

Chapter 2 Umbrella – Legal Contract

Requirements of Legal Contract

A contract is an agreement entered into by two or more parties under the terms of which one or more of the parties, for a consideration, undertakes to do or to refrain from doing some specified act or acts.

In order to be binding on the parties involved, a contract must meet these five basic requirements:

- Offer and acceptance
- Consideration
- Competent parties
- Legal purpose
- Legal form (in some cases)

Let's briefly review each of these requirements.

Offer and Acceptance

A contract is in essence an enforceable promise. In order for a valid contract to exist, there must be a valid offer and an unqualified acceptance of that offer, so that the seller understands the buyer's offer and the buyer understands to what the seller has agreed. In other words, a contract begins with a meeting of the minds.

The general rule is that it is the applicant for insurance who makes the offer, and it is the insurance company that accepts or rejects the offer. For example, the potential insured requests insurance and fills out an application for personal umbrella insurance: the application constitutes the offer. The agent then accepts the offer on behalf of his or her company. Assuming that the other requirements for a valid contract are met, the property casualty agent can usually bind coverage and make it effective immediately. However, the insurer retains the right to investigate, underwrite and cancel the coverage (as described in the policy and in accordance with state law) if the risk does not meet the company's underwriting guidelines. For example, the applicant may not have disclosed several large liability losses that would have made him or her ineligible for umbrella coverage with some insurance companies. In this case, the insurance company may decline to offer coverage. In most cases, the agent cannot bind personal umbrella liability insurance.

Consideration

The second requirement of a valid contract is consideration, which is the value that each party gives to the other. In the case of an umbrella policy, the insured's consideration is the payment of the first premium (or the promise to pay) and his or her agreement to abide by the conditions specified in the policy. The insurance company's consideration is the promise to do certain things that are specified in the policy. This includes indemnifying the insured for covered losses and defending the insured in a liability lawsuit.

It should be noted that the values of the considerations exchanged are not always equal. When the insured purchases a policy, he or she usually pays a relatively small premium in exchange for a comparably large amount of insurance protection. For example, the annual premium for a \$1 million umbrella policy might be less than \$200, a decidedly unequal exchange of values if a large loss occurs. In fact, for the benefits the insured receives, a personal umbrella policy may be the best buy in insurance. This relatively inexpensive policy raises the insured's liability coverage to a million dollars or more, and protects him or her from personal responsibility for damages.

Competent Parties

In order to be legally enforceable, a contract must be between at least two bona fide parties. A person cannot make a legally enforceable promise to himself or herself. Thus, John Doe cannot agree to sell a piece of property to himself. However, he could agree to deed the property to himself and his wife as tenants in common.

The parties involved must be legally competent in order to enter into a valid contract. Generally speaking, competent parties are adults (usually age 18 or 21, depending on the state) who are able to understand the terms and conditions of the contract into which they are entering. In some states, however, minors as young as 14 may enter into some contracts. For example, minors have limited ability to contract, which means that the contract of a minor is valid only if the minor does not disavow a contract entered into during his or her minority or shortly after reaching majority (usually age 18 or 21). For example, a minor possesses the limited capacity to enter into a valid contract to purchase property from an adult. Such a contract would be enforceable by the minor against the adult, but would be voidable by the minor. A voidable contract is an agreement that, for a reason satisfactory to the courts, may be set aside by one of the parties to the contract. Contracts made by minors to obtain such necessities as food, clothing or shelter, however, are not voidable by the minor and will be enforced against him or her.

Some entities are excluded parties to legally binding contracts. When a person has been adjudicated insane or is an officer of a corporation who is not authorized to execute a contract on behalf of the corporation, he or she has no capacity to contract. Lack of a capacity would also cover acts of a corporation beyond its powers as defined in the articles of incorporation.

Also considered incompetent is any person who is impaired by reason physical or mental disability, drugs, alcohol, age or any other cause to the extent that he or she lacks sufficient understanding or capacity to make or communicate responsible decisions concerning himself or herself. Therefore, insane and, in certain, intoxicated people are incapable of entering into valid contracts. An illiterate person, however, is not incompetent as long as he or she understands the nature of his or her acts.

Legal Purpose

In order to be enforceable, contracts must be made for some legal purpose. If the contract does not have a legitimate purpose, it would be contrary to public policy to enforce such a contract. For example, Robert may contract with another person to paint his house for a fee. Such a contract is considered legal and binding. However, Robert cannot legally contract with another person to kill his wife. Because murder-for-hire is not legal, it is not considered a valid contract and would not be enforceable in a court of law.

Legal Form

Unless otherwise required by laws, oral contracts can be just as valid as written contracts. Generally, however, an insurance contract must follow a specific legal form and must be in writing to be enforceable. All essential terms of the contract must be complete and certain so that the entire agreement is set forth in writing and nothing material to the contract is left to be agreed upon in the future. Once the policy is issued, changes may be made by endorsement, but only if the insurer agrees to the requested changes.

Knowing Policy Conditions

Insurance policies are conditional contracts that create a continuing relationship between the insured and the insurance company. In the policy's Insuring Agreement, the insurance company promises to pay on behalf of the insured those sums for which the insured is found legally responsible, to provide a defense for the insured or to furnish other services as stated in the policy. However, the insurer's promises are enforceable only if an insured peril occurs and if the insured has complied with certain conditions contained in the policy. Insureds understand that they must pay premiums in order to keep their insurance policies in force, but that is not the only thing they have to do. Additional duties are spelled out in the Conditions section of the policy.

As an insurance professional, you should review insurance policies before they are forwarded to your clients to assure that the policies have been issued as you requested. You should also discuss the policy with your client to assure that he/she understands what is covered and excluded. You should also be certain he/she is aware of his/her rights and obligations under the contracts so he/she will have fewer problems should a loss occur. We will discuss the important conditions that apply to most personal umbrella liability policies and explain how you can help your insureds to understand this important part of their insurance coverage.

Understanding Policy Conditions

All property-casualty insurance contracts are written subject to certain conditions or prerequisites. The duties of the insured are primarily listed in the Conditions section of the policy. However, other provisions that qualify the otherwise enforceable promise of the insurer may also be found elsewhere in policy forms or endorsements. As explained previously, insureds should fully understand their obligations under their policies because they cannot expect the insurance company to fulfill its part of the contract unless the insured fulfills all of the required policy conditions. Failure to do so may release the insurer from its obligations.

Most of the policy's conditions have to do with such matters as loss settlements, actions required at the time of a loss, cancellation of coverage and suits against the insurer. Under most umbrella contracts, insureds are obligated to report losses in a timely manner, provide any required documentation of losses to the insurer, cooperate with the insurer in investigating, negotiating and settling claims, and avoid any action that would risk the insurer's rights to recover from a responsible third party.

