Chapter 8

Property Loss Exposures and Policy Provisions

Educational Objectives

After studying this chapter, you should be able to:

1. Describe the types of property that might be exposed to loss and that are typically covered by property insurance. (pp. 8-5 to 8-8)
2. Explain the ways in which causes of loss are treated in various types of property insurance policies. (pp. 8-8 to 8-9)
3. Identify and describe the potential financial consequences of property losses. (pp. 8-10 to 8-12)
4. Identify and describe the parties that might be affected by property losses. (pp. 8-12 to 8-13)
5. Explain how covered property and locations are specified in property insurance policies. (pp. 8-14 to 8-18)
6. Explain how covered causes of loss are typically described in various property insurance policies. (pp. 8-18 to 8-25)
7. Identify and describe the causes of loss that are usually excluded in property insurance policies. (pp. 8-25 to 8-26)

8. Identify and describe the financial consequences of loss that might be covered by property insurance policies. (pp. 8-27 to 8-28)
9. a. Identify the parties that can be covered by property insurance policies. (pp. 8-28 to 8-31)
   b. Explain how property insurance policies provide coverage for various parties. (pp. 8-28 to 8-31)
10. Explain how various policy limits and other provisions affect the amounts of recovery under a property insurance policy. (pp. 8-31 to 8-34)
11. Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Chapter 8

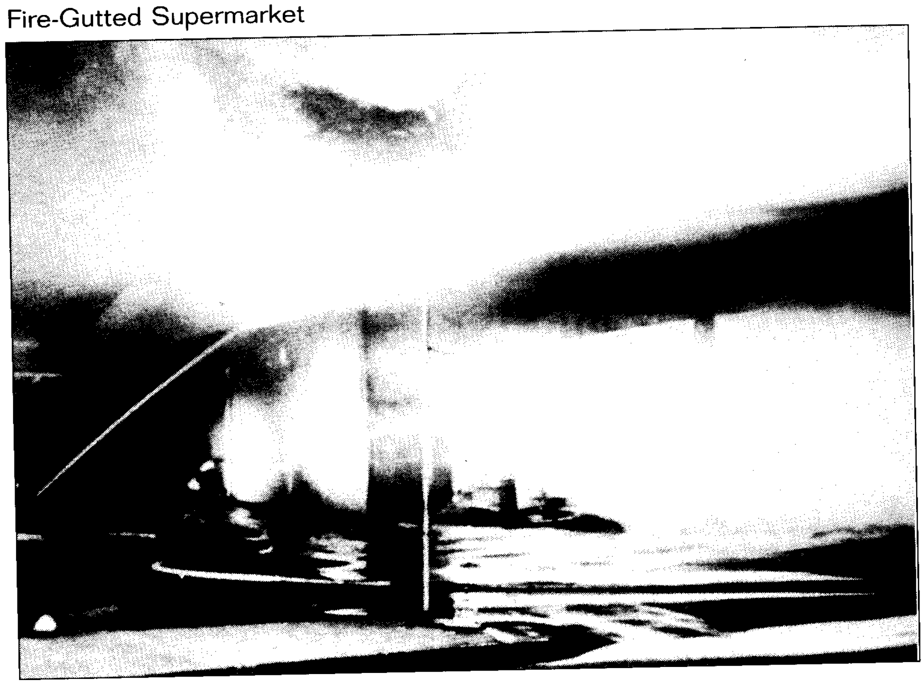
Property Loss Exposures and Policy Provisions

Everything seemed normal when Mr. Brown closed the supermarket for the night. Therefore, he was shocked when he was later awakened by a telephone call from someone exclaiming, "Get down to the shopping center. Your store is on fire!"

The fire apparently started in the market's storage area. A problem in an electrical fixture probably caused some sparks that ignited trash in a nearby bin. Paper goods, bags of charcoal, and other combustible materials in the storage area were apparently ablaze long before the fire was visible from outside the building. The fire spread rapidly through the sprawling open spaces of the store. (Exhibit 8-1 shows a fire-gutted supermarket, similar to Mr. Brown's.)

A few months after the fire, Mr. Brown cut the ribbon for the store's grand reopening sale, and it was soon business as usual. Thanks to his property insurance, Mr. Brown was in almost the same financial condition he would have been in had the fire not occurred. The building had been rebuilt, and the food, freezers, and other contents had been replaced. Business income insurance also reimbursed Mr. Brown for the income lost while the store was closed, as well as for the extra expenses he incurred due to the fire.

Exhibit 8-1
Fire-Gutted Supermarket



It was not by chance that Mr. Brown's insurance enabled him to reopen quickly. He had planned ahead. With the help of his insurance agent, he had identified his property loss exposures and made sure that he was insured against the financial consequences of damage from fire and other causes. This was no simple task. Mr. Brown had to identify the various items of property that could be lost or damaged, and he had to determine what could occur to cause loss or damage. In addition, he had to estimate the dollar amount that he could lose. Having done these things well, he was aware of his property loss exposures and had taken steps to properly insure the property.

To help you understand how Mr. Brown was able to successfully handle the consequences of the fire, this chapter explores the various aspects of *property loss exposures* and then describes various policy provisions that cover those exposures.

Reminder

As stated in Chapter 1, a *property loss exposure* is any condition or situation that presents the possibility that a property loss will happen.

Property Loss Exposures

This chapter begins the study of property loss exposures by examining three important aspects of those exposures:

- *Types of property* that might be exposed to loss, damage, or destruction

- *Causes of loss* that might result in property being lost, damaged, or destroyed
- *Financial consequences* that might result from a property loss

In addition to describing the above aspects of property loss exposures, this chapter discusses the parties that might be affected when property is lost, damaged, or destroyed.

Educational Objective 1

Describe the types of property that might be exposed to loss and that are typically covered by property insurance.

Types of Property

Property is any item with value. Individuals, families, and business organizations own and use property, depend on it as a source of income or services, and rely on its value. Property can decline in value—or even become worthless—if it is lost, damaged, or destroyed. Different kinds of property have different qualities that affect the owner's or user's exposure to loss.

Property can be classified in a number of different ways. One common approach is to distinguish between *real property* and *personal property*. Insurance practitioners use categories that relate to the insurance treatment of property, such as:

- Buildings
- Personal property ("contents") contained in buildings
- Money and securities
- Motor vehicles and trailers
- Property in transit
- Ships and their cargo
- Boilers and machinery

These categories overlap to some extent. Consider, for example, money and waterborne cargo. Money is personal property and can therefore be included in the contents of buildings; it can also be property in transit. Cargo on a ship is also a form of property in transit. These categories are listed separately here because they represent types of property for which specific forms of insurance have been developed.

Reminder

Real property consists of land as well as buildings and other structures attached to the land or embedded in it. The term "real estate" is commonly used to refer to real property.

Personal property consists of all tangible or intangible property that is not real property.

Buildings

Buildings include more than bricks and mortar and other building materials. Most buildings also include plumbing, wiring, and heating and air conditioning equipment, which can lead to leaks, electrical fires, and explosions. Most buildings contain some basic portable equipment—fire extinguishers, snow shovels, lawn mowers, and so forth—required to service the building and surrounding land, and this equipment is considered part of the building. A high-rise building usually has elevators and might have specially designed portable platforms, hoists, and tracks for use by window washers. This equipment is also considered to be part of the building. Property that is permanently attached to the structure, such as wall-to-wall carpeting, built-in appliances, or paneling, is generally considered part of the building as well.

Personal Property (Contents) Contained in Buildings

The contents of a typical home include personal property such as furniture, clothing, televisions, jewelry, paintings, and other personal possessions. The contents of a commercial building might include the following:

- *Furniture and fixtures*, such as the desks in an office or portable shelves in Mr. Brown's store.
- *Machinery and equipment*, such as cash registers in Mr. Brown's supermarket.
- *Stock*, such as the groceries in Mr. Brown's store or the raw materials and completed products in the inventory of a shoe factory. A shoe factory's "stock" includes leather (raw materials), partly finished shoes (goods in process), and shoes (finished goods).

