

Chapter 9

Liability Loss Exposures and Policy Provisions

Educational Objectives

After studying this chapter, you should be able to:

1. Distinguish among the following: (pp. 9-5 to 9-6)
 - a. Constitutional law
 - b. Statutory law
 - c. Common law
2. Distinguish between criminal law and civil law. (pp. 9-6 to 9-8)
3. Explain how each of the following can create the legal basis for a claim by one party against another for damages: (pp. 9-8 to 9-14)
 - a. Torts
 - b. Contracts
 - c. Statutes
4. Identify and describe the four elements of negligence. (pp. 9-9 to 9-10)
5. Describe the potential financial consequences of liability loss exposures. (pp. 9-14 to 9-15)

6. Identify and describe activities and situations that create liability loss exposures. (pp. 9-15 to 9-18)
7. Identify and describe the parties that might be insured by a liability insurance policy. (pp. 9-19 to 9-20)
8. Identify and describe the various types of injury or damage that are typically covered in liability insurance policies. (pp. 9-21 to 9-23)
9. Describe the costs typically covered in liability insurance policies. (pp. 9-23 to 9-27)
10. Demonstrate an understanding of the difference between occurrence basis and claims-made coverage. (pp. 9-27 to 9-29)
11. Explain how claim payments are affected by various limits and provisions in liability insurance policies. (pp. 9-29 to 9-31)
12. 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 9

Liability Loss Exposures and Policy Provisions

The day seemed like any other at the Alpha Insulation Company (AIC). Trucks entered and left the plant, and the chemical processing operations ran at 100 percent of capacity to keep up with demand. The only unusual event in the day's schedule was a tour by chemical engineering students who were impressed by the plant's efficiency.

However, disaster struck at 11:08 A.M. when the No. 2 storage tank exploded. Minor explosions had occurred before but had done little damage. Things turned out differently this time.

Apparently the No. 2 storage tank had been filled beyond its listed capacity, leaving inadequate space for expansion as the temperature of the contents increased. A pressure relief device failed to function, and the tank wall finally popped at a seam, causing the contents of the tank to spread into the plant yard. A large amount of the contents went into a drain leading to a nearby river. Some of the fluid flowed into one of AIC's buildings, where a furnace ignited the fluid. The fire spread quickly and burned for two days. Fumes from the fire injured 150 of AIC's employees, killed 15 other employees, and injured 10 of the visiting engineering students. Six more employees were injured in an auto accident as they attempted to escape from the fire and fumes. The accident injured three occupants in another vehicle and caused \$5,000 damage to that car.

Reminder

As discussed in Chapter 1, a *liability loss* is a claim for monetary damages because of injury caused by a person or organization to another party or because of damage done to another party's property.

A *liability loss exposure* is any condition or situation that presents the possibility that a liability loss will happen.

The neighborhoods around the plant had to be evacuated, and some businesses near the plant were closed for two weeks. Over the next six months, a series of customer complaints and claims led AIC to conclude that the spillage and fire had caused impurities in its products from several production runs.

In addition to the losses that AIC suffered to its own property because of the explosion and ensuing fire, AIC could suffer devastating financial consequences because of the harm suffered by others. AIC could be legally liable to a number of persons and businesses, and it could suffer large *liability losses* as a result of the explosion and ensuing fire. This chapter explores *liability loss exposures*, based on the concept of legal liability, and the insurance policy provisions that deal with those exposures.

Liability Loss Exposures

In the AIC case, various liability loss exposures led to an occurrence that will inevitably result in claims for monetary damages. These claims arise from AIC's legal obligations to those people and organizations that were injured or suffered property damage caused by the explosion and its aftermath. The explosion at the AIC plant could lead to at least one court case, which might last for many months or even years. If the court rules against AIC and the ruling is upheld despite any appeals made by AIC's attorneys, the company will have no choice but to pay the amount stipulated by the court. AIC's liability losses might not be as obvious on the day after the explosion as its property losses, but the financial consequences of AIC's legal liability could be much greater than the financial consequences of its property losses.

Legal Liability

Legal liability means that a person or organization is legally responsible, or liable, for injury or damage suffered by another person or organization.

An understanding of **legal liability** is essential to recognizing liability loss exposures. Although complex legal questions require the professional expertise of an attorney, knowledge of some fundamental legal terms and concepts is essential for anyone dealing with liability loss exposures or liability insurance.

Laws exist in a civilized society to enforce certain standards of conduct. Although laws generally make the world safer and more secure, they also impose certain duties. Where there are rights, there are also responsibilities. People must accept the constraints of the law in order to enjoy its benefits. The law accomplishes its objectives by holding people responsible for their actions.

Educational Objective 1

Distinguish among the following:

- a. Constitutional law
- b. Statutory law
- c. Common law

Sources of Law

The legal system in the United States derives essentially from the following:

- The Constitution, which is the source of *constitutional law*
- Legislative bodies, which is the source of *statutory law*
- Court decisions, which is the source of *common law*

Constitutional Law

The supreme law in the United States is the Constitution, which specifies the structure of the federal government and outlines the respective powers of the legislative, executive, and judicial branches of the government. The Constitution provides for a federal system of government in which powers not specifically granted to the federal government are reserved for the individual states. With its amendments, the Constitution also guarantees to all citizens certain fundamental rights, such as freedom of speech, freedom of religion, freedom from unreasonable searches and seizures, the right to a trial by jury, and the right to due process of law.

All other laws must conform to **constitutional law**. The courts interpret the Constitution to decide constitutional issues. If the U.S. Supreme Court decides that a particular law conflicts with the Constitution, that law is invalidated. The Supreme Court is the highest court of appeal, and lower courts must follow the Supreme Court's decision in judging future cases involving the same issue.

Each of the states also has a constitution establishing the powers of the state government. Each state has some type of supreme court to resolve legal conflicts in the state government and to hear appeals on matters of state law. States must ultimately follow the Constitution of the United States.

Statutory Law

Legislatures at national, state, and local levels enact laws, or statutes, to deal with perceived general problems. At the national level, Congress considers many proposed new laws each year. Any member of the U.S. Senate or House of Representatives may introduce a bill. After its introduction, a bill may be referred to a committee for study or perhaps for hearings before it is debated on the floor of the Senate or the House. If

Constitutional law consists of the Constitution itself and all the decisions of the Supreme Court that involve the Constitution.

Statutory law consists of the formal laws, or statutes, enacted by federal, state, or local legislative bodies.

Common law, or **case law**, consists of a body of principles and rules established over time by courts on a case-by-case basis.