Common Personal Umbrella Conditions

Personal umbrella liability policies contain a number of conditions that describe the circumstances under which the contract is to operate. Insureds should be certain that they understand how these conditions modify, suspend or rescind the original obligations. In the Conditions section of most policies, the insurer explains that the insured must meet a number of obligations before insurance coverage will apply.

For instance, the policy might state the following:

There are certain responsibilities, which you must fulfill (in addition to paying the premium) as a condition for us to provide coverage.

Policy conditions may be classified in one of these two ways:

- A Condition Precedent
- A Condition Subsequent

Condition Precedent

A Condition Precedent is a requirement or qualification that must take place before the contract exists. For example, in a contract of insurance, the insured agrees to pay the premium and the insurer agrees to provide certain insurance coverages in return. The principal duty of the insurer is to provide this coverage, but this obligation is conditioned on the insured's payment of the premium. The failure of the insured to pay the premium (condition precedent) relieves the insurance company of its principal obligation and, in fact, nullifies or voids the contract.

Condition Subsequent

A Condition Subsequent is a requirement that must be met after the contract is in force. For example, the insured must report all accidents and potential claims to the insurer as soon as possible.

A typical clause might read in this way:

In case of a claim or "occurrence" that may be covered by this policy or if a "covered person" is sued in connection with an "injury" or "damage" which may be covered under this policy, the "covered person" must do the following:

- Promptly notify us or our agent in writing
- Promptly send us copies of any notices, legal documents and any other documents that will help us with your defense
- Cooperate with us in the investigation, settlement or defense of any claim

Assume the insured is involved in an auto accident. The insured feels he or she was not at fault, so the insurance company is not notified of the accident until a year later when the other driver files a lawsuit. Because the insured breached the contract by not notifying the insurance company "promptly," the insurer may be relieved of its obligation to defend and indemnify the insured for that particular loss. The insured's failure to comply with this policy condition does not void the entire contract. The insurer will still respond to other losses during the policy term with the same obligation to defend and indemnify the insured, provided that the insured complies with the policy's terms and conditions.

The things that an insured or other covered person must do as a condition before the insurance company will provide coverage will vary by company. Generally speaking, umbrella insurers will include conditions relating to claims notification, assignment of the policy, cancellation of coverage and legal action against the insurer.

Understanding Insuring Agreements

You'll recall that an insurance contract is an agreement entered into by two parties: the insurance company and the insured. The contract usually begins with an insuring clause (or clauses) called Insuring Agreements that outlines the insurance coverage that the company promises to provide in return for the insured's promise to pay a premium and compliance with the terms of the contract. Technically, complying with these conditions is also a part of the consideration. If a covered loss occurs but the conditions are not met by the insured, the insurer has no obligation to pay.

A rather broad Insuring Agreement might read like this:

"We will provide the insurance described in this policy if you pay the premium and comply with all the terms of the policy."

With this statement, the insurance company (one competent party) enters into a legally binding contract with the insured (a second competent party). Based on the insured's application for insurance (offer) and payment of a specified premium (consideration), the umbrella insurer agrees to provide coverage (acceptance) and issues a personal umbrella liability policy (legal form). In return for the insured's premium and promise to abide with the terms of the policy, the insurer agrees to assume many of the insured's liability loss exposures. The exact terms of the agreement are specified in the various policy provisions.

Coverage Restrictions

At first glance, Insuring Agreements like the one above might appear to cover every loss exposure. However, because it is unlikely that a company intends to provide unlimited coverage, the insurance producer should look for words or phrases in a policy's Insuring Agreements that might restrict or limit coverage. In our first example, the words insurance described in this policy are included to warn the reader to look for additional definitions, conditions, exclusions and miscellaneous provisions throughout the policy that will clarify exactly what the insurer intends to cover under the policy. The policy is not intended to cover every hazard an insured

faces. Coverage applies only as described throughout the policy.

Insurance companies may include words or phrases in their Insuring Agreements that have a special meaning as used in its personal umbrella policy. This interpretation may be quite different from that normally used by the average person. As explained previously, many insurers use boldface type, italics or quotation marks throughout the policy to identify words or phrases that may be used in a special way by the insurer. An insurance producer or insured who is uncertain about what the insurer intends to cover when a loss occurs will usually find that the intended meaning of a term is explained in the Definitions section of the policy. The definitions are included to reduce confusion about what the insurer expects to cover.

For example, the following Insuring Agreements contain a number of accented words:

The company agrees to indemnify the "insured" for "ultimate net loss" in excess of the "retained limit" which the "insured" shall become legally obligated to pay as damages because of "personal liability".

In this case, the insurer wishes to alert the insured that certain words, including "insured", "ultimate net loss", "retained limit" and "personal liability" are used in a way that may be unique to this particular company. The insurance producer and the insured should use the policy's Definitions section to determine whether these terms are used in a way that is familiar to them. Let's review how most insurance companies define these highlighted terms.

Insured

An Insured (or covered person) is defined under most personal umbrella policies as the person named in the Declarations, his or her spouse and any relatives living in the named insured's household. As mentioned earlier, some companies will limit coverage to relatives under a specified age or require that the named insured have custody of child or stepchild in order for coverage to apply. In many cases, any person insured under the named insured's basic or underlying policies is also covered under the personal umbrella.

Ultimate Net Loss and Retained Limit

The intent of an ultimate net loss provision is to limit the insurer's liability to the amount specified in the Declarations less any required retained limits, either specified underlying limits or a retained limit or self-insured retention (a form of deductible). The policy wording will usually go on to explain exactly how and when the insurer intends to make payments under the policy.

A Retained limit provision requires the insured to pay some portion of a covered loss before the umbrella policy pays. A retained limit is the larger of these:

- The total of the applicable limit(s) of all required underlying insurance required by the insurer and described in the Declarations or elsewhere in the policy and any other insurance available to a covered person

- Any deductible required by the insurer or by the state in which the insurer does business

The insured bears the risk to the extent of the uninsured amount. The retained limit or retention applies on a per loss basis to any loss covered under the umbrella policy but excluded in primary underlying policies. The retained limit does NOT apply when the umbrella is simply supplementing a primary policy that has exhausted its limits in the payment of a covered claim.

In other words, before the umbrella insurer makes any payment, the primary coverage must pay first or the insured must meet a specified deductible, such as \$250 per occurrence. There is a common misunderstanding that there is a GAP or space between the primary and the umbrella coverage. No such corridor exists. In those cases where the insured has purchased the required

underlying primary coverage, the protection applies right up to the top collar of the umbrella. In other words, if the insured has the required primary coverage, only that coverage and the umbrella coverage come into play. The insured is not out of pocket for any deductible.

