit a particular policyholder's needs. The declarations contain (declare) information about the insured from the insurance application. They also summarize the coverage provided under the policy, along with other information unique to the policy. See the exhibit "Homeowners Policy Declarations."

Categories of Property-Casualty Insurance Policy Provisions

Category	Description	Effect on Coverage
Declarations	Unique information on the insured; list of forms included in policy	Outline who or what is covered, and where and when coverage applies
Definitions	Words with special meanings in policy	May limit or expand coverage based on definitions of terms
Insuring Agreements	Statements containing insurer's promise to make payment	State circumstances under which the insurer agrees to pay
Conditions	Qualifications on promise to make payment	Outline steps insured needs to take to enforce policy
Exclusions	Provisions stating what the insurer will not cover	Eliminates coverage for excluded persons, places, things, or actions
Miscellaneous Provisions	Wide variety of provisions that may alter policy	Deal with the relationship between the insured and the insurer or establish procedures for implementing the policy

[DA00443]

The declarations page typically contains these items:

- Policy number
- Policy inception and expiration dates
- Insurer's name
- Producer's name
- Named insured (policyholder's name)
- Named insured's mailing address
- Physical address and description of covered property or operations
- Numbers and edition dates of all attached forms and endorsements
- Dollar amounts of applicable policy limits
- Dollar amounts of applicable deductibles
- Names of persons or organizations whose additional interests the policy covers (such as mortgagees, loss payees, or additional insureds)
- Premium amount
- Any optional coverages the applicant has chosen

Policy forms or endorsements also may contain information that qualifies as declarations, often in the form of **scheduled coverage**. For example, a hom-

Scheduled coverage
Insurance for property specifically listed (scheduled) on a policy, with a limit of liability for each item.

eowner might want increased limits of theft coverage for antique silverware stored in the home. A policy endorsement would list the details for such increased limits in a personal property schedule.

Homeowners Policy Declarations

Homeowners Policy Declarations

POLICYHOLDER: (Named Insured) David M. and Joan G. Smith
216 Brookside Drive
Anytown, USA 40000

POLICY NUMBER: 296 H 578661

POLICY PERIOD: **Inception:** March 30, 20XX
Expiration: March 30, 20XX

Policy period begins 12:01 A.M. standard time at the residence premises.

FIRST MORTGAGEE AND MAILING ADDRESS:

Federal National Mortgage Assn.
C/O Mortgagee, Inc.
P.O. Box 5000
Businesstown, USA 55000

We will provide the insurance described in this policy in return for the premium and compliance with all applicable policy provisions.

SECTION I COVERAGES	LIMIT
A—Dwelling	$ 120,000
B—Other Structures	$ 12,000
C—Personal Property	$ 60,000
D—Loss of Use	$ 36,000

SECTION I DEDUCTIBLE: $ 250
(In case of loss under Section I, we cover only that part of the loss over the deductible amount shown above.)

SECTION II COVERAGES	LIMIT	
E—Personal Liability	$ 300,000	Each Occurrence
F—Medical Payments to Others	$ 1,000	Each Person

CONSTRUCTION: Masonry Veneer **NO. FAMILIES:** One **TYPE ROOF:** Approved

YEAR BUILT: 1990 **PROTECTION CLASS:** 7 **FIRE DISTRICT:** Cook Township

NOT MORE THAN 1000 FEET FROM HYDRANT

NOT MORE THAN 5 MILES FROM FIRE DEPT.

FORMS AND ENDORSEMENTS IN POLICY: HO 00 03, HO 04 61

POLICY PREMIUM: $ 350.00 **COUNTERSIGNATURE DATE:** **AGENT:** A.M. Abel

Definitions

Most insurance policies contain a definitions section defining policy terms to help clarify real or perceived ambiguity. This section is usually located near the beginning or the end of a policy.

A policy's definitions section defines words and expressions having specific meaning within the policy. In some policies, defined words may appear in boldface or within quotation marks every time the policy uses them with the specified meaning.

Insuring Agreements

The purpose of an **insuring agreement**, which often follows the declarations and sometimes follows the definitions section, is to state in broad terms the insurer's promises to the insured. A policy providing more than one coverage can have more than one insuring agreement. For example, the Personal Auto Policy (PAP) contains provisions for liability, medical payments, uninsured motorists, and physical damage coverages, and each coverage has its own insuring agreement.