Criminal law is the category of law that applies to wrongful acts that society deems so harmful to the public welfare that government takes the responsibility for prosecuting and punishing the wrongdoers.

the bill receives a majority vote in both the Senate and the House and the President signs it, the bill becomes law. State legislatures also make new laws in similar fashion. Laws made by local governments are often called ordinances. Collectively, these formal enactments of legislative bodies are referred to as **statutory law**.

Numerous federal, state, and local government agencies have regulatory powers derived from authority granted by legislative bodies. Examples of such agencies include the Federal Trade Commission, the Environmental Protection Agency, state public utility commissions, and local zoning boards. These regulatory bodies issue detailed rules and regulations covering a particular public concern or relating to a particular industry. They also render decisions on the application of these rules and regulations in certain cases.

Common Law

In contrast to statutory law, common law has evolved in the courts. When the king's judges began hearing disputes in medieval England, they had little basis for their decisions except common sense and the prevailing notions of justice. Each decision, however, became a precedent for similar cases in the future. Gradually, certain principles evolved that the judges applied consistently to all the cases they heard. These principles became known as **common law**, or **case law**.

These common law principles guided judges not only in England but also in the English colonies in America. Thus, the English common law heavily influenced the American legal system. When neither constitutional nor statutory law applies, judges still rely on precedents of previous cases in reaching their decisions. In many areas, laws have been passed that modify or replace common law principles, but common law is still important in matters of legal liability.

Educational Objective 2

Distinguish between criminal law and civil law.

Criminal Law Versus Civil Law

An important distinction exists in the U.S. legal system between criminal law and civil law. While criminal law cases generally receive more headlines, legal cases related to insurance usually involve civil law.

Criminal Law

Certain kinds of conduct so endanger the public welfare that society, through its legislative bodies, makes laws to prohibit them and to punish those who engage in such conduct. To cite only a few examples, **criminal laws** prohibit murder, rape,

robbery, arson, fraud, theft, and driving while intoxicated. Such offenses are crimes (wrongs against society).

Crimes are punishable by fines, imprisonment, or, in some states, even death. The government uses its power to punish in order to enforce criminal laws. When a crime occurs, the police investigate and, if sufficient evidence is found, criminal charges are brought on behalf of the state against the accused wrongdoer. For example, if Jesse James were arrested for robbing the City Bank of Sedalia, the case would go to court as "The State versus Jesse James." The district attorney presenting the evidence against Jesse James would represent society as a whole, not just the City Bank of Sedalia. If the jury were to find Jesse James guilty of the bank robbery, he would probably go to jail. Such a punishment is meant to protect the public, to punish Jesse, and to deter other people from committing the same crime.

Civil Law

Actions that are not necessarily crimes can still cause considerable harm to other people. In the absence of laws, a dispute between neighbors can turn into a never-ending feud. **Civil law** proceedings provide a forum for hearing disputes between private parties and rendering a decision binding on all parties. This procedure enables individuals to protect themselves against infringement of their rights by others.

Civil law protects personal and property rights. If someone invades the privacy or property of another person or harms another's reputation, the injured person may seek amends in court. By protecting such personal and property rights, civil law contributes to the welfare and safety of society.

Civil law also protects contract rights. People and businesses are more willing to make agreements or contracts with one another when they know that those contracts are enforceable. If two parties make a contract that one party does not honor, the other party can ask the court to compel adherence to the contract or to assess damages. **Contract law** promotes commerce by making contracts more reliable.

Civil law is the category of law that deals with the rights and responsibilities of citizens with respect to one another. Civil law applies to legal matters not governed by criminal law.

Contract law is the branch of civil law that deals with contracts and settles contract disputes.

Criminal and Civil Consequences of the Same Act

Criminal and civil law do not necessarily deal with entirely different matters. A particular act can often have both criminal and civil law consequences. Consider, for example, the following two incidents in the life of Karen Smith.

Because she is an executive who travels frequently, Karen usually has large amounts of cash in her purse. Once when she was walking down the street, a stranger grabbed her purse and ran off. The police later found the stranger. He still had Karen's purse, but the money was gone. The stranger was arrested, tried,

and convicted of the crime of robbery. Karen might also have started civil law proceedings against the robber to recover her money, but that would have accomplished little since the robber had no money and was going to jail.

Another time Karen put her purse on the conveyor belt for an airport security check and then retrieved it on the other side of the X-ray machine. When she stopped to buy coffee on her way to the plane, she discovered that the money was missing from her purse. Since Karen suspected that one of the guards had taken the money from her purse, she called the police. Although the police investigated, they did not find the missing money, nor was there sufficient evidence to bring criminal charges against any of the guards. However, Karen did bring a civil suit against the airport authority that employed the guards, and the court ordered the airport authority to repay the money Karen had lost.

In each incident, someone apparently took money from Karen's purse; and in each incident, both criminal and civil law proceedings could have resulted. The differing circumstances influenced the practical effectiveness of each type of legal action.

Elements of a Liability Loss Exposure

A liability loss exposure involves the possibility of one party becoming legally responsible for injury or harm to another party. This section examines the following elements of a liability loss exposure:

- The legal basis of a claim by one party against another for damages
- The financial consequences that might occur from a liability loss

Educational Objective 3

Explain how each of the following can create the legal basis for a claim by one party against another for damages:

- Torts
- Contracts
- Statutes

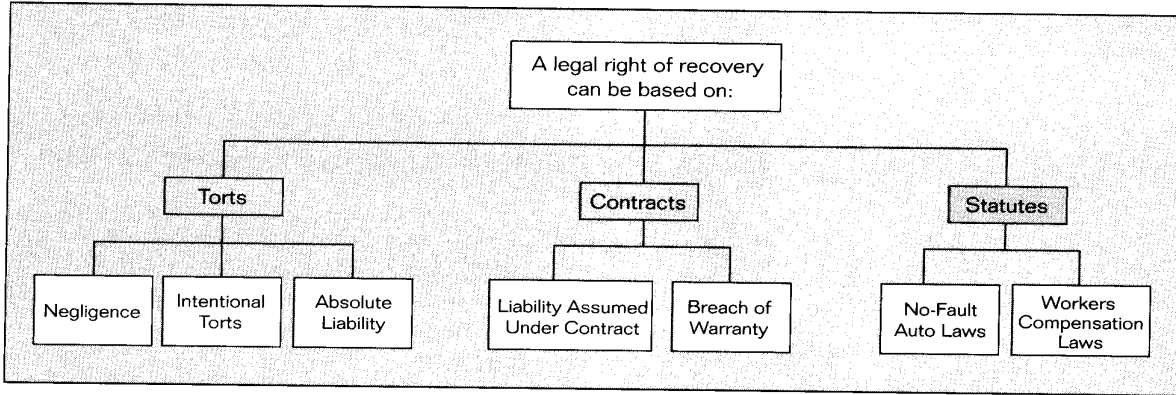
Legal Basis of a Liability Claim

For an injured party to have a right of recovery from another party, some principle of law must create a link between the two parties. This link can appear in tort law, in contract law, or in statutory law. Any law or legal principle that establishes a relationship between the two parties can be the basis for a claim

of liability, but this discussion is confined to the most common types of recovery. Exhibit 9-1 illustrates the different aspects of civil law that can give an injured party the legal basis for recovering damages from another party.