Personal Liability

In most umbrella policies, the term personal liability means:

- Bodily injury, sickness, disease, disability, shock, mental anguish and mental injury
- False arrest, false imprisonment, wrongful entry or eviction, wrongful detention, malicious prosecution or humiliation
- Assault and battery, including death resulting therefrom

Many policies also include injury to or destruction of tangible property, including its loss of use.

To illustrate how an umbrella policy would indemnify an insured for a loss, assume an insured's umbrella policy specifies that its retained limits are the larger of either the minimum underlying comprehensive personal liability limits of \$300,000 or \$250. The insured's homeowners' policy has a \$300,000 limit of liability. The insured is found legally responsible for covered damages of \$500,000 when someone is injured. In this case, the primary coverage (the liability section of the homeowners' policy) pays the first \$300,000 (the retained limit) and the umbrella policy pays the remaining \$200,000. There is no corridor or gap between the primary and excess coverages and the insured pays no deductible himself or herself.

Now, assume that the insured is found legally responsible for slander in the amount of \$500,000. Coverage for personal injury damages is not provided under the homeowners' policy. However, coverage is provided under the personal umbrella, up to its policy limits of \$1 million. In this case, there is no underlying coverage so the insured must pay the first \$250 (retained limit) before the umbrella insurer is obligated to pay the remaining balance of \$499,750.

Now, assume that the insured in these examples allows the required homeowners' policy to lapse and is subsequently found legally responsible for covered damages of \$500,000 when someone is injured on his or her property. In this case, there is no primary liability coverage available. However, the personal umbrella insurer is NOT relieved of its obligation to pay even though the insured has failed to maintain the basic liability limits required as a condition of obtaining and maintaining personal umbrella liability coverage. Before the insurer pays, however, the insured, in essence, must take the place of the primary insurer and pay the amount that the primary insurer would have paid if the homeowners' coverage had been in force. The umbrella insurer then responds in the same way it would have had the primary liability insurance been in force and that is to act as the retained limit. In this case, the insured pays the first \$300,000 (the retained limit) before the personal umbrella insurer pays the remaining \$200,000. The insured does NOT pay an additional \$250 deductible.

Excess vs. Personal Umbrella Liability

Many insurance producers use the term excess personal liability insurance and umbrella insurance interchangeably. These two insurance coverages are actually quite different and should not be confused. Unlike excess liability that provides additional coverage ONLY if the underlying policy provides coverage for a loss exposure, a typical personal umbrella policy will respond in two ways.

If the listed underlying insurance coverages, such as the homeowners' policy or personal auto policy, are exhausted in the payment of a loss, the umbrella picks up the protection and continues payment on behalf of the insured until the personal umbrella's limit of liability is also exhausted.

If a loss occurs that is NOT insured under the underlying policies, because of policy exclusion or for any other reason, the personal umbrella policy will often cover a loss subject to a deductible, RETAINED LIMIT or SELF-INSURED RETENTION payable by the insured. However, the umbrella

policy does NOT cover every loss, and it should be analyzed to determine any coverage exclusions.

Required Underlying Limits

The insurer will include policy language that clearly states the types and minimum limits of liability that the insured must carry. In some policies, this provision is called MAINTENANCE OF INSURANCE OR REQUIRED UNDERLYING LIMITS.

A typical provision might read as follows:

The named insured agrees that as of the inception and for the duration of this policy (1) the following underlying insurance shall be maintained in force for at least the minimum primary limits stated hereafter, and (2) that such underlying insurance insures all residences occupied by the insured and all farms, watercraft and land motor vehicles owned, rented, hired or controlled by the named insured.

As explained earlier, an umbrella insurer does not intend to provide first-dollar coverage. Therefore, the insurer requires that certain primary insurance be in place to provide the first layer of liability coverage if a loss occurs. To illustrate how a claim involving an umbrella policy should be settled, assume the umbrella insurer requires underlying automobile liability insurance with split limits of 250/500/50 (or a combined single limit of \$500,000) and homeowners' liability coverage in the amount of \$300,000 before it will insure a personal umbrella policy for \$2 million.

The insured purchases the required policies in the required amounts, and an umbrella policy is issued. The insured is involved in an auto accident and found legally liable for the other driver's bodily injuries. Damages of \$1.3 million are awarded. The insured's auto policy pays up to \$500,000 for the covered accident and the umbrella policy pays the remaining \$800,000.

To guarantee that the applicant is aware of its underlying insurance requirements, insurers include questions about underlying limits on their umbrella applications. In addition, when the umbrella policy is issued, the Declarations page typically includes information about the insured's primary insurance coverage. The types of loss exposures, names(s) of the insurance carrier(s), policy numbers, and effective dates of coverage and limits of liability are shown. Finally, the policy will include some explanation of how a loss will be handled when the primary insurance required by the umbrella policy is in place.

Failure to Provide Underlying Limits

Although the insured is expected to supply certain underlying limits, these basic policies may be unavailable at the time of a loss for a number of reasons. For example, the insured may have allowed the primary policy to lapse or it may have been canceled for nonpayment of premium. The limits of coverage may be less than required by the umbrella insurer or may have been reduced by payments of losses. The primary insurance company may have become insolvent or it may refuse to pay a claim because a covered person has not complied with the terms of the primary policy.

As stated earlier, umbrella insurers intend to pay only for damages that exceed a retained limit. Therefore, insurers safeguard themselves by having certain coverage exclusions which will apply if the underlying insurance is missing.

For example, a policy might state this:

If your "primary insurance" has terminated, is uncollectable, or reduced, this will not void coverages. In these cases, we will pay the same manner as though your "primary insurance" was in force, collectable and with required limits, and you had fully complied with all conditions or agreements.

This provision explains the insurer's intention for provide defense, investigation, legal fees, court costs or any similar fees or costs. However, the insured becomes personally responsible for the amounts of coverage that would have been in effect if the policies had remained in force. For example, if the underlying insurance would have provided the first \$300,000 of liability coverage, the insured must pay that amount BEFORE the umbrella insurer steps in. The insurer has no legal obligation until the retained limit has been met. It should be noted, however, that the umbrella insurer retains the right to enter the matter sooner and provide a defense. This could occur when the insurer sees the opportunity to quickly settle a lawsuit that could escalate if left uninvestigated or undefended.