Insuring agreement

A statement in an insurance policy that the insurer will, under described circumstances, make a loss payment or provide a service.

An insuring agreement usually introduces a coverage section, but it also can introduce other policy sections, such as coverage extensions, additional coverages, and supplementary payments.

An insuring agreement introducing a coverage section broadly states what the insurer agrees to do under the policy, subject to clarification in other parts of the policy, such as the policy definitions. Insuring agreements usually contain one or more defined terms crucial to understanding the coverage.

Conditions

A policy's **conditions** section clarifies the insurer's and insured's duties, rights, and options. Some policy conditions are included in a policy's conditions section; others may be found in the forms, endorsements, or other documents that together make up the entire insurance policy.

Condition

Any provision in an insurance policy that qualifies an otherwise enforceable promise of the insurer.

The insured must comply with conditions for a policy to cover a loss. The insurer is obligated to perform its promise only if the insured has fulfilled its contractual duties as specified in the policy conditions.

The insurer's obligations, as stated in the insuring agreement, may include these duties:

- To pay covered losses
- To defend the insured from lawsuits
- To provide other services to the insured

The insured's obligations, which stem from the policy conditions, include these:

- To pay premiums
- To report losses promptly
- To provide appropriate documentation for losses
- To cooperate with the insurer, as in legal proceedings, for example
- To refrain from jeopardizing an insurer's rights to recover from responsible third parties (subrogate)

If the insured fails to perform these duties, the insurer might be released from its policy obligations.

Exclusions

Exclusion

A policy provision that eliminates coverage for specified exposures.

Exclusions are policy provisions that state what the insurer will not cover. The primary function of exclusions is not only to limit coverage but also to clarify the coverages granted by the insurer.

An exclusion can serve one or more of these purposes:

- Eliminate coverage for uninsurable loss exposures—Some loss exposures are not generally insurable. Exclusions allow insurers to eliminate coverage for causes of loss that are difficult to insure, such as war, earthquake, or flood.
- Assist in managing moral hazards—Exaggerated or intentionally caused losses for the purpose of collecting insurance proceeds may be the result of moral hazards such as poor financial condition or a history of dishonesty. Exclusions help insurers minimize loss exposures that are affected by moral hazards.
- Assist in managing morale hazards—Losses often arise from carelessness or indifference because an individual is insured, reflecting morale, or attitudinal, hazards. Exclusions help insurers minimize loss exposures that are affected by morale hazards.
- Reduce the likelihood of coverage duplications—Sometimes two types of insurance policies may cover the same loss. Exclusions ensure that policies work together to provide complementary, but not duplicate, coverages.
- Eliminate coverages that the typical insured does not need—Exclusions can allow insurers to exclude coverage for loss exposures that typical insureds do not face. These exclusions eliminate the possibility that all insureds would have to share the costs of covering substantial loss exposures of relatively few insureds. For example, a policy might exclude coverage for destruction of a motorboat, because many insureds do not own motorboats. Watercraft policies or endorsements can provide coverage for this loss exposure.
- Eliminate coverages requiring special treatment—These coverages might require rating, underwriting, risk control, or other treatment that differs

from that normally applied to the policy. An example is workers compensation coverage, which is normally provided in a self-contained policy.

- Assist in keeping premiums reasonable—Exclusions allow insurers to decline loss exposures that would increase overall insurance costs. By excluding such loss exposures, insurers can offer less costly premiums.

Exclusions typically appear in the exclusions section of the policy, but they may be contained in other policy sections, such as insuring agreements or definitions.

Miscellaneous Provisions

Insurance policies often contain miscellaneous provisions that do not qualify strictly as declarations, definitions, insuring agreements, conditions, or exclusions. Miscellaneous provisions may deal with the relationship between the insured and the insurer or may help establish procedures for implementing the policy. Miscellaneous provisions may affect coverage but do not have the force of conditions. Consequently, if the insured does not follow procedures specified in miscellaneous provisions, the insurer typically still must fulfill its contractual promises.

Apply Your Knowledge

Carol, an insurance agent, is analyzing an insurance policy that contains this provision:

> We cover (a) the dwelling on the "residence premises" shown in the declarations, including structures attached to the dwelling; and (b) materials and supplies located on or next to the "residence premises" used to construct, alter or repair the dwelling or other structures on the "residence premises".