Although most policies use the term "personal property" to refer to the contents of a building, many insurance practitioners and policyholders use the term "contents" as a matter of convenience and common practice. Property insurance policies refer to personal property, rather than contents, because the property is often covered even when it is not literally contained in the building. When the contents of a commercial building are involved, policies generally use the term "business personal property."

Money and Securities

Money means currency, coins, and bank notes. Traveler's checks, credit card slips, and money orders held for sale to the public are also considered money in some cases.

Securities are written instruments representing either money or other property. Stocks and bonds, for example, are securities.

For insurance purposes, **money** and **securities** are classified separately from other types of contents because their characteristics present special problems. Money and securities are highly susceptible to loss by theft. Cash is particularly difficult to trace, since it can be readily spent. In contrast, other types of property must be "fenced," or sold for cash, before the thief can make a profit. Money and securities are also light in weight, easily concealed, and easy to transport.

Besides being susceptible to theft, money and securities are easily destroyed by fire. Unless Mr. Brown made a bank deposit every night when the store closed, he probably lost a considerable amount of currency and checks during the fire in his store.

Motor Vehicles and Trailers

The primary purpose of most vehicles is to move people or property, and this movement exposes vehicles to several causes of loss. It is difficult to classify motor vehicles. No matter what categories are used, some vehicles (such as snowmobiles) fit into more than one category, depending on the purpose for which they are owned and used. To identify property loss exposures, however, it helps to think of the following three broad vehicle categories:

- Autos and other highway vehicles
- Mobile equipment
- Recreational vehicles

In insurance terminology, the meaning of the word **auto** is very broad. It includes vehicles, such as cars, trucks, trailers, and buses, designed for road use and can also include such diverse vehicles as fire engines, ambulances, motorcycles, and camping trailers. **Mobile equipment** such as tractors, bulldozers, road graders, front-end loaders, forklifts, backhoes, and power shovels, might be damaged in a highway collision, but the most frequent exposures to loss involve off-road situations. **Recreational vehicles** include a wide range of vehicles used in a variety of sports and recreational activities. Examples include dune buggies, all-terrain vehicles, and dirt bikes. Most snowmobiles also fall into this category. In some cases, the owners of these recreational vehicles face exposures to loss both on and off the road.

In insurance, **auto** is a broad term that includes cars, trucks, buses, and other motorized vehicles designed for use on public roads.

Mobile equipment, which is specifically defined in most commercial insurance policies, includes many types of land vehicles—usually designed for use principally off public roads—including equipment attached to them. Examples include bulldozers, farm machinery, and forklifts.

Recreational vehicles are vehicles used for sports and recreational activities. Examples include dune buggies and all-terrain vehicles.

Property in Transit

A great deal of property is transported by truck, but property is also moved in cars, buses, trains, airplanes, and ships. When a conveyance containing cargo overturns or is involved in a collision, the cargo could also be damaged. In addition, cargo might be destroyed without damage to the transporting vehicle. Liquids can leak out of a truck, fragile articles can be tossed around during transit, and heat-sensitive objects can melt or spoil in a conveyance with a defective refrigeration system.

When property is damaged or lost in transit, it must be replaced. Delays often result, since replacement property might have to be shipped from the place where the first shipment originated. The property owner might also incur expense to move the lost or damaged property.

Ships and Their Cargo

Ships and their cargo are exposed to special perils not encountered in other means of transit. For example, ships that operate along coastal waters can run aground, leaving the cargo stranded. Even more than other property, ocean cargoes fluctuate in value according to their location. If the ship cannot reach its intended destination and the cargo must be sold in a different port, the price received for the cargo might be less than the price expected at the original destination.

Boilers and Machinery

Many businesses have objects that can be classified as boilers or machinery. For example, many buildings use steam boilers to provide heat. A steam boiler is a large water tank heated by burning gas, oil, or coal to produce steam. Dry cleaners and laundries invariably have boilers. Public utilities, refineries, and steel mills often use boilers to generate power. Other objects that can be classified as boilers or machinery include unfired pressure vessels, such as air tanks; refrigerating and air conditioning systems; mechanical equipment, such as compressors and turbines; production equipment; and electrical equipment. Machinery such as transformers and other electrical apparatus is found in most factories and power stations. Boilers and machinery share two characteristics:

- They are susceptible to explosion or breakdown that can result in serious financial losses.
- They are less likely to have explosions or breakdowns if they are periodically inspected and properly maintained.

Educational Objective 2

Explain the ways in which causes of loss are treated in various types of property insurance policies.

A **cause of loss** (or **peril**) is the actual means by which property is damaged or destroyed. Examples include fire, lightning, windstorm, hail, and theft.

Causes of Loss to Property

Most **causes of loss**, or **perils**, adversely affect property and leave it in an altered state. A fire can change a building to a heap of rubble. A collision can change a car to twisted scrap. Some causes of loss do not alter the property itself, but they do affect a person's ability to possess or use the property. For example, when property is lost or stolen, it is still usable, but it is no longer usable by its proper owner.

Named perils are listed and described in the policy. Only losses caused by those listed perils are covered.

Special form coverage (also called **open perils**) provides coverage for "risk of direct loss" to property; in other words, coverage is provided for any direct loss to property unless the loss is caused by a peril specifically excluded by the policy.

Many property insurance policies list the 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 are specifically excluded. These policies are known by several different terms, including **open perils** policies; in this text we refer to them as **special form coverage** policies.

Perils and Hazards

The terms "peril" and "hazard" are often confused.

As stated earlier, a *peril* is a cause of loss. Fire, theft, collision, and flood are examples of perils that cause property losses. (Many property insurance policies use the term "cause of loss" instead of "peril." This text uses these terms interchangeably.)

As explained in Chapter 5, a *hazard* is anything that increases the likelihood of a loss or the possible severity of a loss. Examples include the following:

- Careless smoking practices are a fire hazard because they increase the likelihood of a fire.
- Paint cans and oily rags are fire hazards because they enable a fire to spread and cause severe damage.
- Keeping large amounts of money in a cash register overnight is a theft hazard affecting both the likelihood of loss and the severity of loss. This practice would attract thieves if they became aware of it. The amount that would be stolen—the severity of the loss—is also affected by the amount of cash in the register.

Burden of Proof

An important difference between named perils and special form ("all-risks") coverage involves the burden of proof.

- With a named perils policy, for coverage to apply, the insured must prove that the loss was caused by a *covered* cause of loss.
- With a special form coverage policy, if a loss to covered property occurs, it is initially assumed that coverage applies. However, coverage may be denied if the *insurer* can prove that the loss was caused by an *excluded* cause of loss.

In the first case, the burden of proof is on the insured; in the second, it is on the insurer.

By shifting the burden of proof, special form coverage can provide an important advantage to the insured who suffers a property loss by an unknown cause. For example, suppose that after a flood strikes the community, the insured's wrought-iron patio furniture is missing. Assume also that the patio furniture is clearly covered property. It is possible that the furniture was swept away in the flood, but it is also possible that the furniture was stolen following the flood. If a named perils policy covered theft but not flood, the *insured* would have to prove that the property had been stolen. Under a special form coverage policy, the insurer would have to pay the claim (even if the policy excluded flood losses) unless the *insurer* could prove that the property was swept away in the flood.

Jargon Alert!

"All-risks" is a term used by many insurance professionals to indicate policies that cover all causes of loss that are not specifically excluded. This term was used in previous editions of property insurance policies, and many insurance practitioners continue to use it for the sake of simplicity. However, this term is misleading because the policies do not cover *all* risks of loss; some exclusions always apply. For this reason, the term is not used in current policy forms. Therefore, insurance professionals should avoid the term "all-risks" when talking to customers and others who might misunderstand its meaning. A better term to describe "all-risks" policies is "special form coverage" or "open perils" (meaning that perils are left "open" rather than being "named" in the policy). Other terms used to describe the coverage provided by "all-risks" policies are "risk of direct loss," "risks of direct physical loss," and "accidental direct physical loss," all subject to policy exclusions.