SUMMARY

The Insuring Agreements contain the promises the insurer makes to the insured. Some umbrella policies have relatively simple Insuring Agreements, while others include a number of definitions, exclusions and conditions within their Insuring Agreements. Regardless of the policy wording, however, the Insuring Agreements provide a general description of the circumstances under which the policy becomes applicable.

In addition to Insuring Agreements, umbrella policies contain a separate section called CONDITIONS, which enumerates the duties of the parties to the contract and, in some cases, defines the terms being used. Many conditions found in an umbrella policy, such as notice of occurrence, assignment and the cooperation of the insured, are common to most property-casualty policies. Other conditions, such as maintenance of underlying insurance and appeals, are peculiar to umbrella policies.

It is imperative that an agent and his/her insured understand these important components of an umbrella policy (or any other policy, for that matter). Not understanding what one's responsibilities are – or not knowing what the insurer is responsible for – can result in a rejected claim or a gap in coverage.

Knowing Policy Exclusions

The personal umbrella policy provides broader coverage than any underlying liability policy, but it is not intended to cover every risk that a person might face. Like other property and liability policies, the personal umbrella includes a number of provisions to clarify that certain perils are not to be covered. The wording of various provisions determines what is specifically excluded under the policy.

We will discuss a number of exclusions or coverage limitations that are commonly found in personal umbrella liability policies. Basically, policy exclusions are intended to prevent the insured from profiting from non-fortuitous losses, duplicate insurance coverage or unusual risks. To this end, a basic personal umbrella policy includes a number of exclusions that modify the policy's Insuring Agreements.

Understanding Policy Exclusions

Insurance policies contain a number of policy limitations or restrictions on specific perils, property, locations or losses for which the insurance company does not intend to provide coverage. The personal umbrella liability policy is no exception. Policy exclusions are usually listed and explained in a separate section of the policy called: "What is not covered;" or "Exclusions." The Exclusions section explains any exceptions to the policy's Insuring Agreements and clarifies the insurer's intentions by limiting or modifying certain aspects of coverage that the insurer plans to provide.

In theory, the policy language should clearly express an insurer's intentions as they might apply to a wide variety of loss situations. Unfortunately, the meaning of certain phrases may be debated, and it is not uncommon for the courts to find that coverage applies to losses that the insurer never intended to cover when the policy was developed.

In an attempt to be certain that an umbrella policy provides or limits certain coverages, an underwriter may issue an endorsement to amend, extend, or completely eliminate coverages in the basic contract.

It should be clear that, in order to determine what coverage a personal umbrella policy provides, one must study the entire policy including any endorsements and exclusions. In addition to those exclusions clearly outlined in the Exclusions section of the policy, other coverage limitations or exclusions may appear elsewhere in the policy.

Coverage restrictions may even begin with the Insuring Agreements that state

We will pay that portion of the damages for personal injury or property damage a covered person is legally responsible for which exceeds the retained limit.

This restrictive policy wording means that before the insurance company will make any payment for a claim under the personal umbrella, these certain elements must be in place:

- The insurance company will pay only its share of covered losses after certain other conditions are met.

- A covered person as defined in the policy (usually the named insured, a family member or a person using an auto, recreational vehicle or watercraft owned by the insured with the insured's permission) must have been involved in the event.

The covered person must have done something (or failed to do something) that resulted as follows:

- In personal injury, usually defined as bodily injury, sickness, disease, death, disability, false arrest, libel, slander and so on

- In property damage, usually defined as physical injury to tangible property, to another person

- The covered person must be held legally responsible or liable under law, as interpreted by the courts, for the action

The insured must meet a retained limit, usually the larger of the total applicable limits of all required underlying insurance or some set amount, such as \$250 or more, before the umbrella policy responds to the claim.

Reasons for Exclusions

An insurance company is not required to explain its rationale for incorporating various exclusions in its policy. However, exclusions are generally used to clarify what the insurer does not intend to cover. Depending on the insurance company's underwriting philosophy, provisions that eliminate coverage for specific loss exposures are included in personal umbrella policies for at least the following five reasons:

Avoid Financial Catastrophe

Exclusions help the insurer avoid financial catastrophe. The theory of insurance is that in paying the relatively small premium, each policyholder has benefited by exchanging the uncertainty of a large future loss for the certainty of a small immediate loss (the premium paid). Pooling of losses is the essence of insurance. However, risks must fulfill certain requirements before he/she can be insured. For example, the chance of loss must be calculable, which means the loss must be determinable and measurable. In addition, the loss should not be catastrophic, so insurers exclude

coverage for losses, such as from war or nuclear radiation that involves an incalculable catastrophic potential.

Limit Coverage of Non-Accidental Events

Exclusions limit coverage of non-fortuitous (non-accidental) events - The policy does not intend to provide coverage for occurrences caused by moral or morale hazards. Moral hazards are intentional acts directly attributable to the insured and caused by defects or weaknesses in human character: morale hazards include the mental attitude that may indicate a subconscious desire for a loss. The policy specifically excludes non-accidental losses that may result from these hazards. For example, if the insured intentionally runs over a pedestrian, coverage would not be provided under either the personal auto policy or the personal umbrella policy.

Insurance coverage is provided only for losses that are accidental and unintentional for two reasons. First, if intentional losses were paid, moral hazard would be increased and premiums would rise as a result. A rise in premiums could result in fewer persons purchasing insurance, thereby making prediction of future losses difficult. Second, covering intentional bodily injury or property damage is contrary to the public good.

Standardize Risk

Exclusions help to standardize the risk - If an insurance company were to assume every possible risk facing a policyholder, the insurer would soon be out of business. To prevent adverse selection, an insurance company tries to cover only those risks that meet certain company underwriting guidelines. It would be inequitable to require all insureds to share the costs of covering the significant loss exposures of a few risks. Therefore, any loss exposures that would require special rating, underwriting or loss control, such as aircraft liability coverage or professional liability coverage, are usually excluded from the umbrella policy. In addition, coverages that are not needed by the typical purchaser of a personal umbrella policy are excluded. These coverages include workers' compensation and care, custody or control coverages. People who need these coverages may usually purchase them separately for an additional premium.

Prevention of Coverage Duplication

Insurance is a contract in which the insurer, in consideration of the payment of a premium by the insured, agrees to make good the losses suffered through the occurrence of a designated, unfavorable eventuality. Because property and liability insurance policies are essentially contracts of indemnity, the insured cannot be enriched by a loss and may only receive reimbursement for the actual damage sustained. Therefore, as discussed in previous chapters, umbrella policies are designed to dovetail with the underlying insurance policies and to pick up where the underlying policy leaves off. When the insured receives reimbursement for part or all of the loss from any other source, he or she cannot receive duplicate payment from the umbrella insurer. If two or more personal umbrella policies apply to a loss, each policy pays its share of the loss on a pro-rata basis.