This provision is best described as which of these?

a. Declarations

b. Insuring agreement

c. Condition

d. Miscellaneous provision

Feedback: b. The provision is an insuring agreement because it states that the insurer will cover the described types of property.

PROPERTY POLICY PROVISIONS

Insurance professionals must understand the provisions contained in property insurance policies because understanding these provisions is the foundation for developing essential policy-related skills, such as recommending appropriate property coverages and determining whether property policies cover particular claims.

A property insurance policy indemnifies an insured who suffers a financial loss because property has been lost, stolen, damaged, or destroyed. Generally, the policy must identify which property loss exposures are covered—that is, the types and locations of property, causes of loss, and financial consequences that are covered. Policies must also indicate which parties are covered and how much an insurer will pay in the event of a loss.

Covered Property

An insurance policy specifies what property is covered. Covered property is often described broadly and then refined through a series of limitations and exclusions. Exclusions and limitations are not the same thing; while exclusions eliminate all coverage for excluded property or causes of loss, limitations place a specific dollar limit on specific property that is covered.

In personal insurance, a residential structure is generally called a dwelling and is usually covered under a homeowners policy. A typical policy on a dwelling covers the residence premises. Usually, the policy definition of residence premises also includes other structures attached to the dwelling and materials located on or next to the dwelling used to construct, alter, or repair the residence premises. A freestanding, detached garage is not part of the dwelling. A separate insuring agreement for other structures covers such detached items. The coverage for the residence premises does not apply to land.

In commercial insurance, a permanent structure with walls and a roof is usually called a building. Other outdoor structures such as carports, antenna towers, and swimming pools are not considered buildings, but they can also be insured. A typical commercial property policy covers the building or structure described in the declarations. The policy definition of "building" may include additions that are either completed or under construction, as well as materials and supplies used for constructing the additions. Permanently installed fixtures, machinery, and equipment are also included as part of the building.

Personal property is another type of property covered by property insurance policies. Although buildings and personal property can be insured with the same policy, they are usually treated as separate coverage items.

Commercial property insurance policies usually refer to the contents of buildings as business personal property, which includes personal property of the insured located in or on the building described in the declarations, such as furniture, equipment, and stock.

Property insurance policies usually clarify what property is covered by listing property that is not covered. For example, policies that cover buildings and personal property typically show autos as property not covered because autos are more appropriately covered under auto insurance policies.

Property insurance policies often provide coverage for property that is owned by someone other than the insured. Homeowners policies provide coverage for the personal property of others, such as guests or employees, while the property is in the insured's home. Commercial property policies generally include limited coverage for the personal effects of officers, partners, and employees as well as for the personal property of others while it is in the care, custody, or control of the insured. The personal auto policy provides coverage for damage to a borrowed auto if the owner of the borrowed auto does not have physical damage coverage.

Covered Locations

Buildings are covered at the fixed location stated in the policy. However, in some instances, buildings do not necessarily remain at a fixed location. Portions of a building may be removed from the premises for repair or storage. For example, screens may be removed from the building's windows and placed in storage during the winter while storm windows are being used.

Some property insurance policies cover personal property that may not remain at a fixed location. For example, homeowners policies cover personal property of the insured while it is anywhere in the world. Auto insurance policies typically provide coverage while the insured's auto is in the United States, its territories and possessions, Puerto Rico, or Canada. Commercial property insurance policies are more restrictive; they typically provide coverage for the insured's business personal property while it is in the insured building or within 100 feet of the building. Commercial property policies often include a coverage extension that provides a certain limit, such as $10,000, of coverage for property off-premises; this extension, however, applies only to losses that occur in the specified policy territory, which is typically the U.S. and Canada.

A property insurance policy for covering personal property that moves from one place to another is often called a **floater** because it provides coverage that floats, or moves, with the property as it changes location. Policies covering movable property may have territorial limits such as the U.S. and Canada, or they may provide broader territorial limits such as "anywhere in the world." When insuring satellites or other property sent into outer space, a policy may cover property "anywhere."

Floater

A policy designed to cover property that floats, or moves, from location to location.