Educational Objective 3

Identify and describe the potential financial consequences of property losses.

Potential Financial Consequences of Property Losses

The loss of or damage to property can have undesirable financial consequences. The adverse financial effects of a property loss might occur in one or more ways:

- Reduction in the value of the property
- Lost income
- Increased expenses

Reduction in Value of Property

When a property loss occurs, the property is reduced in value. The reduction in value can be measured in different ways, sometimes with differing results. If the property can be repaired or restored, the reduction in value can be measured by the cost of the repair or restoration. Property that must be replaced has no remaining worth, unless some salvageable items can be sold as junk. Consider the following examples:

- A fence worth $5,000 is damaged by a car, and the owner of the fence will have to pay $1,000 to have the damage repaired. The accident—a *partial loss*—has reduced the value of the fence by $1,000.
- A camera worth $200 was run over by a truck. The value of the now worthless camera has been reduced by $200. The camera is a *total loss*.

If an item is lost, is stolen, or otherwise disappears, its value *to the owner* is reduced just as though it had been destroyed and retained no salvage value.

A further reduction in value might occur if repaired property is worth less than it would be if it had never been damaged. This is true for items such as fine paintings and other art objects. Many collectibles are valuable largely because they are in "mint condition" or "original condition." An object that has been repaired after damage from a tear, scratch, or fire is no longer in that unspoiled condition, and its value will decline. The owner faces loss in the form of the cost to repair the object, as well as a further reduction in value because of the altered condition.

Reminder

Replacement cost is the cost to repair or replace property using new materials of like kind and quality with no deduction for depreciation.

Actual cash value (ACV) is the replacement cost of property minus depreciation.

Depreciation is an allowance for wear and tear, or technological or economic obsolescence.

Property might have a few different "values," depending on the method by which the value is determined. As discussed in Chapter 6, the most common valuation measures used in insurance policies are *replacement cost* and *actual cash value*

(ACV). In certain situations, however, other valuation measures (such as *agreed value*) are used.

Reminder

Agreed value is a method of valuing property in which the insurer and the insured agree on the value of the property at the time the policy is written, and that amount is stated in the policy declarations and is the amount the insurer will pay in the event of a total loss to the property.

Lost Income

When property is damaged, income might be lost because the income-producing capacity of the property is reduced or terminated until the property is repaired, restored, or replaced. Mr. Brown temporarily lost the income from his store because the building and contents were damaged by fire.

Determining the amount of business income that might be lost due to a property loss requires estimating the future level of activity of an organization and doing a "what if" analysis: "What if the business could not operate for six months because it would take six months to rebuild after a fire? How much income would be lost?" This analysis involves projections of the organization's revenues and expenses in normal circumstances to determine the amount of income that would be lost in the event of a property loss that disrupts normal operations. The comparison of projected revenues and expenses reveals the potential loss of income.

The owner of rental property faces a similar situation because rental income would be lost if the property were damaged and temporarily could not be rented. The owner would probably continue to incur some expenses, such as mortgage payments and taxes, but would not receive the rent that helped to pay those expenses.

Increased Expenses

When property is damaged, the property itself declines in value, and the owner or other affected party suffers a corresponding loss. In addition, the owner or other user of that property might incur increased expenses in acquiring a temporary substitute or in temporarily maintaining the property in usable condition. Consider the following examples:

- A family whose house is damaged might have to live in a hotel temporarily at considerably greater expense than living at home.
- When a newspaper's printing presses are damaged, it might spend extra money to have the newspaper printed on another newspaper company's presses.
- When a car is damaged in a collision, the owner might need to rent a temporary substitute auto until the damage has been repaired.
- If a bank building is damaged, the bank might have to hire additional guards until the building can be made secure.

Because so many variables are involved, it is difficult to estimate the extra expenses that might be required to stay in business following damage to business property or to keep a family together and maintain its standard of living after a home is damaged. Determining the extent of a property loss exposure involves considering the extra expenses required in the event of the loss of property.

Educational Objective 4

Identify and describe the parties that might be affected by property losses.

Parties Affected by Property Losses

Parties that might be affected by a property loss include the following:

- The property owner
- Secured lenders of money to the property owner
- Users of the property
- Other holders of the property

The Property Owner

The party most affected when property is lost, damaged, or destroyed is usually the owner of the property. If property has some value and is lost, damaged, or destroyed, the owner of the property incurs a financial loss because of the cost of repairing or replacing the property. In the earlier example, Mr. Brown incurred a considerable financial loss because he had to rebuild his store and restock the shelves.

Secured Lenders

A **mortgagee** (or **mortgage holder**) is a lender that loans money on a home, building, or other real property.

A **mortgagor** is the person or organization that borrows money from a mortgagee to finance the purchase of real property.

When money is borrowed to finance the purchase of a car, the lender usually acquires some conditional rights to the car, such as the right to repossess the car if the car's owner (the borrower) fails to make loan payments. This right gives the lender security. Such a lender is therefore called a secured lender or a secured creditor. When a person or business borrows money to buy a home or a building and the property serves as security for the loan, the secured lender is called a **mortgagee** (or **mortgage holder**), and the borrower is a **mortgagor**.

When property is used to secure a loan, both the property owner and the lender are exposed to loss. If, for example, Mr. Brown had a mortgage on his supermarket building, the mortgagee would lose the security for the mortgage loan when the building burned. Similarly, if a financed car is destroyed in an accident and the owner has no money to repay the loan, there would be no car for the lender to repossess. Property insurance policies generally protect the secured lender's interest in the financed property by naming the lender on the insurance policy and by giving the lender certain rights under the policy.

Users of Property

Some events result in losses to users of the damaged property, even though the users do not own the property. Consider the following example: Fish Store's twenty-year lease, signed eight years ago, specifies a rental rate much lower than the cost to rent similar space today. If the building is destroyed, the lease will be canceled, and Fish Store will probably have to pay higher rent, either for the rebuilt building or another location.

Other Holders of Property

Some parties are responsible for the safekeeping of property they do not own. Dry cleaners, TV repair shops, common carriers, and many other businesses temporarily hold property belonging to others. Holders of property entrusted to them by others are called **bailees.**

A **bailee** is a person or business that holds the property of others for some specific purpose.

For example, assume that Mr. Brown's supermarket offered a film-processing service. He would be the bailee of the rolls of film his customers left for developing. In estimating his property loss exposures, Mr. Brown would have to consider not only the property he owned, but also the property (such as film) that he held for others.

Property Insurance Policy Provisions

Property insurance policies must specify exactly 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 state what parties are covered and how the value of insured property will be determined.

Property insurance is any type of insurance that indemnifies an insured who suffers a financial loss because property has been lost, stolen, damaged, or destroyed.

This section examines characteristics common to policies that provide property insurance. Property insurance includes many different types of coverages, including those coverages that are classified as "boiler and machinery," "auto physical damage," and "crime" insurance. Property insurance is sometimes written alone and sometimes as a part of a policy that also provides liability coverage. In this chapter, the discussion focuses on illustrating certain principles rather than on the content of specific policies. (For those who are interested in specific policy details, INS 22—*Personal Insurance* discusses personal insurance policies, and INS 23—*Commercial Insurance* discusses commercial insurance policies.)

Educational Objective 5

Explain how covered property and locations are specified in property insurance policies.

Covered Property and Locations

An insurance policy must carefully specify the property that is covered and where the property is covered. For example, a typical auto insurance policy covers collision damage to an auto described in the declarations, provided the collision occurs in the United States, its territories and possessions, Puerto Rico, or Canada.