Exhibit 9-1

Legal Basis of a Liability Claim



Torts

A **tort** is any wrongful act other than a crime or breach of contract. Crimes differ from torts, because criminal law allows the state to prosecute and civil law does not. The central concern of **tort law** is determining responsibility for injury or damage. Although largely modified or restated in statutes, tort law is still based mainly on common law.

Regardless of how much sympathy might be felt for the victim of an injury, the victim can be compensated by someone legally responsible for the injury only if there is some standard for assigning that responsibility. Under tort law, an individual or organization can face a claim for legal liability on the basis of any of the following:

- Negligence
- Intentional torts
- Absolute liability

Exhibit 9-2 presents a summary of the types of torts that might give rise to a liability loss.

A **tort** is a wrongful act, other than a crime or breach of contract, committed by one party against another.

Tort law is the branch of civil law that deals with civil wrongs other than breaches of contract.

Educational Objective 4

Identify and describe the four elements of negligence.

Negligence The greatest number of liability cases arise from negligence. **Negligence** occurs when a person or other entity fails to exercise the appropriate degree of care. It usually in-

Negligence is failure to act in a manner that is reasonably prudent. Negligence occurs when a person or organization fails to exercise the appropriate degree of care under given circumstances.

volves acting differently from the way a reasonably prudent person would act under similar circumstances. Tort law gives injured parties the right to seek compensation if they can demonstrate that someone else's negligence led to their injuries.

Exhibit 9-2

Types of Torts

Negligence (Failure to act in a prudent manner)	Intentional Torts (Deliberate acts that cause harm)	Absolute Liability (Inherently dangerous activities)
Elements: Duty owed to another Breach of that duty Injury or damage Unbroken chain of events from breach of duty to injury or damage	Examples: Assault Battery Libel Slander False arrest Invasion of privacy	Examples: Owning a wild animal Blasting operations

A liability judgment based on negligence depends on the following four elements:

1. *A duty owed to another.* The first element of negligence is that a person or organization must have a duty to act (or not to act) that constitutes a responsibility to another party. For example, the driver of an automobile has a duty to operate the car safely. In the AIC case, AIC had a duty to provide safe conditions at its plant.
2. *A breach of that duty.* In order for a person or organization to be held negligent, a breach of the duty owed to another party must occur. A breach of duty is the failure to exercise a reasonable degree of care expected in a particular situation. In AIC's case, the fact that a storage tank had been filled beyond its listed capacity could indicate that AIC had failed to act reasonably and had breached its duty to provide safe conditions. However, if no breach of duty can be proved, no negligence can be found.
3. *Injury or damage.* The third element of negligence requires that the claimant must suffer definite injury or harm. Although a legal duty to act and a breach of that duty may exist, no recovery can be made based on negligence unless someone suffers injury or damage to property. For example, AIC could be accused of causing injury to the visiting students by breaching its duty to provide safe conditions.
4. *Unbroken chain of events between the breach of duty and the injury or damage.* A finding of negligence also requires that the breach of duty initiate an unbroken chain of events leading to the injury. The breach of the duty must be the *proximate cause* of the injury. In the AIC example, the injured students would have to prove that AIC's breach of its duty to provide safe conditions was the proximate cause of their injuries.

Reminder

The *proximate cause* of a loss is the event that sets in motion an uninterrupted chain of events contributing to the loss.

A person, a business, or another party whose conduct is proved to be negligent is generally responsible for the consequences. This party is called the **tortfeasor**, the wrongdoer, or the negligent party. All three terms refer to a party who does something that a reasonable person would not do (or fails to do something that a reasonable person would do) under similar circumstances. Besides the person who actually commits the act, other persons or organizations might be held responsible for the tortfeasor's action. This responsibility is called **vicarious liability**. Vicarious liability often arises in business situations from the relationship between employer and employee. An employee performing work-related activities is generally acting on behalf of the employer. Therefore, the employer can be vicariously liable for the actions of the employee. If, for example, an employee drives a customer to a meeting and negligently causes an accident in which the customer is injured, both the employee and the employer could be held liable for the customer's injuries. Responsibility would not *shift* from the employee to the employer but rather could *extend* to include the employer.

Intentional Torts A deliberate act (other than a breach of contract) that causes harm to another person, regardless of whether the *harm* is intended, is called an **intentional tort**. Assault and battery are probably the most common intentional torts. **Assault** is an intentional *threat* of bodily harm under circumstances that create a fear of imminent harm. **Battery** is any unlawful and unprivileged *touching* of another person. Assault and battery often happen together at approximately the same time, but either can happen without the other.

Another common example of an intentional tort is defamation, which includes both libel and slander. **Libel** occurs when someone prints and distributes an untrue defamatory statement about another person. **Slander** is a spoken, untrue defamatory statement about another person. As a rule, the law affords public figures less protection against libel and slander than ordinary persons except when a false statement is also malicious. For defamation to occur, someone other than the defamed person must read or hear the false statement. Even if others read or hear the statement, the truth is a complete defense against a defamation claim.

False arrest or detainment is any unlawful physical restraint of another's freedom. This intentional tort presents a potential problem for retail stores. False arrest can occur when a store employee detains a customer suspected of shoplifting. If it is later determined that the customer had not stolen any merchandise, the detainment is a false arrest that inconveniences and embarrasses the customer.

Still another intentional tort is **invasion of privacy**, which is an encroachment on another person's right to be left alone. Legal liability for invasion of privacy can arise from the unauthorized release of confidential information, the illegal use of hidden

A **tortfeasor** is a person, a business, or another party who has committed a tort.

Vicarious liability is legal responsibility that occurs when one party is held liable for the actions of another party. For example, parents might be found vicariously liable for the actions of their minor children.