Covered Causes of Loss

Examples of covered causes of loss include fire, lightning, windstorm, hail, and theft. Many property insurance policies list their covered causes of loss. Such policies are commonly known as **named perils** policies because they name or list the covered perils. Usually, these policies also list the causes of loss that are excluded from coverage. Other policies cover all causes of loss except those that the policy specifically excludes. These policies are known by several different terms, including **special form or open perils policies**. The term "open perils" is used here.

Named peril

A specific cause of loss listed and described in an insurance policy. Also used to describe policies containing named perils.

Special form, or open perils policy

A policy that provides coverage for any direct loss to property unless the loss is caused by a peril specifically excluded.

insurance policies must specify which financial consequences of a property loss are covered and which are not.

Direct loss

A reduction in the value of property that results directly and often immediately from damage to that property.

A reduction in the value of property is a **direct loss**. If the property is not restored, it is not worth as much after the loss as it was before. Homeowners policies and commercial property policies both provide coverage against direct physical loss to covered property by a covered cause of loss.

Time element loss (indirect loss)

A loss that arises as a result of damage to property, other than the direct loss to the property.

Net income

The difference between revenues (such as money received for goods or services) and expenses (such as money paid for merchandise, rent, and insurance).

Another covered financial consequence is lost income, often referred to as **time element losses or indirect losses**. The longer a property is unusable, the greater the time element loss. Business income insurance protects a business from income lost because of a covered direct loss to its building or personal property. Coverage is provided for the reduction in the organization's **net income** that results from damage by a covered cause of loss to the property at the insured's location.

Homeowners policies also provide coverage for lost income. When a covered cause of loss damages the part of a residence that an insured rents or holds for rental to others, "fair rental value" coverage in the homeowners policy indemnifies the insured for the loss of rental income until the rented portion of the residence is restored to livable condition.

Extra expenses

Expenses, in addition to ordinary expenses, that an organization incurs to mitigate the effects of a business interruption.

Additional living expense

A coverage in homeowners policies that indemnifies the insured for the additional expenses that are incurred following a covered property loss so that the household can maintain its normal standard of living while the dwelling is being restored.

Extra expenses are another covered financial consequence. The reason a business incurs extra expenses after experiencing a direct property loss is to continue its operations, which may also reduce the business income loss. **Additional living expense** coverage in homeowners and other policies covering dwellings is another example of extra expense coverage that applies if a direct loss to a dwelling makes it uninhabitable.

Covered Parties

Named insured

A person, corporation, partnership, or other entity identified as an insured party in an insurance policy's declarations page.

Although a property insurance policy is a contract between the insurer and the **named insured**, the named insured is not always the only party that can recover in the event of an insured loss. Depending on the policy terms and conditions, property insurance can protect the insured and sometimes other parties that have an insurable interest in the property and that suffer a financial loss because covered property is lost, damaged, or destroyed.

Persons or organizations with an insurable interest in property can include property owners, secured lenders, users of property, and other holders of property. Insurance policies are written to cover these persons and organizations:

- The owner of a building is the named insured on a property insurance policy covering the building. Because the owner does not also occupy the building, typically there is no separate personal property of the owner's to insure at the building location.
- A party that owns and occupies a building is the named insured on a policy covering both building and personal property.

- A tenant occupies and uses rented space in a building and is therefore the named insured on a property insurance policy covering the tenant's personal property in that rented portion of the building.
- A secured lender, the party that provided funds to help finance purchase of an insured property, is usually not a named insured but is listed by name in the declarations (or in an endorsement) as a mortgagee or a **loss payee**.
- A bailee is the named insured on a bailee policy, which covers property of others that is in the bailee's custody.

Loss payee

A party entitled to share in whatever loss payment an insured receives.

Amounts of Recovery

When covered property is damaged by a covered cause of loss, how much will an insurer pay to an insured with an insurable interest? Any insurance policy providing property coverage must clearly address that question. The answer depends on policy provisions in these categories:

- Policy limits
- Valuation provisions
- Settlement options
- Deductibles
- Insurance-to-value provisions
- "Other insurance" provisions

When buying property insurance, the applicant usually requests a certain policy limit, which is the dollar amount of coverage. If the insurer agrees to provide that amount of coverage, the policy limit is established and the applicable policy limit is entered in the policy declarations.