Many types of property insurance are designed primarily to cover buildings and personal property. The identification of a covered building is generally not a problem because its location is fixed. However, stating the location of covered property might not be as simple as it seems. One challenge lies in describing *precisely* what is and is not covered under an insurance policy that provides building coverage. Another challenge lies in the fact that buildings and personal property do not necessarily remain at a fixed location. Portions of a building might be removed from the premises for repair or storage. For example, screen windows might be removed from the building and placed in storage during the winter while storm windows are being used. Furniture might be found not only inside buildings but also on outdoor patios and decks. Items usually kept in a building might be temporarily located in a car or truck.

Floaters are policies that are designed to cover property that "floats," or moves from location to location.

Other types of property insurance policies are designed to cover personal property that often moves from place to place. Such policies are called **floaters** because they provide coverage that "floats," or moves, with the property as it changes location. Examples of policies that cover movable personal property are floaters that cover jewelry, furs, cameras, and other types of property owned by individuals and families; transportation policies that cover property transported on trucks or other conveyances; and contractors equipment floaters that cover earthmovers and other construction equipment. Policies covering movable property might have territorial limits, or they might provide coverage anywhere in the world.

Dwellings, Buildings, and Other Structures

A property insurance policy generally stipulates that the policy covers only the building or buildings at the specific location listed in the declarations. The policy also defines exactly what items qualify as part of the building and are therefore covered by insurance.

Dwellings and Other Structures

In personal insurance, a residential structure is generally called a dwelling and is usually covered under a homeowners or dwelling policy. A typical policy on a dwelling covers the "residence premises," which is defined as the location shown in the policy declarations. Usually, the policy definition of residence premises also includes structures attached to the dwelling and materials and supplies located on or next to the dwelling used to construct, alter, or repair the dwelling or other structures on the premises. The coverage for a residence premises does not apply to land.

"Structures attached to the dwelling" include an attached garage or carport. A free-standing, detached garage is not part of the dwelling. A separate insuring agreement for "other structures" covers such detached items. What difference does it make whether a garage is part of the dwelling or qualifies as an "other structure," since it seems to be covered either way? The answer is that different policy limits (dollar amounts of insurance) apply for the dwelling and for other structures. When determining how much insurance the insured should purchase to adequately insure real property—and how much the insurer must pay when a claim occurs—it is necessary to know whether the garage is considered part of the dwelling or a separate structure.

Buildings and Other Structures

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, might not be buildings, but they also need insurance coverage.

A typical commercial property policy covers the building or structure described in the declarations. The policy definition of "building" might 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. Thus, items such as a pipe organ in a church or equipment installed in a manufacturing plant would be considered part of the insured building.

The building coverage of a commercial property policy also includes some items that might seem to be personal property, such as fire extinguishing equipment, outdoor furniture, wall-to-wall carpeting, and refrigerators.

Personal Property

Although buildings and personal property can be insured in the same policy, they are treated as separate coverage items. When a building sustains damage by fire or some other peril, the personal property in that building is often damaged. Likewise, a fire that starts in a wastebasket, for example, is likely to spread and damage the building. Therefore, it is not surprising that buildings and personal property are often covered in the same policy.

On the other hand, because personal property can be moved more easily than buildings, it is exposed to additional perils, such as theft. In addition, property such as valuable papers, computer programs, accounts receivable records, fine arts, stamp collections, money, and securities give rise to loss exposures that require special handling.

Dwelling Personal Property

The personal property coverage of a homeowners policy typically covers personal property owned or used by an insured while it is anywhere in the world. The homeowners insuring agreement for personal property is a very broad statement of coverage, but such broad coverage is restricted by a number of *exclusions* and *limitations*.

Exclusions and Limitations

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. Consider these examples:

- Commercial property insurance policies usually contain *exclusions* for money. A business needing insurance on money should buy an appropriate crime insurance policy or endorsement for the amount exposed to loss.
- Homeowners policies usually have a *limitation* for money of $200 or some other relatively small amount. Homeowners who need coverage for larger amounts of cash might be able to increase the limitation by purchasing an endorsement to the homeowners policy.

Business Personal Property

As stated, 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. Business personal property also includes personal property in the open (or in a vehicle) within 100 feet of the described premises.

Regarding locations where coverage applies, the usual 100-foot limitation in commercial policies is obviously narrower than the worldwide coverage of most homeowners policies. Commercial property policies often include an additional coverage (known as 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.

Further definitions in commercial property policies make it clear that coverage for business personal property applies to such items as furniture, machinery and equipment that is not part of the building, and stock.

Property Other Than the Insured's Buildings and Contents

Property insurance policies usually clarify coverage by listing "property not covered." Policies that cover buildings and personal property typically show autos in such a listing because autos are more appropriately covered under auto insurance policies. Some policies exclude money and securities because these items should be insured under crime insurance policies.

Autos

The declarations page of an auto insurance policy, either personal or commercial, describes the specific autos that are covered, including the vehicle identification number (serial number) unique to each vehicle. The declarations also state where each vehicle is normally kept (or "garaged") because this information is necessary to establish the proper premium. However, the location where coverage applies is not limited to the garage but includes anywhere in the specified coverage territory.

Most auto insurance policies do not cover personal property while transported in autos, but some provide a minimal amount of coverage for "personal effects." Such personal property owned by individuals or families can be covered by homeowners policies. When businesses need coverage, business personal property in transit can be covered by a transportation policy.

Nonowned Property

As noted previously, 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 residence employees, while the property is in the insured's home. Commercial property policies generally extend a limited amount of coverage to the personal effects of officers, partners, and employees as well as to 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.

Movable Property

As mentioned, some property insurance policies cover personal property that does 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 provide coverage while the insured auto is in the United States, its territories and possessions, Puerto Rico, or Canada. Commercial property insurance policies are more restrictive; they provide coverage for the insured's business personal property while it is in the insured building or within 100 feet of the building. Commercial policies also provide limited coverage for property away from the insured premises under certain circumstances. Many floaters provide coverage for movable property anywhere in the world.

Educational Objective 6

Explain how covered causes of loss are typically described in various property insurance policies.

Covered Causes of Loss

The causes of loss examined in this section are commonly covered by property insurance policies and create the majority of property losses. In named perils policies, these causes of loss are specifically listed and defined. In special form coverage policies, the causes of loss are not specifically listed because they are covered unless excluded.

Most property insurance policies today cover many causes of loss, which was not always the case. Property insurance policies once covered only fire losses. Over time, however, policies evolved and expanded, and most now cover many different perils in addition to fire. The various types of crime losses, such as burglary and robbery, are covered by crime insurance policies as well as by some package policies; losses from earthquake and flood can be covered by special types of policies or endorsements.

Most property insurance policies group several causes of loss and offer coverage for them in one policy form. Insureds can obtain the coverage they need by selecting among the forms covering various causes of loss.

Personal and commercial property insurance policies on buildings and personal property are available with three different degrees of coverage:

1. *Basic form coverage*—the lowest-cost version that provides coverage for approximately a dozen named perils.
2. *Broad form coverage*—a higher-cost version of coverage that adds several perils to those covered by basic coverage.
3. *Special form (open perils) coverage*—the version that covers all causes of loss that are not specifically excluded. Special form coverage covers all the perils of broad form coverage, as well as other perils.

Most homeowners policies currently in use provide either broad or special form coverage. Homeowners policies providing basic form coverage are not available in most states.

Basic Form Coverage

Property insurance policies define many causes of loss in some detail. The precise definitions vary by policy. The causes of loss discussed below are generally included in policies, both personal and commercial, that provide basic form coverage.

Fire and Lightning

Fire is one of the most serious causes of loss, but not every fire causes a loss. A gas fire in a kitchen oven, an oil fire in a furnace, and a wood fire in a fireplace serve a specific purpose and cause no loss—unless they blaze out of control.

The term **friendly fire** refers to fires that remain in their intended places. Such fires are generally *not* covered by property insurance policies. A fire that leaves its intended place is called a **hostile fire** and *is* generally covered by property insurance. If a person's wig accidentally fell into a fireplace and was burned, many property insurance policies would not cover the loss because the fire did not leave its intended place. However, if sparks flying from the fireplace set the house on fire, a hostile fire would have occurred and the damage would be covered.