Keeping Premiums Reasonable

One of the most important functions of an insurance company relates to the pricing of its policies. The insurer does not know in advance what its actual costs are going to be for the year, but it relies on the company's past loss experience and industry statistics to determine its rates. Insurance pricing must meet certain regulatory and business objectives in order to keep premiums at a reasonable level. From a regulatory standpoint, an insurer's rates must be adequate (high enough to pay all losses and expenses while earning a profit for the company), not excessive (rates should not be so high that policyholders are paying more than the value of their insurance coverage) and not unfairly discriminatory (similar exposure units should be charged the same rates).

From a business standpoint, an insurance company's rating system should be:

- Easy to understand
- Stable over short periods so consumer satisfaction can be maintained
- Responsive over time to changing loss exposures and economic conditions
- Encouraging of loss prevention activities by rewarding insured's with reduced rates for loss control measures that reduce the frequency and severity of losses

Common Personal Umbrella Exclusions

A liability insurance policy promises to pay on behalf of the insured the amount (up to the policy limit) that the insured becomes obligated to pay because of the liability imposed on him or her by law for damages caused by a covered occurrence. As explained previously, the term occurrence is defined as an accident that results in bodily injury or property damage neither expected nor intended by the insured. This definition includes continuous or repeated exposures to conditions that result in injury or damage.

Personal umbrella liability protection is quite broad, but it is possible for the insurance agent and the insured to overestimate the extent of financial protection actually afforded by a policy if they do not fully understand what is excluded from coverage.

Every peril or hazard is not covered. If, for example, a claim arises and the details of the incident show that the source of the claim is an excluded condition or incident, no coverage is afforded under the umbrella policy. The insured would be personally responsible for the expense of investigating and defending the claim. Furthermore, if the insured and the insurance company differ as to the details of the incident, it is the responsibility of the insured to convince the insurer that the incident falls within the policy coverage and should be covered.

Although personal umbrella policy exclusions will vary by insurer, most companies will usually exclude coverage for loss exposures that are better insured under another policy.

Workers' Compensation

Most personal umbrella policies exclude coverage for injuries to employees that should be covered by workers' compensation policy. Workers' compensation insurance covers loss of income, medical and rehabilitation expenses that result from work-related accidents and occupational diseases. This insurance evolved as a means of enabling employers to meet the requirements of the workers' compensation laws of the states in which they operate. Prior to the enactment of these laws, the only recourse open to any employee injured on the job was a negligence lawsuit against the employer - a process that put the employer and the employee on opposite sides of a legal argument.

Briefly, workers' compensation legislation protects workers by providing benefits to a worker or a worker's dependents for injury, disability or disease contracted by the worker in the course of his or her employment. Compensation is made without regard to fault or legal liability. Although specific workers' compensation benefits vary by state, medical and hospital expenses are generally fully reimbursed and monetary allowances are granted for various types of disability. In addition, burial expenses are paid up to a statutory limit.

Care, Custody or Control

Standard liability policies, including most personal umbrella policies, contain a Care, Custody or Control Exclusion. This provision eliminates coverage for property belonging to others that for some reason is in the insured's possession, and that the insured has agreed to assume liability for damage to the property.

The intention of this exclusion is to eliminate coverage for damage to property that:

- Should have been prevented by the insured by exercising care
- Should have been covered by some other form of insurance coverage

Unfortunately, courts do not always agree about what constitutes "care, custody or control". The courts may determine, for example, that leased machinery and equipment or property under construction is considered to be under the insured's custody. Therefore, the insured is held responsible for losses to that property.

Some umbrellas provide coverage if the insured was not obligated to provide insurance coverage for property in his or her care, custody or control and it was damaged. In addition, umbrella coverage usually applies on an excess basis if the primary policy covers the loss.

Nuclear Energy

The personal umbrella policy is not intended to cover the catastrophic risk of a nuclear disaster. In addition, loss caused by nuclear reaction or radioactive contamination, whether controlled or uncontrolled, is excluded from the underlying property and casualty policies. There are specific policies to cover nuclear risk under various pooling arrangements. Nuclear Energy Liability policies, issued by nuclear insurance pools, cover firms that own or operate nuclear reactors and provide proof of a company's financial responsibility if a nuclear accident should occur.

Policies are issued by any of the following or their successors:

- American Nuclear Insurers
- Mutual Atomic Energy Liability Underwriters
- Nuclear Insurance Association of Canada

These insurers issue policies that cover virtually everyone against liability for causing a nuclear incident. Therefore, liability coverage will not be duplicated under the personal umbrella policy.

War Risks

Insurance companies only cover risks that they consider being insurable. Generally, personal umbrella policies have specific wording to eliminate liability coverage for large loss exposures that are considered uninsurable by most insurers. For example, personal umbrella policies usually contain a War Risk Exclusion for losses from war, civil war, insurrection, rebellion or revolution. The insurer is not liable for loss by fire or other perils caused, directly or indirectly, by enemy attack by armed forces, including action taken by military, naval or air forces in resisting an actual or an immediately impending enemy attack. Likewise, damage caused by internal rebellion or other warlike acts is excluded.

Intentional Acts

Any intentional acts of the insured that can be directly attributed to the insured are considered moral hazards and are excluded under most liability contracts. However, in most cases, coverage is provided for unintentional torts caused by the insured's negligence or for the acts of others for which the insured is vicariously liable.

FOR EXAMPLE: If the insured's friend borrows a covered auto and intentionally runs over a mutual acquaintance, the insured would be vicariously liable if the driver was acting as an agent of the insured at the time of the injury.

In essence, the driver while driving the insured vehicle with the permission of the insured is also an insured. However, in this situation, if the insured were driving and the injury was caused by the intentional act of the insured, coverage would be excluded.

Aircraft

Many policies define the term aircraft as a plane, seaplane, amphibian or helicopter, including operating and navigational instruments, radio equipment and other equipment attached to or carried on the aircraft. Aircraft may also be defined as a heavier-than-air or lighter-than-air

vehicle designed to transport persons or property through the air. The definition usually excludes coverage for a hovercraft, which is considered to be a recreational vehicle.

Aircraft liability insurance is similar in design to an automobile liability policy and provides coverage for losses arising out of the ownership, maintenance or use of aircraft for which the insured is liable. Under this coverage, two types of bodily injury may be covered: Bodily Injury Liability, excluding passengers, and Passenger Bodily Injury Liability. Typically, Property Damage and Medical Payments are also covered.