A policy limit has several purposes. It tells the insured the maximum amount of money that can be recovered from the insurer after a loss. By comparing the policy limit to the value that may be lost, the insured can determine whether the amount of insurance is adequate. The policy limit is also important because it allows insurers to keep track of their overall obligations in any one geographic area and because the premium charged is directly related to the policy limit for most property insurance coverages.

Valuation provisions are used to set a value on covered property. The two most common valuation approaches in property insurance policies are replacement cost and actual cash value. A third approach, used for certain types of property, involves agreed value.

An insurer generally has these three settlement options when settling a loss:

- Paying the value (as determined by the valuation provision) of the lost or damaged property
- Paying the cost to repair or replace the property (if repair or replacement is possible)
- Repairing, rebuilding, or replacing the property with other property of like kind and quality instead of paying money

Deductible

A portion of a covered loss that is not paid by the insurer.

Property insurance policies usually contain a **deductible** provision, which serves several functions. Deductibles encourage the insured to try to prevent losses because the insured will bear a part of any loss. Shifting the cost of small claims to the insured also enables the insurer to reduce premiums. Handling claims for small amounts often costs more than the dollar amount of the claim. Thus, deductibles enable people to purchase coverage for serious losses at a reasonable price without unnecessarily involving the insurer in small losses.

Insurance-to-value provision

A provision in property insurance policies that encourages insureds to purchase an amount of insurance that is equal to, or close to, the value of the covered property.

Coinsurance

An insurance-to-value provision in many property insurance policies providing that if the property is underinsured, the amount that an insurer will pay for a covered loss is reduced.

Many property insurance policies include **insurance-to-value provisions**. Although total losses are much less frequent than partial losses, they do occur, and it is good risk management for property owners to insure their property for its full value. Accordingly, insurers develop property insurance rates on the assumption that all policyholders will insure their property to at least 80 percent of its full value. If policyholders do not insure their property to that level, use of the insurer's property rates will result in premiums that are inadequate to cover all losses that the insurer must pay. Consequently, insurers encourage their insureds to buy insurance to value or to insure to a high percentage of the property's value. The traditional approach to encouraging insurance to value is to include a **coinsurance** provision in the policy.

In some cases, more than one insurance policy provides coverage for the same item of property, which can trigger "other insurance" provisions in either policy. If two or more insurers paid in full for the same loss, the insured could profit from the loss, violating the principle of indemnity. Most policies contain an "other insurance" provision to deal with this potential problem. When more than one policy covers a loss, the amount paid by each policy depends on the allocation procedure specified in the "other insurance" provisions of the policies.

LIABILITY POLICY PROVISIONS

Insurance professionals must understand the provisions contained in liability insurance policies because understanding these provisions is the foundation for developing essential policy-related skills such as recommending appropriate liability coverages and determining whether liability policies cover particular claims.

The insuring agreements of most policies that provide liability insurance make essentially the same promise: to pay damages (usually for bodily injury or property damage) for which an insured becomes legally liable and to which the coverage applies. The insurer also promises to pay related defense costs. To clarify the intent of the insuring agreement, which is usually a relatively brief statement, the provisions of a liability insurance policy must address the covered activities, covered types of injury and damage, excluded loss exposures, covered costs, covered time period, covered parties, and amounts of recovery.

Covered Activities

Property insurance claims usually involve only two parties: the insurer and the insured. Liability insurance claims involve three parties: the insurer, the insured, and a third party. The third party is the claimant making a claim against the insured for injury or damage allegedly caused by the insured. Although the claimant is not a party to the insurance contract, he or she is a party to the claim settlement. Under a liability policy, the insurer will pay damages only to those third parties who suffer injury or damage for which the insured is legally liable if the harm arose from a covered activity.

Liability insurance policies use two approaches to defining covered activities. Certain policies state the specific activity or source of liability covered, such as an auto insurance liability policy stating that it applies to claims that result from covered auto accidents. General liability insurance, in contrast, covers all activities or sources of liability that are not specifically excluded.

A commercial general liability (CGL) policy is an example of a policy that provides general liability insurance. The insurer agrees to pay damages "to which this insurance applies." However, the extent of coverage depends to a large degree on the exclusions. That is, general liability policies essentially cover those claims that are not excluded. General liability insurance policies specifically exclude coverage for claims that are better handled by other liability insurance policies, such as automobile liability, workers compensation, aircraft liability, watercraft liability, and professional liability. Exclusions dealing with difficult-to-insure exposures, losses expected or intended by the insured, and loss exposures that would be too costly to insure are also contained in general liability policies. For example, nearly all liability policies exclude coverage for losses that arise from war and nuclear hazard.