A **friendly fire** is a fire that stays in its intended place. For example, a fire in a fireplace is a friendly fire as long as it remains contained in the fireplace.

A **hostile fire** is a fire that leaves its intended place. For example, if a spark escapes the fireplace and sets the carpet on fire, the fire becomes a hostile fire.

Some fires ensue from another peril. Lightning might strike a house and set it on fire. It is standard practice that policies covering fire also cover loss caused by lightning.

In property policies, "damage caused by fire" includes damage resulting from those conditions accompanying the fire (such as heat and smoke) and those events that can be linked to the fire in an unbroken chain of causation (such as collapse resulting from the fire or water damage caused by firefighters). When these conditions occur because of a fire, the fire is considered the **proximate cause** of the entire loss. It does not matter that the fire itself was caused by some other peril, such as an earthquake. If property insurance covers loss from fire but not from earthquake, damage from *fire* would be covered even if the fire resulted directly from the earthquake. The insurance policy would cover the portion of the loss caused by fire but not the portion caused exclusively by earthquake.

The proximate cause of a loss is the event that sets in motion an uninterrupted chain of events contributing to the loss. For example, if property is damaged by firefighters spraying water to control a fire, the proximate cause of the water damage is the fire.

Windstorm

Like fire, windstorm can cause serious damage to buildings and their contents, as well as to other property. Windstorm includes hurricanes and tornadoes but is not confined to those disturbances. Less severe winds can also cause damage.

Water damage due to flood, waves, or spray sometimes accompanies a windstorm. Many insurance policies cover windstorm damage but not water damage, unless wind causes an opening in the structure through which water enters. When a loss occurs, it is not always easy to determine which damage was done by wind and which by water. Exhibit 8-2 shows coastal property destroyed by a hurricane.

Exhibit 8-2
Coastal Property Destroyed by Hurricane

Hail

Hail consists of ice particles created by freezing atmospheric conditions. Hailstones the size of marbles, golfballs, or baseballs can cause substantial damage to autos, buildings, and other property in the open. Aluminum siding and metal roofs are susceptible to "dimpling" caused by hail. Light hail that is not capable of damaging most property can cause serious crop damage by knocking kernels out of standing grain or by destroying blossoms on fruit trees, for example.

Aircraft

Aircraft damage occurs when all or part of an airplane or satellite strikes property on the ground. Although such incidents are rare, the damage can be severe. For example, if debris from an airplane crash damages Anita's home, Anita could collect from her homeowners insurer for the damage to her house. (Her homeowners insurer could then subrogate against the airline and thus attempt to recover its payment to Anita.)

Vehicle Damage

Vehicle damage refers to damage caused by a motor vehicle to some other kind of property, such as a building. When a car runs into a house, the house suffers vehicle damage and the car suffers collision damage. The homeowner could submit a claim for the vehicle damage to his or her homeowners insurer, and the insurer could in turn subrogate against the driver for the claim paid under the homeowners policy.

Vehicle damage is damage done by a motor vehicle to some other kind of property.

Riot and Civil Commotion

While legal distinctions might exist between riot and civil commotion, both terms refer to approximately the same kind of unruly mob behavior, and insurance covering riot invariably covers civil commotion. Although losses from these perils do not occur very often, they can be quite large. For example, insured losses from the 1992 riots in Los Angeles totaled almost $800 million.

Explosion

An explosion is a violent expansion or bursting accompanied by noise. Explosions include combustion explosions resulting from the ignition of gases, dust, or other explosive materials; combustion explosions are often followed by fire. Explosions can also occur when a pressurized object bursts, such as when a tank containing compressed air bursts. An explosion can destroy an entire building, as illustrated in Exhibit 8-3.

Exhibit 8-3
Building Destroyed by Explosion

Smoke

The sudden or accidental release of large amounts of smoke can result in considerable damage to walls and other objects. When damaging smoke comes from a fire, the fire is generally considered to be the proximate cause of the loss. However, the sudden malfunction of an oil-burning furnace might result in the discharge of clouds of grimy, sooty smoke. In that case, the resulting damage is not caused by fire but by a peril independent of fire. Property insurance policies that cover loss from fire almost always include smoke as a covered cause of loss as well. However, coverage for smoke damage does not include smoke produced by many industrial operations.

Some property is particularly susceptible to smoke damage. In a clothing or grocery store, a relatively small amount of smoke can cause considerable damage. Clothes must be cleaned to remove the smell and might be permanently stained. Foods such as fresh vegetables might be a total loss. Other property—such as a stack of plumbing pipes—might be essentially undamaged by a large volume of smoke.

Vandalism

Vandalism is willful and malicious damage to or destruction of property.

Vandalism losses are not accidental; they are intentionally caused, usually by an unknown person or persons. However, since they are not intentionally caused *by the insured*, they can be covered in insurance policies. Examples of vandalism include graffiti spray painted onto building walls, defacement of statues or other objects of art, and the multiple incidents of mischief that often occur on Halloween. Some insurance policies refer to "vandalism and malicious mischief"; others simply use the term "vandalism." The meaning is the same in either case.

Sprinkler Leakage

Sprinkler leakage is the accidental leakage or discharge of water or other substance from an automatic sprinkler system.

Many commercial and institutional buildings, as well as some private residences, are equipped with automatic sprinkler systems. An automatic sprinkler system is designed to discharge water (or a chemical or gas) when a fire occurs, thus extinguishing or containing the fire. When a fire sets off a sprinkler, the fire is considered the proximate cause of any water damage from the operation of the sprinkler. However, sometimes an automatic sprinkler system discharges accidentally. The system's pipes can freeze and burst, or a buildup of heat from some cause other than fire can cause the system to discharge. Maintenance workers might accidentally bang a ladder against a sprinkler head and cause it to discharge. The peril of **sprinkler leakage** includes such accidental discharges. Compared to fire, sprinkler leakage in most cases is not a serious threat to a building. The vulnerability of a building's contents could be another matter, however. With some occupancies, such as dealers in paper products, sprinkler leakage losses can be devastating.

Sinkhole Collapse and Mine Subsidence

The action of underground water on limestone or similar rock formations can create empty spaces underground. A **sinkhole collapse** occurs when land suddenly sinks or collapses into one of these empty spaces, as illustrated in Exhibit 8-4. This problem occurs most often in Florida, but other states are also susceptible to sinkhole losses.

Sinkhole collapse is a cause of loss involving damage by the sudden sinking or collapse of land into underground empty spaces created by the action of water on limestone or dolomite.

A similar problem exists in states such as Pennsylvania and West Virginia because of underground mining. The **mine subsidence** peril is present when the ground surface sinks as underground open spaces, caused by mining operations, are gradually filled in by rock and earth from above.

Mine subsidence is a cause of loss involving the sinking of ground surface when underground open spaces, resulting from the extraction of coal or other minerals, are gradually filled in by rock and earth from above.