Intentional Torts

An **intentional tort** is a deliberate act (other than a breach of contract) that causes harm to another person. Intentional torts include:

- **Assault**—the intentional *threat* of bodily harm
 - **Battery**—the unlawful *physical contact* with another person
 - **Libel**—a *written or printed* untrue statement that damages a person's reputation
 - **Slander**—an *oral* untrue statement that damages a person's reputation
 - **False arrest**—an unlawful physical restraint of another's freedom
 - **Invasion of privacy**—an encroachment on another person's right to be left alone
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Absolute liability (sometimes called **strict liability**) is legal liability that arises from inherently dangerous activities or dangerously defective products that result in injury or harm to another, regardless of how much care was used in the activity. Absolute liability does not require proof of negligence. ("Strict liability" is also used to describe the liability imposed by certain statutes, such as workers compensation laws.)

A **hold harmless agreement** is a contractual provision that obligates one party to assume the legal liability of another party.

microphones or other surveillance equipment, an unauthorized search, or the public disclosure of private facts.

Absolute Liability Although most liability cases arise from negligence and some arise from intentional torts, liability under tort law is not entirely limited to cases of injury caused by negligent or deliberate conduct. In situations involving inherently dangerous activities, tort law can give an injured person a right of recovery without having to prove negligence or intent. Inherently dangerous activities can give rise to **absolute liability** (sometimes called **strict liability**) for any injury regardless of the intent or the carefulness of the person held liable. The situation itself, rather than the person's conduct, becomes the standard for determining liability.

For example, the owner of a wild animal, such as a pet rattlesnake or a circus lion, is liable for any injury the animal inflicts, regardless of the precautions the owner might have taken. Blasting operations present an exposure to absolute liability for business organizations. The mere fact that the business conducts blasting operations is enough to make the owners of the business liable for any injuries or damage that results.

Contracts

Contract law enables an injured party to seek recovery because another party has breached a duty voluntarily accepted in a contract. As discussed in Chapter 7, a contract is a legally enforceable agreement between two or more parties. If one party fails to honor the contract, the other may go to court to enforce it. In such a case, it is the specific contract, rather than the law in general, that the court interprets. Two areas of contract law important to insurance are liability assumed under a contract and breach of warranty.

Liability Assumed Under Contract Parties to a contract sometimes find it convenient for one party to assume the financial consequences of certain types of liability faced by the other. The party assuming the liability might be closer to the scene, exercise more control over operations, or have the ability to respond to claims more efficiently. For example, James Smith, the owner of a building, and Jane Jones, a contractor, make a contract in which Jones accepts responsibility for certain actions of Bob White, a subcontractor. If one of the specified actions of White injures a customer, Bonita Brown, and Brown sues Smith, then Jones will pay any damages owed to Brown because of White's specified action. Such arrangements, called **hold harmless agreements**, are common in construction and service businesses. They are called hold harmless agreements because they require one party to "hold harmless and indemnify" the other party against liability arising from the activity (or product) that is specified in the contract.

Businesses can transfer the financial consequences of certain types of liability to other persons and organizations through contracts, but, as a matter of public policy, not all types of liability can be transferred. Normally, one party cannot transfer to another party its liability for gross negligence, willful or wanton misconduct, or criminal actions.

Breach of Warranty The law of contracts also governs claims arising from breach of warranty. Contracts for sales of goods include **warranties**, or promises made by the seller. The law also implies certain warranties. A seller warrants, for example, that an item is fit for a particular purpose. If Juanita buys the hair conditioner recommended and sold by her beautician, she relies on the warranty that the conditioner will be good for her hair. If the conditioner damages her hair instead, the beautician (as well as the manufacturer) could be held liable for a breach of warranty. The buyer does not have to prove negligence on the part of the seller. The fact that the product did not work shows that the contract was not fulfilled.

Warranties are promises, either written or implied, such as a promise by a seller to a buyer that a product is fit for a particular purpose.

Statutes

Statutory liability exists because of specific statutes. Although common law may cover a particular situation, statutory law may extend, restrict, or clarify the rights of injured parties in that situation or similar ones. One reason for such legislation is the attempt to ensure adequate compensation for injuries without lengthy disputes over who is at fault. Prominent examples of this kind of statutory liability involve no-fault auto laws and workers compensation laws. In these legal areas, a specific statute (rather than the common law principles of torts) gives one party the right of recovery from another or restricts that right of recovery.

Statutory liability is legal liability imposed by a specific statute or law.

No-Fault Auto Laws Automobile accidents are among the leading causes of injury in the United States. Because of this fact, state legislatures seek ways to improve the system for distributing the generally high costs of those accidents. Specific statutes now modify many of the common law principles of negligence that apply to automobile accidents. Since these laws are enacted by state legislatures, the provisions vary considerably by state.

In an effort to reduce the number of lawsuits resulting from auto accidents, some states have enacted "no-fault" laws. These laws recognize the inevitability of auto accidents and restrict or eliminate the right to sue the other party in an accident, except in the more serious cases defined by the law. Victims with less serious injuries collect their out-of-pocket expenses from their own insurance companies without the need for expensive legal proceedings.

Workers Compensation Laws A similar concept of liability without regard to fault applies to workplace injuries. Each of the

fifty states has a workers compensation statute. Such a statute eliminates an employee's right to sue the employer for most work-related injuries and also imposes on the employer automatic (strict) liability to pay specified benefits. In place of the common law principle of negligence, workers compensation laws create a system in which injured employees receive benefits specified in these laws. As long as the injury is work-related, the employer pays the specified benefits regardless of who is at fault. In the AIC case, the workers compensation law in AIC's state would require that AIC provide benefits (such as medical, disability, and rehabilitation benefits) to the injured employees as well as death benefits to the survivors of the employees who were killed.

Educational Objective 5

Describe the potential financial consequences of liability loss exposures.

Potential Financial Consequences of Liability Loss Exposures

Reminder

As discussed in Chapter 6, *damages* refer to a monetary award that the law requires one party to pay to another who has suffered loss or injury for which the first party is legally responsible.

Legal liability cases might involve various types of damages:

- *Compensatory damages*—damages that are intended to compensate a victim for harm actually suffered. Compensatory damages can include *special damages* (for specific out-of-pocket expenses) and *general damages* (for losses, such as pain and suffering, that do not have a specific economic value).
- *Punitive damages*—damages awarded by a court to punish wrongdoers who, through malicious or outrageous actions, cause injury or damage to others.