Although some personal umbrella policies provide aircraft liability coverage, most exclude coverage for any personal injury or property damage due to the ownership, maintenance, use, loading or unloading of aircraft owned or chartered by the insured. However, if the insured has an underlying aircraft liability policy and it is listed on the personal umbrella Declarations page, some coverage may be provided by the umbrella. In most cases, the insurer will pay the difference between what is payable under the aircraft liability policy and the total legal liability of the insured, up to the liability limit of the umbrella.

Watercraft

Many liability policies, including the Commercial General Liability policy, contain an exclusion for "bodily injury" or "property damage" that arises from the ownership, maintenance, operation, use, loading or unloading of any owned or non-owned watercraft. The personal umbrella liability policy will also typically exclude this coverage.

There is an exception, however, in that this exclusion does not apply to any injury or damage arising from owned or non-owned watercraft while they are ashore and on premises owned, rented or controlled by the insured.

It should be noted that the homeowners' policy provides some liability coverage for certain types of watercraft owned or operated by the insured. For example, liability coverage is provided for non-owned watercraft that are not sailing vessels and are powered by an inboard or inboard-outboard engine or motor power of 50 horsepower or less. When there is underlying coverage, most umbrellas provide excess coverage in the same way that the primary policy covers the insured. For example, if the primary policy covers "property damage" due to the ownership, maintenance, use, loading or unloading of any watercraft under 25 feet in overall length, the umbrella policy will normally pick up the excess liability coverage.

Recreational Vehicles

For insurance purposes, the definition of a recreational vehicle includes vehicles such as snowmobiles, mini-bikes, all-terrain vehicles (ATVs) and any similar vehicles designed principally for use off public roads, whether or not the vehicles are subject to motor vehicle registration. The definition does not include motorcycles.

Some personal umbrella policies exclude liability arising out of the ownership, maintenance or use of recreational vehicles unless the insured carries underlying limits of liability for these vehicles. For example, an insured may add snowmobile liability coverage for \$100,000 to a homeowners' policy by endorsement. If the insured also purchases a personal umbrella policy, that policy typically provides excess liability protection for the insured as long as the underlying limits remain in force.

Business Pursuits

Many umbrella policies exclude coverage for liability arising out of a business activity or business property unless the liability results from the named insured's or a family member's use of a private passenger vehicle. The insurer's intention is to limit coverage for any trade, profession or occupation in which the insured is engaged and which might increase the chance of loss. The definition of business pursuits usually applies to any type of usual or ongoing business, ranging

from a professional office in the home to weekly garage sales. In many cases, the umbrella insurer will provide coverage for incidental business pursuits if this loss exposure is covered by an underlying insurance policy, but coverage will be no broader than the underlying insurance coverage.

Professional Liability Insurance

Personal umbrella policies contain exclusions for all claims arising out of a professional person's errors or mistakes made in the performance of the duties of that profession. When a professional fails to meet the standards of skill and care generally accepted for that profession or occupation and causes injury or damage to a client, however, that professional may be held liable and may be required to pay money damages to the injured party. There are two types of professional liability insurance that have been developed to cover this type of legal liability. One is malpractice insurance where the negligent act causes direct injury or harm to a human being. The other is errors and omissions insurance where the negligent act causes losses involving physical things, which in turn may cause damage or injury to both people and property.

Directors and Officers Liability

The personal umbrella policy typically excludes coverage for liability due to the insured's activity as a member of a board of directors or as an officer of an organization other than a charitable, religious or civic nonprofit organization. This exclusion is in keeping with the personal umbrella policy's intention not to provide coverage for business activities that may be covered by another type of policy.

For example, Directors and Officers Liability Insurance (D & O Insurance) has been developed to cover the director or officer for liability claims resulting from poor judgment and wrongful acts. D & O Insurance pays on behalf of directors and officers (or reimburses their corporation if the executive receives indemnification) for claims arising out of error, neglect, breach of duty or misleading statement. The policy also provides for legal defense. It will not cover any active or deliberate fraud.

Although the personal umbrella policy excludes liability for business activities, it typically covers liability due to the insured's civic activities. For example, assume that a teacher, for defamation of character, sues the insured and other members of a school board collectively and individually. Most personal umbrella policies would determine that service on a school board is not a "business activity" and would, therefore, provide a legal defense for the personal actions of the insured. It is also possible that the school board could provide defense for individuals in such a matter, and that the board would pay any judgment.

In addition, the personal umbrella usually provides legal defense when an insured is allegedly slandered or slanders someone else. For example, assume the insured runs for a public office and, during the course of the campaign, he or she accuses an opponent of corruption in several newspaper ads and radio spots. If the insured is later sued for libel or slander, the cost of the legal defense and any judgment against the insured will usually be paid by the personal umbrella carrier.

As part of their duties, underwriters do the following:

- Identify and evaluate loss exposures
- Price the insurance product
- Determine policy terms and conditions
- Make the final risk selection
- Monitor and service the account

The series of steps that underwriters use to select, evaluate, and approve (or reject) applicants for insurance is called the underwriting process. An underwriter who understands and observes

each step in this process is likely to achieve a profitable book of business for the insurer.

Identifying and Selecting a Risk

The personal umbrella underwriting process begins with the identification and selection of a particular risk. In most cases, it is the property-casualty insurance producer who initially determines whether a risk will be acceptable to the company. In essence, the producer is a field underwriter for the company who often selects the umbrella risk from his or her existing book of business. The producer typically has had personal or business dealings with the applicant and may attest to his or her personal reputation, background and loss experience over a long period. In fact, the insured's long-term relationship with the insurance producer is often the primary reason that a personal umbrella policy is issued.

In many cases, the prospect for umbrella coverage will be an affluent client, although this is not a requirement for umbrella coverage. As we have stated, anyone who has loss exposures that could result in large liability claims is a candidate for personal umbrella coverage. However, the producer should be careful not to select applicants who present loss exposures greater than those assumed by the insurer in its rates or premiums. Risks should be in the good to above-average range to assure that they may be profitability underwritten.

Using Underwriting Information

The insured is usually asked to answer a series of questions on a detailed application for insurance. Although the producer may complete the application, the named insured is usually asked to verify the information and then sign the application. The application requests information about the risk being considered for insurance coverage and, in some cases, the completed application will be attached to and become part of the umbrella policy.

The questions on the application will vary by insurer, but most applications will ask for information in these three specific categories:

- Personal information about the named insured and other members of the household
- Information about real and personal property owned, leased or the insured that might present a liability exposure
- General insurance information that can be used to assist the underwriter in determining a premium to be charged for the umbrella coverage

In the following sections, the information from these three categories will be used to show how to determine whether a risk is acceptable.