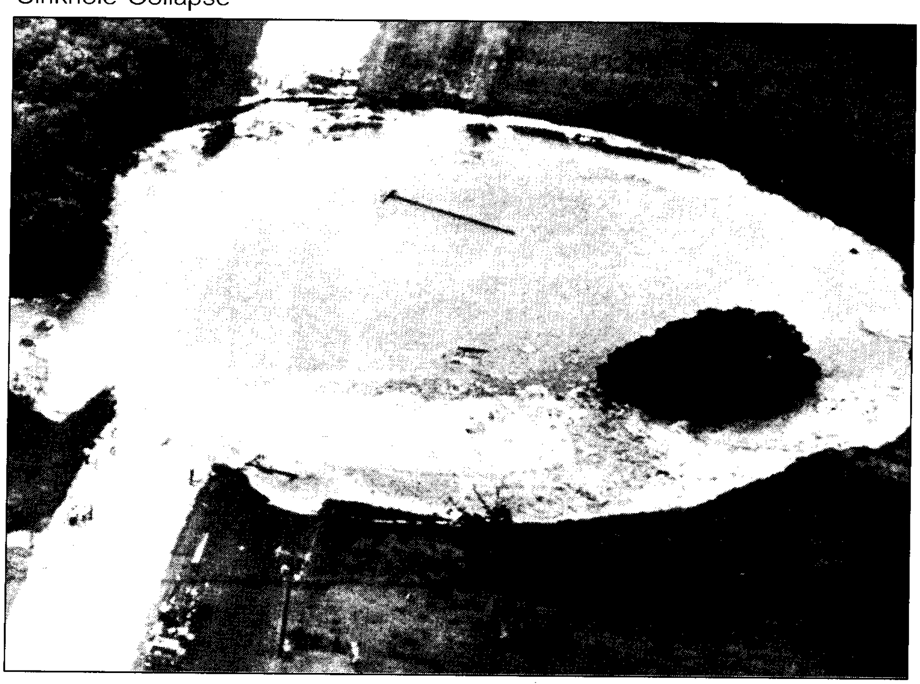
Volcanic Action

Losses caused by **volcanic action** occur primarily in the Pacific coastal states, Alaska, and Hawaii. Volcanic action encompasses loss resulting from the eruption of a volcano, such as Mount St. Helens in 1980 and Kilauea and Redoubt in 1992.

Volcanic action is a cause of loss by lava flow, ash, dust, particulate matter, airborne volcanic blast, or airborne shock waves resulting from a volcanic eruption.

Many property insurance policies used to specifically exclude losses caused by volcanic eruption. However, since there were no volcanoes considered active in the continental United States, specific reference to volcanoes began to disappear from insurance policies as they were revised and simplified. When Mount St. Helens erupted in 1980, many policies did not

Exhibit 8-4
Sinkhole Collapse



specifically provide or exclude coverage for volcanic action but did cover the peril of "explosion." There was considerable debate over whether a volcanic eruption constitutes an explosion. Insureds, seeing explosion as a covered cause of loss and noting no policy definition of the term, requested coverage for damage from the eruption. The outcome was that many losses were treated as explosion losses, and claims were paid. Now, most property insurance policies specifically include coverage for volcanic action, but some specifically exclude such coverage.

Broad Form Coverage

While property insurance policies that cover basic form causes of loss cover the perils discussed above, other property insurance policies add coverage against additional causes of loss that are commonly referred to as "broad form coverage" or "broad form perils":

- Breakage of glass—Glass can break as a result of causes other than basic causes of loss.
- Falling objects—Trees or other objects might fall onto a building.
- Weight of snow, ice, or sleet—The weight of accumulations of any of these might damage or destroy buildings and their contents.
- Sudden and accidental water damage—Sudden leaks might, for example, damage carpets, floors, or ceilings.

Collapse

Although collapse is usually not listed as either a basic or a broad form peril, many property insurance policies provide an additional coverage for loss or damage involving collapse of all or part of a building, but only if the collapse is caused by one or more of the basic or broad causes of loss described above. Other covered causes of collapse are hidden decay; hidden damage by insects or vermin; weight of people or contents; weight of rain that collects on a roof; and use of defective material or methods in construction, remodeling, or renovation if the collapse occurs during the construction, remodeling, or renovation.

Burglary is the taking of property from inside a building by someone who unlawfully enters or exits the building.

Robbery is the taking of property from a person by someone who has caused or threatened to cause the person harm.

Theft is a broad term that means any act of stealing; theft includes burglary and robbery.

A break-in is a burglary; a purse snatching or a holdup is a robbery; and both are thefts.

Crime Perils

Coverage for various crime perils can be included in insurance policies. The definitions of these causes of loss as used in crime insurance might differ somewhat from the usual definitions of these terms. For example, **burglary** is a type of crime committed by someone who breaks into a building and illegally removes property. The definition of burglary in insurance policies also includes breaking *out* of a building because thieves might hide inside a building before it is closed for the night and make a forcible exit after stealing some of the contents. **Robbery** is a type of theft committed by someone who takes property from a person in the presence of that person through use of intimidation or force. **Theft** is a general term meaning any act of stealing. It includes robbery, burglary, and other forms of stealing. Some insurance policies cover the peril of theft, but others cover only a specific type of theft, such as burglary or robbery.

Auto Physical Damage

Insurance policies that provide auto physical damage coverage (property coverage for autos) offer the following types of coverage:

- **Collision**
- **Other than collision** (also called **comprehensive**)
- **Specified causes of loss** (used primarily in commercial auto policies)

Like other property, cars and trucks are subject to fire, theft, vandalism, and other perils. However, the most serious cause of loss to autos is collision. Insurance against collision costs considerably more than insurance against all other perils combined. Collision coverage is not included with either of the other coverages and must be purchased as a separate coverage.

Collision covers damage to an insured motor vehicle caused by its impact with another vehicle or object or by its upset or overturn.

Other than collision (or **comprehensive**) covers losses to a covered auto by fire, theft, vandalism, falling objects, flood, and various other perils. Other than collision is a type of open perils ("all-risks") coverage because it covers any "direct and accidental loss" that is not caused by collision and is not specifically excluded.

Specified causes of loss is a less expensive alternative to comprehensive coverage in commercial auto policies. This coverage is a named perils coverage that covers loss to a covered vehicle caused by fire, lightning, theft, windstorm, hail, earthquake, flood, vandalism, and other specifically listed perils.

Educational Objective 7

Identify and describe the causes of loss that are usually excluded in property insurance policies.

Causes of Loss Often Excluded

Discussion to this point has focused on causes of loss covered by most property insurance policies. Numerous other perils can also cause loss to property but are usually excluded from insurance policies.

Catastrophe Perils

Insurance functions best when many insureds pay relatively small premiums in order to provide a fund for paying large losses incurred by relatively few insureds. Some perils that affect a great many people at the same time are generally considered to be uninsurable by insurance companies, since the resulting losses would be so widespread that the funds of the entire insurance business might be inadequate to pay all of the claims.

For this reason, almost all property insurance policies exclude coverage for losses from catastrophes such as war and nuclear reaction. However, there are policies that provide so-called war risks coverage on oceangoing vessels and cargo. Insurance against losses to property from nuclear reaction is available for nuclear power plants and transporters of nuclear materials. Most property insurance policies also exclude property losses resulting

Reminder

As discussed in Chapter 7, insurance policies contain exclusions for several reasons:

- To avoid covering "uninsurable" losses
- To avoid insuring losses that could be prevented
- To eliminate duplicate coverage
- To eliminate coverage that most insureds do not need
- To eliminate coverage for exposures that require special handling by the insurer
- To keep premiums reasonable

from governmental action, such as governmental seizure of property.

Most policies providing coverage on buildings and personal property at fixed locations exclude coverage for earthquake and flood losses. An earthquake can be a catastrophe affecting many different properties in the same geographic area at the same time. Also, the extent of earthquake damage depends in part on the type of construction of the property. A building that is susceptible to fire damage might be less susceptible to earthquake damage, and vice versa. For these and other reasons, insurers prefer to handle earthquake coverage separately, making a specific decision on how to handle each application for insurance.

Flood damage can also be catastrophic. However, floods are much more predictable than earthquakes. For property in low-lying areas near rivers, creeks, or streams, the question is not whether floods will occur, but when. Insurance companies are generally not willing to provide coverage for a loss that is certain to occur. However, flood insurance on buildings and personal property is available through the National Flood Insurance Program sponsored by the federal government. Auto insurance policies and other policies covering movable personal property generally include coverage against flood losses.