Covered Types of Injury or Damage

Liability policies typically cover claims for bodily injury and property damage for which the insured is legally liable. Other types of injury may also be covered; for example, the CGL policy also covers personal and advertising injury.

Bodily Injury

Bodily injury

Physical injury to a person, including sickness, disease, and death.

The standard CGL policy describes "**bodily injury**" as bodily injury, sickness, or disease sustained by a person, including death resulting from any of these at any time. This description indicates that, as used in the CGL policy, the term includes some things that may not be included in its everyday use. Sickness and disease are often considered forms of illness that do not involve injury. Death could be considered the severest form of injury, but unless it is specified in the policy, the applicability of bodily injury liability coverage may be questioned.

Property Damage

Property damage

Physical injury to, destruction of, or loss of use of tangible property.

In typical CGL and homeowners policies, **property damage** includes physical injury to tangible property and loss of use of tangible property, whether or not it is physically injured. The definition of "property damage" in a typical CGL policy also specifies that data are not tangible property.

Thus, according to both CGL and homeowners policies, property damage includes both direct losses and time element (or indirect) losses sustained by the claimant. For example, a fire at a store in a strip mall can cause indirect loss to the owners of surrounding businesses if they have to cease operations despite the fact that there might not be direct physical damage to their properties.

Personal and Advertising Injury

Personal injury

Injury, other than bodily injury, arising from intentional torts such as libel, slander, or invasion of privacy.

In addition to bodily injury, harm can be inflicted in ways such as damage to one's reputation. Although attorneys tend to use the term "personal injury" when referring to bodily injuries, in liability insurance policies, **personal injury** usually refers to a specific group of intentional torts. For insurance purposes, intentional torts are usually considered personal injury offenses and are either excluded from coverage or are covered separately.

Advertising injury, which is covered by most CGL policies, typically includes libel and slander; publication of material that constitutes an invasion of privacy; misappropriation of advertising ideas or business style; and infringement of copyright, trade dress, or slogan.

Because the definitions of personal injury offenses and advertising injury offenses overlap somewhat, current versions of the CGL policy include both personal and advertising injury in the same insuring agreement to avoid duplication of coverage. Coverage for personal injury liability (but not advertising injury) also can be added by endorsement to a homeowners policy.

Excluded Loss Exposures

No insurance policy can reasonably cover all loss exposures. The exclusions in liability insurance policies generally follow these broad guidelines:

- Avoid covering uninsurable losses. For example, war is a catastrophic event that is not economically feasible to insure.
- Avoid insuring losses that occur because of illegal activities, such as distribution of illegal drugs.
- Eliminate duplicate coverage provided by policies specifically designed to address particular exposures. For example, watercraft liability and aircraft liability are excluded under CGL policies and the liability section of homeowners policies.
- Eliminate coverage that most insureds do not need. For example, racing exclusions appear in personal and commercial automobile policies.
- Eliminate coverage for exposures that require specialized coverages and underwriting. The homeowners policy excludes coverage for professional services, such as those provided by physicians, architects, and lawyers.
- Keep premiums reasonable. For example, commercial liability policies generally exclude all but limited exposures from pollution. Businesses with more serious pollution liability exposures must purchase specialty policies to cover those exposures. If broad pollution coverage were provided under all liability policies, the coverage would not be affordable.

Covered Costs

Liability insurance policies typically cover these two types of costs:

- The damages that the insured is legally liable to pay
- The cost of defending the insured against the claim

In addition, liability policies commonly cover incidental expenses under the policy's supplementary payments provision and cover medical payments for injured persons, regardless of whether the insured is legally liable.