After the application has been completed and signed by the applicant, the insurance producer forwards the information to the line underwriter (usually located in the home office) who makes the final determination about whether the risk can be written and at what premium. The home office underwriter analyzes the information provided on the application and measures it against a theoretically ideal risk to judge whether the applicant is a good candidate for insurance.

Personal Information

The underwriter needs personal information about the insurance applicant to determine whether the risk presents any unwanted hazards for the company. The underwriter looks for specific warning signs of potential moral or morale hazard. For example, assume that during the ten years the insured has carried homeowners' and auto insurance with a particular insurer he or she has maintained extremely low limits of liability. The applicant's sudden interest in increasing the underlying limits and obtaining an umbrella may indicate that this is a poor umbrella risk. The underwriter should question what has happened to make the applicant now interested in increased limits.

The application provides the underwriter with basic information about the individual applying for

insurance (the named insured) and members of the named insured's household. The information is used to give the underwriter a feeling for the loss exposures faced by the entire household.

The application typically asks for the following details:

- Name, mailing address and residence address of the applicant
- Marital status; age (or birth date) of the applicant and spouse, in states where such questions are permitted
- Occupation and employer of applicant and spouse (if any)
- Information about stability factors, such as ownership of home, years at present address, previous residence address and length of time at that address
- Information about any liability claims made against the insured during a specified period (usually three to five years)

Such information is intended to assist the underwriter in deciding whether the applicant has any unusual exposures to loss. For example, many insurers will decline coverage for people, such as actors, professional athletes and politicians, whose professions or activities expose them to extraordinary publicity and potentially large lawsuits.

Property Loss Exposures

The personal umbrella liability application asks the applicant to describe any residence or other real property owned by the insured that could generate a liability claim. The underwriter is specifically looking for clues about the property, such as inferior construction or poor housekeeping, which might increase the chance of loss.

Because the personal umbrella typically provides coverage on a worldwide basis, the underwriter needs information about all the property at risk.

The application seeks the following:

- Information about all residences occupied by the applicant, type of interest (owned or rented), description of any other buildings on the residence premises, the number of swimming pools at each location
- Information about any farms owned or rented by the applicant, including the acreage and value of any leased property
- Information about all automobiles owned or leased by the applicant, including the type and principal operator of each, where it is garaged and the rate class used for each vehicle
- Information about watercraft owned or leased by the applicant, including manufacturer, model year, type, length, horsepower, location of operation and whether any underlying policy has restrictions on water-skiing
- Information about any aircraft owned or used by the applicant with descriptions of each aircraft and additional information about the pilot
- A description of employer's liability or workers' compensation exposures, including number and type of domestic and/or farm employees
- A description of all business pursuits and business properties of the applicant
- A description of any unusual hazards, such as dangerous animals on the premises, water-skiing activities by any member of the family, child care duties (such as babysitting) by any member of the family, plans to enter a race, contest or exhibition, etc.

General Insurance Information

An underwriter needs as much general information about the risk as possible to properly quote the risk. Rating is based in part on an underwriter's experience and judgment and without fairly complete knowledge of the risk, an underwriter cannot provide a competitive quotation.

At the very least, an underwriter will request the following:

- The policy limits desired and the requested effective date
- A schedule of all applicable underlying policies: automobile, homeowners', boat, recreational vehicles, aircraft, employer's liability or workers, compensation insurance (information typically includes the name of the insurer, policy number, effective dates, limits of liability and the premium per policy)
- Information about other insurance policies in force, such as those providing coverage for business pursuits or business properties (any exclusions or limitations of liability coverage must be noted on the application for the personal umbrella policy)
- Information about any previous personal umbrella insurer, including name of the insurer, policy number, effective dates and reason for changing insurers
- An explanation of the circumstances if any insurer has ever canceled, refused, or denied renewal of a personal umbrella policy for the applicant

Accepting or Rejecting the Risk

Based on the personal, property and general information received on the application and an analysis of that information, the underwriter will make a decision about whether to accept or reject the risk. Many underwriters will not go to great lengths to secure information other than that on an application. They assume that if another insurer willingly provided underlying insurance, the risk should be acceptable for umbrella insurance. However, some insurance companies will write umbrella coverage only if they also write the required underlying coverage. Other insurers write stand-alone policies and do not require that they issue the underlying policies but only that the coverages are in place with some insurance company.

The underwriter determines the acceptability of a particular risk by checking it against a large number of factors known to be related to loss potential. Some underwriters feel that if a property is eligible for a homeowners' policy under another insurer's underwriting guidelines, it is also eligible for umbrella coverage. Most underwriters would agree, however, that even though a risk is eligible for insurance coverage, it might be declined for any number of reasons. For example, the applicant may have an attractive nuisance, such as a swimming pool or a vicious dog, which is not properly safeguarded. Although the primary insurer may consider this an acceptable risk, the umbrella underwriter may be concerned about the likelihood of a multimillion-dollar lawsuit if a child drowns in the insured's pool or is killed by the insured's dog. It is likely that an umbrella underwriter would decline such a risk or require additional safeguards before the umbrella policy is issued. The underwriter may also charge an additional premium for certain hazardous exposure.

Most insurers refuse to issue coverage for persons who are engaged in illegal activities, who have unusual exposures to libel or slander suits, such as broadcasters and newspaper reporters, or whose activities cause them to face significant publicity, such as actors, professional athletes, public lecturers and politicians. The general feeling among insurers is that such persons offer substantial exposure to lawsuits and large liability settlements.

Pricing the Risk

One of the most important parts of a personal line underwriter's job is to determine the proper

pricing for various insurance products. The policy premium is determined by multiplying an insurance rate, the dollar amount charged per a particular amount of insurance coverage, by the amount of insurance needed. Actuaries who collect data and analyze the many factors that determine the relative hazards of different risks usually accomplish the highly technical procedure of establishing rates. The costs of establishing rates would be prohibitive if each insurance company were to maintain its own rating bureaus. A practical method of solving this problem is for groups of insurers to act together to set up a central body to promulgate proper rates. In addition, the pooling of various insurers, experience makes more accurate results possible.

Strictly speaking, no two personal umbrella risks present exactly the same hazards. Even if two applicants have identical dwellings, the structures will differ as to their contents, maintenance, number of occupants and so forth. The applicants will have different types and numbers of automobiles, insurance requirements, loss histories, etc. Because these applicants have different loss exposures, an underwriter will use specific (or schedule) premium rates. The rate is determined by an analysis of the insured's application, which is compared in terms of the relative loss exposures against a theoretical average risk. Using a predetermined average price as a base, the risk being considered is given credit for superior elements, such as fire-resistive construction, loss control devices and high-level maintenance. Risks with hazardous exposures, such as swimming pools, are often surcharged if the underwriter wishes to cover those types of risk.