A person must sustain some definite harm for a liability loss to result in a valid claim. For the visiting engineering students to collect damages from AIC, for example, they must prove that they actually suffered some harm as a result of the explosion. Perhaps they had to be treated in the hospital emergency room, their clothing was ruined, or they could not go to their jobs and thus lost a day's pay. To those who can show that actual harm or injury was suffered because of AIC's negligence, the court may award *damages* that AIC will have to pay. In addition, AIC might incur *defense costs* to defend itself in court. Exhibit 9-3 shows the various types of damages and defense costs that might have to be paid as the result of a liability claim.

Damages

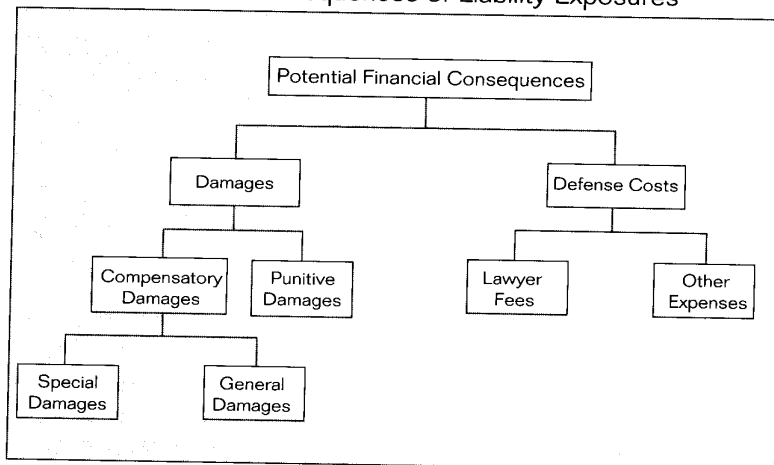
As explained in Chapter 6, *compensatory damages* are intended to compensate the victim for the harm actually suffered. An award of compensatory damages is the amount of money that has been judged to equal the victim's loss, and it is the amount the party responsible for the loss will have to pay. Compensatory damages include both *special damages* and *general damages*. In addition, the court could award *punitive damages*.

Defense Costs

In addition to the damages that might have to be paid because of liability for injury or damage, a liability loss might also include the costs to defend the alleged wrongdoer in court. These defense costs include not only the fees paid to lawyers but also all the other expenses associated with defending a liability claim. Such expenses can include investigation expenses, expert

Exhibit 9-3

Potential Financial Consequences of Liability Exposures



witness fees, the premiums for necessary bonds, and other expenses incurred to prepare for and conduct a trial. Even in the unlikely event that all the possible lawsuits against AIC are ultimately found groundless, AIC and its liability insurer will probably incur substantial defense costs.

Educational Objective 6

Identify and describe activities and situations that create liability loss exposures.

Activities and Situations Leading to Liability Loss Exposures

The potential for a liability loss exists whenever some activity or relationship can create liability to others. Numerous activities and situations have this potential. Although the following list is far from exhaustive, liability can arise from any of the following exposures:

- Automobiles and other conveyances
- Premises
- Business operations
- Completed operations
- Products
- Advertising
- Pollution
- Liquor
- Professional activities

Automobiles and Other Conveyances

A significant liability exposure that faces almost all persons and businesses comes from the ownership and operation of automobiles. In the United States, auto accidents produce the greatest number of liability claims. Even people or businesses that do not own an auto can be held vicariously liable for the operation of an auto by others. As shown in the AIC case, AIC could be held liable for the auto accident caused by its employee fleeing the fire, whether the employee was driving his own vehicle or one owned by AIC.

Liability loss exposures are also created by owning and operating other conveyances such as watercraft, aircraft, recreational vehicles, and the like.

Premises

Anyone who owns or occupies property has a premises liability exposure. If a visitor slips on an icy front porch, the homeowner might be held liable for the injury. A business has a similar loss exposure arising from its premises. As seen in the AIC case, the engineering students were injured while on AIC's premises, and AIC will probably be held liable for their injuries.

Business Operations

Businesses must be concerned not only about the condition of the premises but also about their business operations. As AIC discovered, whatever activity the business performs has the potential to go wrong and cause harm to someone else. When employees of a furniture store deliver a sofa, they must take care not to damage the customer's door or door frame. Damage caused by employees while delivering furniture, installing appliances, or repairing air conditioning, for example, is the responsibility of the employer.

Completed Operations

Even after a plumber, an electrician, a painter, or another contractor completes a job and leaves the work site, a liability exposure remains. If faulty wiring or toxic paint leads to an injury, the person or business who did the work might be liable. Considerable time could pass in the interim, but the person or business might still be held liable if faulty workmanship created the condition that eventually caused the injury. If, for example, AIC could prove that the explosion was caused by the negligence of the contractor who installed the pressure relief device on the storage tank, the contractor might be liable for some or all of the resulting damage and injury.

Products

Liability resulting from products that cause bodily injury or property damage is a significant exposure for manufacturing

companies. This exposure begins with the design of the product and might not cease until the product is properly disposed of by the ultimate consumer. Mass-produced products are used by millions of people, and foods and pharmaceutical products are consumed by customers. A prescription drug might be dangerous, but the danger might not be known for several years, when it is too late to help the people who have taken the drug. AIC's customers complained of impurities in its products; if these impurities caused injury to one or more of its customers, AIC could be held liable for damages. If the manufacturer of the pressure relief device was found to be negligent, the manufacturer might also incur some liability.

Advertising

In their advertisements, businesses often include pictures of people using their products. If a local retailer cannot afford professional models, it might use pictures of people using its products or shopping in its store. Unless the retailer obtains proper permission, publishing the pictures could lead to a lawsuit alleging invasion of privacy. Using another company's trademarked slogan or advertisement can also give rise to a liability claim.

Pollution

Many types of products pollute the environment when they are discarded. In addition, the manufacture of some products creates contaminants that, if not disposed of properly, cause environmental impairment, or pollution. If the explosion at AIC's plant polluted the nearby river, AIC might have yet another liability loss. As illustrated by the Love Canal case in New York State some years ago, industrial products or wastes can have a tremendous effect on the environment. Toxic wastes in the Love Canal area polluted the ground water and made the surrounding community a dangerous place in which to live. Cleanup costs and expenses to relocate the residents can be enormous in such cases.

Liquor

Very serious dangers exist when people consume too much alcohol. Intoxicated persons threaten themselves as well as others. Providers of alcohol can be responsible for customers or guests who become intoxicated and injure someone while driving drunk. Both the drunk driver and the person who served the alcohol can be held legally liable. A business that sells or serves alcoholic beverages, therefore, has a significant liability loss exposure.