Damages

The CGL policy typically contains two insuring agreements that express the insurer's promise to pay damages on behalf of the insured:

> Coverage A: Bodily Injury and Property Damage Liability
>
> We agree to pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies.
>
> Coverage B: Personal and Advertising Injury Liability
>
> We agree to pay those sums that the insured becomes legally obligated to pay as damages because of "personal and advertising injury" to which this insurance applies.[1]

A person who has suffered bodily injury, property damage, or personal and advertising injury for which the insured is allegedly responsible may make a claim for damages. The claim is most often settled out of court. Generally, out-of-court settlements, with the insurer paying the claimant on behalf of the insured, are attractive to both sides because they resolve cases quickly, spare the parties financial and emotional costs, and eliminate uncertainty about the outcome of a claim. In exchange for payment, the third party signs a **release**.

Release

A legally binding contract between the parties to a dispute that embodies their agreement, obligates each to fulfill the agreement, and releases both parties from further obligation to one another that relates to the dispute.

If a case goes to court, the claimant may be awarded two types of damages: compensatory damages and punitive damages (exemplary damages). Most liability insurance policies do not state whether punitive damages are covered. Some states do not permit insurers to pay punitive damages because the punishment is viewed as less effective if the responsible party does not personally pay the required damages. However, insurers will pay punitive damages if allowed by the state and not excluded by the policy.

Insurers, the court system, and society favor out-of-court settlements in general. Claim costs would soar if insurers had to resolve all liability claims through the courts, and the courts would be overwhelmed with cases and expenses. Society benefits when injured parties receive prompt compensation and when all parties put their legal disputes behind them.

Defense Costs

An insurer's duty to defend insureds against liability claims is often more important than its duty to pay damages. If the defense is successful, the court may award no damages or a smaller amount of damages. Most courts in the United States interpret the insurer's duty to defend as requiring the insurer to pay the costs of defending an insured against any claim or lawsuit, even those without a legitimate basis, whenever a claimant's allegations (if proved) would be covered under the policy.

The insurer's duty to defend implies that the insurer will retain the attorneys and pay their fees and expenses. The insurer is also responsible for the costs of investigation, legal research, expert witness fees, and similar costs incurred in preparing and presenting the case.

Supplementary payments

Various expenses the insurer agrees to pay under a liability insurance policy (in addition to the liability limits) for items such as premiums on bail bonds and appeal bonds, loss of the insured's earnings because of attendance at trials, and other reasonable expenses incurred by the insured at the insurer's request.

Prejudgment interest

Interest that may accrue on damages before a judgment has been rendered.

Postjudgment interest

Interest that may accrue on damages after a judgment has been entered in a court and before the money is paid.

Medical payments coverage

Coverage that pays necessary medical expenses incurred within a specified period by a claimant (and in certain policies, by an insured) for a covered injury, regardless of whether the insured was at fault.

Supplementary Payments

Liability insurance policies typically include a **supplementary payments** section describing various expenses that the insurer agrees to pay in addition to liability limits. Other costs that relate to the claim may also be included in the list of supplementary payments. Two examples are **prejudgment interest**, which may accrue between the time of the injury or damage and the time when a court awards a judgment to the claimant, and **postjudgment interest**, which accrues when an appeal to a higher court delays the payment of the judgment.

Medical Payments

Liability policies may also provide **medical payments coverage**, which can help avoid larger liability claims. If a homeowners policy includes $1,000 of medical payments coverage, for example, a neighbor injured on the insured's property can receive emergency medical treatment up to that amount without having to sue the insured to recover the cost. In homeowners policies, this coverage is called "medical payments to others" and does not cover injuries to an insured or regular residents of his or her household. In personal auto policies, medical payments coverage does cover an insured's injuries, up to a specified limit.

Covered Time Period

Personal auto insurance is often written for a six-month term, but other types of liability insurance are usually written for a one-year period. Depending on the type of liability insurance policy, coverage is usually "triggered" by either of these situations:

- Injury or damage that occurs during the policy period (in an occurrence basis policy)
- Claims made (submitted) during the policy period (in a claims-made policy)

From the insured's standpoint, **occurrence basis coverage** offers valuable protection for unknown and unforeseen claims. For example, if the claimant was injured in an automobile accident caused by the insured only a few hours before the policy period expired, the resulting claim would be covered, even if the claim is not submitted until after the policy expired. For the insurer, however, occurrence basis coverage means that liability claims may surface long after a policy has expired. This particular problem contributed to the development of claims-made coverage.

Occurrence basis coverage

Coverage that is triggered by the actual happening of bodily injury or property damage during the policy period.