Maintenance Perils

Property insurance policies also typically exclude loss from wear and tear, inherent vice, latent defect, and other "maintenance perils." Such losses are generally uninsurable because they either are certain to occur, over time, or are avoidable through regular maintenance and care. Maintenance perils that are excluded from most policies include:

- Wear and tear
- Marring and scratching
- Rust
- Gradual seepage of water
- Damage by insects, birds, rodents, or other animals

These maintenance perils are usually not covered even in the broadest property insurance policies. As stated in Chapter 1, insurance works well only for definite and accidental losses. Some of these excluded perils (wear and tear, marring and scratching, or rust) involve the results of ordinary use and aging rather than unexpected damage. Damage from the other perils (water seepage, insects, or rodents) is preventable through proper care and maintenance.

Educational Objective 8

Identify and describe the financial consequences of loss that might be covered by property insurance policies.

Covered Financial Consequences

As stated, property losses can lead to any or all of the following financial consequences:

- Reduction in the value of the property
- Lost income
- Extra expenses

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

Reduction in Property Value (Direct Loss)

A reduction in the value of property is often referred to as **direct loss.** The loss occurs directly and often immediately when a covered cause of loss affects covered property. It costs money to replace or restore a home, a commercial building, or the personal property in either to its pre-loss condition. If the property is not restored, it is not worth as much after the loss as before.

Direct loss is a reduction in the value of property that results directly and often immediately from damage to that property.

Time Element (Indirect) Loss

Discussion to this point has described insurance that covers the reduction in value of property that has been damaged or destroyed. However, lost income and increased expenses can also be insured.

The insurance coverages that apply to loss of income and increased expenses are often called **time element loss** coverages. The longer the property is unusable, the greater the time element loss. If a building cannot be occupied for six months, the financial loss for the insured is much more severe than if the building cannot be occupied for only a few days. Sometimes the term **indirect loss** is used to distinguish the effect of the loss on future income and expenses from the direct property loss, but that term is not as precise as "time element loss," which indicates that the extent of loss is directly related to the passage of time. Time element losses include lost income, extra expenses, or both.

Time element loss (or **indirect loss**) includes loss of income or extra expenses resulting from direct loss to property. This type of loss is called "time element" because it takes place over days, weeks, months, or even years following a direct loss.

Lost Income

Business income insurance protects a business from income lost because of a covered direct loss to its building or personal property. Covered business income includes the organization's net profit (income minus expenses) that *would have been earned* if the insured property had not been damaged. It also includes the operating expenses that continue while the business is interrupted. By replacing lost profits and reimbursing expenses, business income insurance can put the business in the same financial position it would have experienced if no direct loss had occurred.

Coverage for loss of income is also provided by homeowners policies. When a covered cause of loss damages the part of the residence that the 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 while the rented portion of the residence undergoes repair.

Extra expenses are expenses that reduce the length of a business interruption or enable a business to continue some operations when the property has been damaged by a covered cause of loss.

Additional living expense is 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 uninhabitable.

Extra Expenses

With regard to business income losses, **extra expenses** include additional expenses that reduce the length of the business interruption or enable a business to continue some operations despite damage to its property. For example, Iris Arnold, an insurance agent, might rent office space to conduct her business at a temporary location during the repairs to her office building following a fire. Ms. Arnold's rental expense would be covered as an extra expense, as would as any extra expenses (over and above her normal expenses) such as installing telephone service and notifying her clients of the temporary location.

The **additional living expense** coverage in homeowners and other policies covering dwellings is also an example of extra expense coverage. If a direct loss to the dwelling makes the dwelling uninhabitable, this coverage indemnifies the insured for the *additional* expenses that are incurred so that the household can maintain its normal standard of living while the dwelling is being restored.

Another example of coverage for extra expenses is the optional rental reimbursement coverage available by endorsement to personal auto policies. This coverage pays up to a certain amount per day toward the cost of renting a substitute vehicle because the covered auto has been damaged by collision or some other covered cause of loss.

Educational Objective 9

a. Identify the parties that can be covered by property insurance policies.
b. Explain how property insurance policies provide coverage for various parties.

Parties Covered by Property Insurance

Although a property insurance policy reflects an agreement between the insurance company and the insured, the insured is not always the only party who 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.

As mentioned, persons or organizations with an insurable interest in property can include property owners, secured lenders, users of property, and other holders of property. How do property insurance policies handle these various interests? Generally, policies are written to cover these interests as follows:

- The owner of a building is the named insured on a property insurance policy covering the building.
- A party that owns and occupies a building is the named insured on a policy covering both building and personal property.
- The tenant of a building is the named insured on a property insurance policy covering the tenant's personal property in that building.
- A secured lender, although usually *not* a named insured, is listed by name in the declarations (or in an endorsement) as a mortgagee or a loss payee.
- A bailee, such as Warehouse, Inc., is the named insured on a bailee policy.

Named Insured(s)

The declarations page of a policy has a space labeled **named insured(s)**. Only parties whose names appear *in that space* (or on an attached endorsement listing "additional named insureds") are, in fact, named insureds. In personal insurance, the named insured's spouse usually receives the same coverage as the named insured, even if the spouse is not named on the declarations page. Coverage for the spouse of a named insured depends on the policy definition of "named insured" and generally requires that the spouse live in the same household as the named insured. For example, a homeowners policy states:

The **named insured** is the policyholder whose name(s) appears on the declarations page of an insurance policy.

> In this policy, "you" and "your" refer to the "named insured" shown in the Declarations and the spouse if a resident of the same household.

Therefore, if Larry Maple's name is the only name that appears on the declarations page of his homeowners policy as a "named insured," the policy also provides coverage for his wife, Mary, who lives in the house with Larry. The wording in the preprinted portion of the policy, following the declarations page, does not refer to them as "Larry" and "Mary" but uses the word "you" (or "your") to include both Larry and Mary.

The **first named insured** is the person or organization whose name appears *first* as the named insured on a commercial insurance policy and who, depending on the policy conditions, might be the one responsible for paying premiums and the one who has the right to receive any return premiums, to cancel the policy, and to receive the notice of cancellation or nonrenewal.

The situation is somewhat different with commercial insurance. For one thing, several different individuals and business organizations may be listed as named insureds. Do all receive the same protection? Which one of these named insureds should the insurance company deal with? Commercial insurance policies often resolve these issues by stating that the **first named insured** is, in effect, the contact person. The first named insured is responsible for paying premiums and has the right to receive any return premiums and to cancel the policy. If the insurance company decides to cancel or not renew a policy, the first named insured receives the notice of cancellation or nonrenewal.

Secured Lenders

Although secured lenders are generally not named insureds on insurance policies covering property for which they have loaned money, the insurable interests of such lenders are protected when they are listed in the policy.

Mortgagee or Mortgage Holder

Until the loan is paid in full, the lender has an insurable interest in the property because destruction of the property could cause a financial loss to the lender. To protect its interest in real property, a lender usually requires the borrower to purchase property insurance covering the building and to have the lender listed by name as mortgagee on the policy's declarations page.

The **mortgage clause** (or **mortgage holders clause**) of a property insurance policy protects the insurable interest of the mortgagee by giving it certain rights, such as the right to be named on claim drafts for losses to insured property and the right to be notified of policy cancellation.

The mortgagee has the following rights under the **mortgage clause** (or **mortgage holders clause**) of the building owner's insurance policy:

1. The insurer promises to pay covered claims to both the named insured and the mortgagee as their interests appear (that is, to the extent of each party's insurable interest).
2. The insurer promises to notify the mortgagee before any policy cancellation or nonrenewal. This notice enables the mortgagee to replace the policy with other insurance.
3. If the insurer cancels the policy and neglects to inform the mortgagee, the mortgagee's interest is still protected, even if the named insured no longer has coverage.
4. So that the policy will remain in effect, the mortgagee has the right to pay the premium to the insurer if the insured fails to pay the premium.
5. In case of loss, the mortgagee may file a claim if the insured does not.
6. If a claim is denied because the insured did not comply with the terms of the policy, the mortgagee may still collect under the policy.