Professional Activities

As mentioned, negligence involves a failure to exercise the degree of care that is reasonable under the circumstances. It is

Reminder

Errors and omissions (E&O) are negligent acts (errors) or failures to act (omissions) committed by a professional (such as an insurance agent) in the conduct of business that give rise to legal liability for damages.

reasonable to expect that professionals with special competence in a particular field or occupation will exercise great care in performing their duties. Attorneys, physicians, architects, engineers, and other professionals are considered experts in their field and are expected to perform accordingly. Professional liability arises if injury or damage can be attributed to a professional's failure to exercise the appropriate standard of care. For insurance professionals and others, that failure is sometimes called *errors and omissions (E&O)*. For medical professionals, that failure is often called malpractice. For example, a physician who ignores the possible side effects of a drug when prescribing it might be held liable for any resulting harm to the patient, because accepted medical practice requires the doctor to consider possible side effects. Professionals can make errors, and when they do, the injured party often expects to be compensated.

Liability Insurance Policy Provisions

Liability insurance covers losses resulting from bodily injury to others or damage to the property of others for which the insured is legally liable and to which the coverage applies.

As discussed in Chapter 8, *property insurance* indemnifies an insured who suffers a financial loss because property has been lost, stolen, damaged, or destroyed.

Because of differences between the nature of liability loss exposures and property loss exposures, **liability insurance** differs from *property insurance* in several ways:

- Property insurance claims usually involve only *two parties*—the insurer and the insured. Liability insurance claims involve *three parties*: the insurer, the insured, and a “third party”—the claimant who brings a legal complaint against the insured for injury or damage allegedly caused by the insured. Although the claimant is not a party to the insurance contract, he or she is a party to the claim settlement.
- In property insurance, insurers pay claims *to an insured* when covered property is damaged by a covered cause of loss during the policy period. In liability insurance, on the other hand, insurers pay *a third party on behalf of an insured* against whom a claim has been made, provided the claim is covered by the policy.
- Property insurance policies must clarify which *property and causes of loss* the policy covers. In contrast, liability insurance policies must indicate the *activities and types of injury or damage* that are covered.

The insuring agreements of most liability insurance policies make essentially the same broad promise: to pay damages (usually for bodily injury or property damage) for which an insured becomes legally liable and to which the coverage applies. The insurer also promises to pay related defense costs. In order to clarify the intent of the insuring agreement, which is usually a relatively brief statement, the provisions of a liability insurance policy must answer the following questions:

- What parties are insured?
- What activities are covered?
- What types of injury or damage are covered?
- What costs are covered?
- What time period is covered?
- What factors affect the amount of claim payments?

Educational Objective 7

Identify and describe the parties that might be insured by a liability insurance policy.

What Parties Are Insured?

Liability insurance policies provide coverage for the *named insured* as well as others. A liability policy generally gives the broadest protection to the named insured. Coverage for others is generally based on their family or business relationship with the named insured. Therefore, liability insurance policy provisions must define the relationships that determine coverage. For example, the policy declarations page lists the named insured, and many policies provide the spouse of a named insured with the same coverage that is provided to the named insured if they live in the same household. If several named insureds are listed in the declarations of a commercial liability policy, a policy provision usually stipulates that the *first named insured* is the insured with whom the insurer has contact.

The extent of liability coverage provided to parties other than the named insured is determined by their relationship to the named insured as well as by the circumstances. For example, the liability coverage of a typical homeowners policy applies to:

- The named insured and the named insured's spouse, if the spouse is a resident in the household
- Relatives of the named insured or spouse, if the relatives reside in the household
- Children in the care of the named insured or spouse
- Any person or organization legally responsible for animals or watercraft owned by an insured (except in business situations)
- Employees using a covered vehicle, such as a lawn tractor, and other people using a covered vehicle on an insured location with the named insured's consent

Commercial liability policies also cover the named insured and certain others, depending on their relationship to the named insured. For example, a commercial general liability policy usually contains provisions that specify the relationships and circumstances that determine who is insured under the policy.

Reminder

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

The *first named insured* is the person or organization whose name appears *first* as the named insured on a commercial insurance policy. Depending on the policy conditions, the first named insured 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.

One provision clarifies who is insured when the named insured is an individual, a partnership, or some other type of organization, such as a corporation. Another provision defines others who may be covered because of their business relationship to the named insured and the circumstances under which they are covered. The parties who are afforded liability coverage under this provision include:

- Employees of the named insured
- Real estate managers for the named insured
- Persons responsible for the property of a named insured who has died
- Any person who operates mobile equipment owned by the named insured while on a public highway
- Any organization that is newly acquired or formed by the named insured for up to a certain number of days after it is acquired or formed

As these examples illustrate, both personal and commercial liability insurance policies generally cover many individuals and organizations—including some that are not named in the policy declarations.

What Activities Are Covered?

A liability insurance policy must clearly express the insurer's intent to cover claims against the insured for which the insured is legally obligated to pay damages. It is not the insurer's intent to pay damages to every third party who suffers a loss and files a claim. The insurer will pay damages only to those who suffer injury or damage for which the insured is legally liable if the harm arose from a covered activity.

Just as property insurance policies use either a named perils or a special form coverage ("all-risks") approach to define covered causes of loss, liability insurance policies use two approaches to define covered activities. Certain policies state the specific activity or source of liability covered. For example, an auto insurance liability policy states that it applies to claims that result from covered auto accidents. In contrast, general liability insurance covers all activities or sources of liability that are not specifically excluded.

A commercial general liability policy (known as a "CGL" policy) is an example of general liability insurance. A general liability insurer agrees to pay damages "to which this insurance applies." However, the extent of coverage depends on the exclusions. That is, general liability policies essentially cover those claims that are not excluded and specifically exclude coverage for claims that are better handled by specific liability insurance policies, such as automobile liability insurance,

workers compensation insurance, aircraft and watercraft liability insurance, and professional liability insurance.

In addition to excluding coverage for losses best handled elsewhere, general liability insurance policies contain exclusions dealing with uninsurable exposures, preventable losses, and exposures that would be too costly to insure. For example, like property insurance policies, nearly all liability policies exclude coverage for losses arising from war and nuclear reaction.

Educational Objective 8

Identify and describe the various types of injury or damage that are typically covered in liability insurance policies.

What Types of Injury or Damage Are Covered?

Liability policies typically cover claims for bodily injury and property damage for which the insured is legally liable. However, some liability policies, such as commercial general liability policies, also cover other types of injury, such as personal and advertising injury.