Issuing the Policy

After the underwriter has analyzed and priced the risk, he or she will usually forward a written premium quotation to the producer. The underwriter will note the general terms of the policy, such as the required underlying limits of liability, the amount of the self-insured retention, the proposed effective date of the policy and so forth. The producer then forwards the information to the insured that accepts or declines the quote. If the insured accepts, the underwriter proceeds with the issuance of the actual policy. In almost all cases, the producer cannot bind or issue personal umbrella liability coverage.

Although the basic coverages do not vary greatly, the policy appearance and format will be quite different. In addition, the underwriter may change the coverages and modify the basic policy by endorsement. The underwriter may wish to amend the general policy provisions to comply with the special needs of the applicant, to cover unique situations also covered by the underlying policies or to restrict certain risks that the underwriter does not wish to cover.

Monitoring the Risk

The final step of the underwriting process is monitoring the risk throughout the policy term to confirm that the decision to write the risk was a good one. The underwriter often works with other departments, such as the accounting and claims departments, to be certain that the premiums are paid in a timely manner and that the insured's loss experience is not excessive. As part of the monitoring step, the underwriter will often follow up with the producer about three months before the umbrella's expiration date to offer a renewal policy. Although most umbrella policies are annual policies without a guaranteed renewal provision, some underwriters will send a notice of non-renewal if the company does not want to reissue the coverage. Sending a notice of non-renewal informs the producer and the insured that umbrella coverage will have to be placed with another insurer and also protects the insurer if there is some dispute about whether coverage should have been in force after a specific date. In some states, this notice may be required by statute.

Basics of Insurance

Now that we've covered the ins and outs of homeowners', auto, personal property and umbrella insurance, we might as well run through the basics of insurance to refresh your memory of the common and basic terms, definitions and concepts of insurance.

Transferring the Risk

Insurance transfers the risk of an uncertainty of a loss from an individual to an insurer. Loss is a factor of everyday life and most people handle small everyday losses on their own, but when there is a potential for an unmanageable loss, individuals and businesses look for other sources to be protected from financial ruin.

The insurance company fulfills this role and charges a fee or "premium" based on the risk of the loss. The factors that come into play in insuring the risk are

- The certainty of the loss
- The management of the risk
- The reduction of the risk

An example of certainty might be this: Is a home sitting on a mountainside where landslides are an everyday occurrence, or is the home sitting in a subdivision of leveled land where there is no potential of landslide? Another example might be to compare a home situated in a flood plain versus one that is not.

An insurance contract transfers the risk from an individual, a business, or a group of individuals to an insurance company in exchange for a premium. The premiums of many individuals are 'pooled' by the insurance company to create the funds necessary to pay the insureds that suffer the losses.

This method of transferring risk to the insurer is based on statistics showing how many potential losses can occur within a numerical quantity of people. The higher the quantity of people used in establishing the statistics the more accurate the prediction will be.

These predictions are then used by the insurer in establishing premiums to be "pooled" in covering the losses.

Insurable Interest

Before an individual or an entity can be insured it must have insurable interest. Insurable interest is defined as any actual, lawful and substantial economic interest in the safety or preservation of the subject of the insurance from loss or destruction or financial damage or impairment.

In addition to insurability, other criteria are also used in determining if insurance can be used as a vehicle for the transference of the risk.

These other considerations include the following:

- The risk of loss must be definite and difficult to fake.
- The risk must be unexpected.
- The risk must create a financial hardship.
- The loss must be able to be assigned a financial value.
- The cost must be affordable or fractional of the value.
- The loss must be predictable by virtue of a high enough quantity of people to require the same coverage.
- The presence of the "spread of risk" must be available.
- The risk must be pure, not speculative.

Loss Frequency, Reduction and Prevention

Loss frequency, loss reduction, and loss prevention are terms that will be heard over and over again in dealing with property and casualty insurance.

For example, proper training of an employee using a blowtorch or other high-risk machinery would curtail loss frequency. Risk control techniques that diminish the loss frequency come under on the

heading of loss reduction.

Installing a sprinkler system in a home, office, or factory would curtail the severity of the damage and thus serve as a risk reduction.

Types of Risk

Spread of risk is defined as the insurers' ability to spread their insured risks over a large geographical area. Pure risk is defined as a risk in which there is no chance of gain - only loss. On the other hand, a speculative risk is defined as a risk that can either result in a loss or a gain.

Peril and Hazards

In discussing property and casualty insurance, the terms peril and hazard need be defined. A peril is defined as the cause of the loss.

A hazard is anything that increases the chances of a peril occurring. An underwriter examines an insurance application to gain an understanding of the hazards in place for a particular risk, allowing him or her to better identify that risk's level. There are the following four distinct types of hazard:

Physical Hazards – Poor health, dangerous hobbies, and high-risk occupations are types of physical hazards.

Moral Hazards – Moral hazards are psychological. People who demonstrate a level of dishonesty in their lives or have been convicted of a felony or DUI may be declined coverage based on their poor morality (in insurance terms).

Morale Hazards – Careless and irresponsible people fall into this category of hazard. An example of a morale hazard is someone who has numerous reckless driving arrests on his or her record. An individual who appears to be indifferent to loss would present a morale hazard.

Legal Hazard – People who demonstrate a tendency to sue others or file frivolous lawsuits are a clear legal hazard for an insurance company and are often declined.

Other Methods of Handling Risk

We all handle risks differently. How one handles risk affects not just the amount of insurance he or she needs, but how he or she will be viewed by an underwriter. In addition to the transfer of risk, which we have already covered, risk is handled by one or a combination of the following:

Avoidance

One of the best ways to handle risk is to avoid situations that could result in a loss. However, avoidance is not a realistic concept. Common sense tells us that avoiding driving when drunk is a good way to handle risk. An extreme example of avoidance would be to not leave home for fear of becoming injured or killed.

Control

Being in control of an area of possible loss is a way to manage risk. Homeowners can help to control the risk of their homes burning down by installing smoke detectors. Individuals can submit to annual check-ups to help control risks associated with their health.

Retention

Personal acceptance of the price of loss is called retention. People who pay their medical bills, as opposed to purchasing health insurance, or the action of selecting a deductible under an insurance policy are examples of retention.

Sharing

This method of handling risk has a group pooling together to share the costs of a loss experienced by one member. In insurance terms, a group of insurers can bank together and share losses so no one member bears the burden of cost individually.