Loss Payee

While a mortgage clause is used in a policy covering *real property*, a **loss payable clause** is used when a secured lender has an insurable interest in *personal property*. The secured lender is listed as a **loss payee**. A loss payable clause provides that a loss will be paid to both the insured and the loss payee as their interests appear. In addition, a loss payee is entitled to the same advance notice of cancellation as is the named insured. Therefore, to the extent of its insurable interest, a loss payee has the right to participate in the recovery whenever any covered claim entitles the insured to payment. However, a loss payee does not have any right to recover in cases where the insured cannot recover. In this regard, a loss payee does not have the same level of protection that a mortgagee has.

A **loss payee** is a lender, named on an insurance policy, who has loaned money on personal property, such as a car.

A **loss payable clause** provides that a loss will be paid to both the insured and the loss payee as their interests appear and gives the loss payee certain rights. However, a loss payable clause does not extend as many rights to the lender as does a mortgage clause.

Other Parties Whose Property Is Covered

Many property insurance policies provide coverage to parties who are neither named insureds nor secured lenders. The following examples illustrate this point:

- A homeowners policy can provide coverage for property owned by relatives and other persons under the age of twenty-one who reside in the named insured's household.
- A homeowners policy can provide coverage for property belonging to guests, residence employees, and others while it is in the named insured's home.
- A commercial property policy providing coverage on the named insured's personal property can also provide limited coverage for (1) the personal effects of officers, partners, or employees and (2) personal property of others in the care, custody, or control of the insured.
- A personal auto policy can provide coverage for collision damage if the named insured borrows a car belonging to somebody else, the car sustains collision damage, and the owner of the borrowed car has no insurance.

The typical property policy provides that property of others is covered only if the named insured requests that the insurer cover a loss. In the above examples, the other parties do not enter into the insurance contract with the insurer, and they have no specific rights to collect under someone else's policy. However, the named insured can request that the insurer pay claims of this type.

Educational Objective 10

Explain how various policy limits and other provisions affect the amounts of recovery under a property insurance policy.

Amounts of Recovery

When covered property is damaged by a covered cause of loss, how much will an insurer pay to a covered party with an insurable interest? That question must be clearly addressed in any insurance policy providing property coverage. The answer depends on policy provisions in the following categories:

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

Policy Limits

When buying property insurance, the applicant usually requests a certain 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. If a policy provides more than one coverage, different limits are shown for each coverage.

A policy limit plays several roles. It tells the insured the *maximum* amount of money that can be recovered from the insurance company after a loss. By comparing the policy limit to the value that might be lost, the insured can determine whether the amount of insurance is adequate.

The policy limit tells the insurer the maximum amount it may have to pay for a covered loss. This limit is important, because insurance companies must keep track of their overall obligations in any one geographic area. Otherwise, a fire or windstorm that affected several insured properties on, for example, one city block could have an unexpected effect on the insurer who relied on a spread of risk.

The policy limit is important to both the insurer and the insured for another reason. For most property insurance coverages, the premium charged is directly related to the policy limit.

Valuation Provisions

Several approaches may be used to set a value on a single item. As previously discussed, 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*.

Settlement Options

The presence of valuation provisions might create the impression that all insured losses are paid in money. Actually, property insurance policies usually give the insurer the choice of different ways to settle a loss.

The insurer generally has the option of:

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

These options for settling property losses can often reduce the insurer's costs of settling claims without diminishing the insured's actual indemnification. For example, the insurer might choose the second option and pay the cost to repair a partially burned garage if the cost of repair is less than an appraiser's estimate of the garage's decrease in value as a result of the fire.

The third option would allow an insurance company to replace a stolen watch, for example, with one of the same kind. An insurer might exercise that option because it is able to obtain the watch at a wholesale price that is less than the retail value of the watch.

Deductibles

Property insurance policies usually contain a **deductible** provision, which states that a portion of every insured loss will be subtracted (deducted) from the amount the insurer would otherwise pay. Property insurance deductibles serve several functions. Because the insured bears a part of any loss, deductibles encourage the insured to try to prevent losses. 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.

A **deductible** is a portion of a covered loss that is not paid by the insurer. The deductible is subtracted from the amount the insurer would otherwise be obligated to pay the insured.

Insurance-to-Value Provisions

Many property insurance policies include **insurance-to-value provisions**, which encourage insureds to purchase an amount of insurance that is equal to, or close to, the value of the covered property. Few losses are total. Unless all insureds purchase an amount of insurance close to the full value of their property, some insureds will pay considerably less for what provides, in most cases, the same recovery for a loss.

Insurance-to-value provisions are provisions in property insurance policies that encourage insureds to purchase an amount of insurance that is equal to, or close to, the value of the covered property.

Assume, for example, that Jane and Jack both own buildings worth $100,000. Jane insures her building for $100,000, but Jack believes that the largest amount of loss he will suffer is $25,000 and insures his building for that amount. If their policies do not contain insurance-to-value provisions and each building suffers $25,000 damage, Jane and Jack will each receive $25,000 from their insurers to pay for the damage. However, because Jane's policy limit is four times higher than Jack's, her premium was considerably higher. Jack took a chance that his loss would be no more than $25,000 (a fairly safe assumption in most cases) and paid much less for his coverage. This result is not only unfair to policyholders, but it could also result in the insurance company receiving inadequate premiums to cover losses.

Insurers could solve this problem by charging a higher rate for those insureds who insure to less than the property's value. That solution is complicated, however (although it is used in some rare cases). Consequently, insurance companies have encouraged 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. Insurers also offer alternatives to coinsurance, although their goal is still to have property insured to its full value.

Coinsurance is an insurance-to-value provision in many property insurance policies. If the property is underinsured, the coinsurance provision reduces the amount that an insurer will pay for a covered loss.

"Other Insurance" Provisions

In some cases, more than one insurance policy provides coverage for the same item of property. If two or more insurance companies 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 problem. Several approaches are possible. The applicable approach depends on the wording of the particular policy and on the situation.

Educational Objective 11

Define or describe each of the Key Words and Phrases for this assignment. (All Key Words and Phrases appear in bold print in the text and in boxes in the margins throughout this chapter.)

Summary

This chapter begins by exploring various aspects of property loss exposures, with emphasis on the major types of property exposed to loss, potential causes of loss, and financial consequences that might result from a property loss, as well as parties that might be affected by a property loss.

Types of property discussed include:

- Buildings
- Personal property ("contents") contained in buildings

- Money and securities
- Motor vehicles and trailers
- Property in transit
- Ships and their cargo
- Boilers and machinery

These categories are useful for insurance purposes because they emphasize the characteristics that affect property loss exposures.

Causes of loss, or perils, that can damage or destroy property are sometimes listed in insurance policies, called "named perils" policies. Other policies, called "special form coverage" or "open perils" policies, provide coverage for any direct loss to property unless the loss is covered by a peril that is specifically excluded by the policy.

The financial consequences of a property loss can include:

- A reduction in the value of the property
- Lost income because the property cannot be used
- Increased expenses

Property can be valued in several different ways. The two valuation approaches most commonly used in property insurance policies are replacement cost and actual cash value. In certain situations, other valuation approaches (such as agreed value) are used.

Parties in addition to the property owner might be affected by a property loss. These parties include secured lenders, users of property, and other holders of property.

After exploring property loss exposures, this chapter discusses property insurance policy provisions that clarify which property loss exposures are covered. These provisions specify the specific property and locations covered, the causes of loss covered and those excluded, the financial consequences covered, and the parties covered.

Several factors can affect the amount of recovery in the event of a loss. Policy limits stipulate the maximum amount the insurance company will pay in the event of a loss. Policy valuation provisions explain how the amount of a loss payment will be determined, that is, according to replacement cost, actual cash value, or some other valuation method. Settlement options give the insurer a choice of several ways to settle a loss. Property insurance policies often specify a deductible to be subtracted from the amount of the loss payment. Some policies also include an insurance-to-value provision that encourages insureds to purchase insurance equal or close to the value of the property. 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.