Bodily Injury

Since most liability policies provide coverage only for the insured's legal liability for bodily injury or property damage, the policy language must be precise. A typical commercial general liability policy defines **bodily injury** as follows:

"Bodily injury" means bodily injury, sickness or disease sustained by a person, including death resulting from any of these at any time.

The term bodily injury is repeated in the definition for clarity. The definition indicates that, as used in the commercial general liability policy, the term bodily injury also includes some things that might not be included in the everyday use of that term. Sickness and disease are often considered forms of illness that do not result from physical accidents, that is, they do not involve injury. Death could be considered the severest form of injury, but unless it is specified in the policy, there might be reason to question whether coverage for claims for bodily injury liability includes coverage for death claims. Given the above definition, the commercial general liability policy clarifies that it covers claims for injury, sickness, disease, and death.

Bodily injury is any physical injury to a person, including sickness, disease, and death.

Property Damage

The definition of **property damage** in a typical commercial general liability policy reads in part as follows:

Property damage is physical injury to, destruction of, or loss of use of tangible property.

Reminder

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

Time element (or indirect) loss includes loss of income or extra expenses resulting from direct loss to property.

In insurance, the term **personal injury** is generally used to mean injury, other than bodily injury, arising from intentional torts such as libel, slander, or invasion of privacy.

“Property damage” means:

- a. Physical injury to tangible property, including all resulting loss of use of that property; or
- b. Loss of use of tangible property that is not physically injured.

The definition of “property damage” as the term is used in a typical homeowners policy is considerably briefer and reads as follows:

“Property damage” means physical injury to, destruction of, or loss of use of tangible property.

Thus, according to both of these definitions, property damage includes both *direct losses* and *time element (or indirect) losses*. For example, the fire at AIC’s plant caused *indirect* damage to the owners of surrounding businesses since they had to cease operations temporarily. Although there was no actual *direct* physical damage to these surrounding businesses, the business owners still lost the use of their property because of the explosion at AIC. As for the auto accident, if the owner of the other car temporarily lost the use of the car because of the accident, AIC might be liable not only for *direct* damage to the car but also for a *time element loss*, such as the cost of a rental car until the car was repaired or replaced.

Personal Injury

In addition to bodily injury, harm can be inflicted in other ways, such as damage to one’s reputation. One might expect “bodily injury” and “personal injury” to mean the same thing. In fact, attorneys tend to use the term personal injury when referring to bodily injuries. However, when used in liability insurance policies, **personal injury** usually refers to a specific group of intentional torts, including defamation (which includes libel and slander), false arrest, and invasion of privacy. Any of these acts might cause harm to another person for which the tortfeasor may be held liable. For insurance purposes, intentional torts are usually considered personal injury offenses and are either excluded from coverage or are specifically covered as a separate coverage.

A few policies define personal injury in a way that includes not only the types of offenses listed above but also bodily injury. When that interpretation is used, personal injury coverage is broader than bodily injury coverage. However, the more common interpretation allows for separate coverage for bodily injury and personal injury, in which case personal injury coverage supplements bodily injury coverage. For example, the commercial general liability policy automatically includes personal injury coverage under a separate insuring agreement. Coverage for personal injury liability can be added by endorsement to a homeowners policy.

Advertising Injury

Advertising injury, which is covered by most commercial general liability policies, typically includes the following types of offenses:

- Libel and slander
- Publication of material that constitutes an invasion of privacy
- Misappropriation of advertising ideas or business style
- Infringement of copyright, title, or slogan

The definitions of personal injury offenses and advertising injury offenses overlap somewhat. This overlap, however, does not result in duplicate coverage. Some versions of the commercial general liability policy, for example, include both personal and advertising injury in the same insuring agreement, so no coverage duplication results from repeating that a certain type of claim is covered. Furthermore, the policy clarifies that personal injury does not include offenses involving advertising activities and that advertising injury refers only to offenses committed in the course of advertising activities. Therefore, claims are covered as either personal injury or advertising injury, but not both. Newer versions of the commercial general liability policy include both personal injury and advertising injury coverages in a single coverage called "personal and advertising injury liability," which should eliminate any confusion that might have been present in the older policies about the difference in these two coverages.

Educational Objective 9

Describe the costs typically covered in liability insurance policies.

What Costs Are Covered?

Liability insurance policies typically cover two types of costs:

1. The damages that the insured is legally liable to pay
2. The cost of defending the insured against the claim

Some policies also cover other costs, such as supplementary payments and medical payments.

Damages

A person who has suffered bodily injury, property damage, or personal injury for which the insured is allegedly responsible might make a claim for damages. The claim is often settled out of court, and the insurer pays the claimant on behalf of the insured. If a case goes to court, the claimant might be awarded two types of damages, compensatory damages and punitive damages. These damages may or may not be covered by insurance.

Compensatory damages, intended to compensate the claimant for the injury or damage suffered, are covered by liability insurance if the insured is liable for a covered loss. As stated, compensatory damages include both special damages and general damages. A party who is held to be liable for another's injury might have to compensate the injured party for special damages, such as hospital bills, physicians' fees, lost income, and rehabilitation expenses. In addition to these actual expenses, the liable party might be required to pay general damages, such as pain and suffering, to compensate the victim for the physical and mental suffering experienced because of the bodily injury. AIC's liability insurer might have to pay both special damages and general damages if AIC is found liable for both types of compensatory damages because of the explosion and fire.

Most liability insurance policies do not specifically state whether punitive damages, intended to punish the insured for some outrageous conduct, are covered. Some states do not permit insurers to pay punitive damages for their insureds. The reason for this prohibition is that punishment is viewed as less effective if the responsible party does not personally pay the required damages. On the other hand, insurers may pay punitive damages if they are permitted to do so. Some people argue that punitive damages are as much a source of unexpected financial loss as compensatory damages, and that the insured should be entitled to insure against a judgment for punitive damages.

Out-of-Court Settlements

Very few liability claims are decided by the courts. Indeed, most liability claims are settled before the claimant even files a lawsuit. Most liability claims are settled privately between the claimant (or the claimant's lawyer) and the liability insurer (or the insurer's lawyer) on behalf of its insured.

Any party can decline to voluntarily settle a claim, in which case a lawsuit usually occurs, and a court eventually decides the claim. Parties agree to settle claims when they believe a proposed voluntary settlement is more attractive than a lawsuit and court verdict.