Although personal liability insurance policies and most commercial general liability insurance policies are written on an occurrence basis, **claims-made coverage** is sometimes used to insure businesses that face certain types of liability loss exposures, such as medical malpractice, professional liability, or liability for especially hazardous products. Under such a liability policy, the covered event must occur on or after a specified date (called a **retroactive date**) and before the end of the policy period.

Claims-made coverage form

A coverage form that provides coverage for bodily injury or property damage that is claimed during the policy period.

Retroactive date

The date on or after which bodily injury or property damage must occur (or a personal and advertising injury offense must be committed) in order to be covered.

Covered Parties

Liability insurance policies provide coverage for the named insured and others. A liability policy generally gives the broadest protection to the named insured. Coverage for others is generally based on their family or business relationship with the named insured. Therefore, liability insurance policy provisions must define the relationships that determine coverage. For example, the liability coverage of a typical homeowners policy applies to the named insured and these persons:

- The named insured's spouse, if the spouse is a resident in the household
- Relatives of the named insured or spouse, if the relatives reside in the household
- Full-time students who were residents before moving out to attend school, if under twenty-four and a relative or under twenty-one and in the care of an insured

Commercial liability policies also cover the named insured and certain others, depending on their relationship to the named insured. For example, one provision usually contained in a CGL policy defines others who may be covered because of their business relationship to the named insured and the circumstances under which they are covered. The parties who are insureds under this provision include these:

- The named insured's employees and volunteer workers
- Real estate managers for the named insured
- Any organization that is newly acquired or formed by the named insured for up to a certain number of days after it is acquired or formed

If several named insureds are listed in the declarations of a commercial liability policy, a policy provision usually stipulates that the first named insured is the insured with whom the insurer has contact for payment of premiums, claim reporting and claim payment, notices of cancellation or nonrenewal, or interim policy changes.

Amounts of Recovery

When a liability claim is covered, an insurer does not necessarily pay the full amount of the judgment awarded. The extent of the insurer's payment depends on these policy provisions:

- Policy limits
- Defense cost provisions
- "Other insurance" provisions

Policy Limits

Predicting the dollar amount of liability insurance needed to cover an insured's future claims can be difficult. Legal obligations depend on uncertain future events in a changing legal environment. Still, it is necessary for the insured and the insurer to agree on some dollar amount of coverage. As with property insurance, policy limits help an insurer measure the extent of its obligation. Limits also provide options to the insured, who must decide not only how much coverage is desirable but also how much is affordable. Liability insurance limits are generally round numbers such as $100,000, $500,000,

Defense Cost Provisions

Most liability policies place no dollar limit on the defense costs payable by the insurer. The only limitation is that the insurer is not obligated to provide further defense once the entire policy limit has been paid in settlement or judgment for damages. Stated differently, defense costs are usually payable in addition to the policy limits, and policy limits include only payment for damages. Some liability policies place defense costs within the overall policy limit. In such policies, for example, if the policy limit is $100,000 and the insured has a covered claim involving damages of $90,000 and defense costs of $30,000, the insurer would pay a total of $100,000 for both the damages and the defense. The insured would be responsible for the additional $20,000.

"Other Insurance" Provisions

In some cases, two or more policies may cover the same claim. Liability insurance policies contain "other insurance" provisions to resolve this problem and preserve the principle of indemnity. Several approaches can be used, and the applicable approach depends on the wording of the policies, which, depending in the facts of the situation, usually provides a formula for sharing the cost of damages.

SUMMARY

A valid insurance contract has four essential elements:

- Agreement (offer and acceptance)
- Capacity to contract
- Consideration
- Legal purpose

If any of these elements is not satisfied, the contract is not enforceable.

Although all of the rules of contract law apply to insurance policies, certain special characteristics distinguish insurance policies from other contracts. An insurance policy is all of these:

- A contract of indemnity
- A contract of utmost good faith
- A contract involving fortuitous events and the exchange of unequal amounts
- A contract of adhesion
- A conditional contract
- A nontransferable contract

Depending on customers' coverage needs, insurers may use either preprinted or manuscript forms to assemble insurance policies, and policies may be either self-contained or modular. Various documents may either be attached to the

Index

Page numbers in boldface refer to pages where the word or phrase is defined.

D

E

F

G

H

I

J

K

L

M

V

W