Generally, out-of-court settlements are attractive to both sides for two reasons:

1. *Out-of-court settlements resolve cases quickly.* Both sides to a lawsuit suffer significant financial and emotional costs. Out-of-court settlements spare the parties from these costs.
2. *Out-of-court settlements eliminate uncertainty about the outcome of a claim.* Court verdicts are very unpredictable, and either party might do worse than expected. A claimant or a defendant might bear all the costs of a lawsuit and receive a court verdict less favorable than an out-of-court settlement that

was available months or years earlier. Rather than face such an outcome, parties often prefer out-of-court settlements.

An out-of-court settlement is a voluntary agreement to close a claim in exchange for an agreed amount of money. Such settlements occur only after negotiation. Settlement negotiations consist of a series of communications between the parties in which one party suggests a settlement amount and the other party either accepts the amount, rejects it, or suggests another amount. Settlement negotiations can conclude quickly or go on for months, depending on the personalities and experience of the negotiators and on the underlying facts of the claim. Proposed settlement amounts should be based on each party's perception of what a likely court verdict would be. Thus, anything that would be relevant in court should be relevant in settlement negotiations, including the nature of the injuries or damage, the respective legal liability of the parties, and the quality of the witnesses or evidence for each side.

Once negotiations have concluded with a settlement, the parties sign a release, which is a binding contract. A release is a written agreement in which the claimant agrees to drop his or her claim and the insured, through the insurance company, agrees to pay the claimant the settlement amount. A release can be enforced as a legal obligation independent of the underlying claim, but it is not evidence of wrongdoing on the policyholder's part in the underlying claim.

Insurance companies depend on out-of-court settlements. They could not survive if they had to resolve all liability claims through the courts. An ordinary automobile accident claim can cost thousands of dollars in legal fees to prepare for trial and thousands more to put on trial. Legal fees and other defense costs are already a huge expense for insurers even when most claims are settled out of court.

The court system and society in general favor out-of-court settlements. The courts would be overwhelmed with cases and expenses if every legal issue had to go to court. Society benefits when injured parties receive prompt compensation and when all parties put their legal disputes behind them as quickly as possible.

Defense Costs and Expenses

It is sometimes said that an insurer's duty to defend insureds against liability claims is even more important than its duty to pay damages. If the defense is successful, the court delivers a judgment in favor of the defendant (that is, the insured), and no damages are awarded. In other cases, damages might be awarded, but an effective defense results in a lower award than the award sought by the plaintiff (the claimant).

Most liability insurance policies obligate the insurer to defend the insured against any claim or lawsuit in which a claimant seeks damages that would be covered by the policy; the insurer must pay the costs of such a defense. It is often possible to prove that the insured was not responsible for the alleged injury or damage. Even if the claim seems to have no legitimate basis, the insurer must defend the insured if no clear exclusion applies to the loss. Again, the insurer is obligated to defend an insured only when the claimant alleges that injury or damage was caused by a covered activity of the insured. If the claimant is ultimately awarded damages in a situation that originally seemed to be without merit, the insurer has to pay damages covered by the policy.

Litigation expenses are the expenses incurred for legal defense, such as attorneys' fees, expert witness fees, and the cost of legal research.

The expenses incurred for the defense, known as **litigation expenses**, are the insurer's responsibility. Some of these litigation expenses may be specifically described in the policy; others are implicit. The duty to defend, for example, implies that the insurer will retain the attorneys and pay their fees and expenses. Litigation expenses might also include investigation, legal research, expert witness fees, and similar costs incurred in preparing and presenting the case.

Supplementary Payments

Liability insurance policies typically include additional coverages stating the **supplementary payments** the insurer agrees to pay in addition to damages. These supplementary payments usually consist of the following:

- All expenses incurred by the insurer
- The cost (up to a specified limit) of bail bonds or other required bonds
- Expenses incurred by the insured at the insurer's request
- The insured's loss of earnings (up to a specified amount per day) because of attendance at hearings or trials at the insurer's request

Other costs that relate to the claim, such as *prejudgment* or *postjudgment interest*, might also be included in the list of supplementary payments.

Prejudgment Interest

Liability claims that are not settled out of court often involve long delays between the time of the injury or damage and the time when a court awards a judgment to the claimant. The court award to the plaintiff might include damages as well as **prejudgment interest**. This additional sum of money represents the interest that could have been earned if the plaintiff had received compensation at the time of the injury or damage rather than at the time of the judgment.

In liability policies, **supplementary payments** are amounts the insurer agrees to pay (in addition to the liability limits) for items such as premiums on bail bonds and appeal bonds, loss of the insured's earnings because of attendance at trials, and other reasonable expenses incurred by the insured at the insurer's request.

Prejudgment interest is interest that might accrue on damages before a judgment has been rendered.

Postjudgment Interest

When an award for damages is successfully appealed to a higher court, the plaintiff receives no payment. If, on the other hand, the higher court upholds the initial judgment, the plaintiff may also be entitled to receive **postjudgment interest** as compensation for the money that would have been earned if the insurer had paid the claim at the time of the first judgment. Postjudgment interest forces the insurer to bear the expense of the delay in payment caused by the appeal.

Postjudgment interest is interest that might accrue on damages after a judgment has been entered in a court and before the money is paid.

Medical Payments

Some liability policies also provide **medical payments coverage**, which is sometimes offered as an optional coverage the insured can purchase. Medical payments can help avoid larger liability claims. If a homeowners policy includes \$1,000 of medical payments coverage, for example, a neighbor injured on the insured's property can receive emergency medical treatment up to that amount without having to sue the insured to recover the cost. Payment of this relatively modest amount reduces the prospect of a much more expensive claim for damages. In some cases, such as in homeowners policies, this coverage is called "medical payments to others" and *does not* cover injuries sustained by an insured or regular residents of his or her household. In other cases, such as in personal auto policies, medical payments coverage *does* cover an insured's injuries up to a specified limit.

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

What Time Period Is Covered?

Personal auto insurance is usually written for a six-month term. Other types of liability insurance are usually written for a one-year period, though other policy terms are also possible.

A liability insurance policy states what must happen during the policy period in order to "trigger" coverage. Depending on the type of policy, coverage is usually triggered by either:

- Events that occur during the policy period (in an *occurrence basis* policy)
- Claims made (submitted) during the policy period (in a *claims-made* policy)

Educational Objective 10

Demonstrate an understanding of the difference between occurrence basis and claims-made coverage.

Occurrence Basis Coverage

Bodily injury or property damage that occurs during the policy period triggers coverage under a liability policy that provides

Occurrence basis coverage covers liability claims that occur during the policy period, regardless of when the claim is submitted to the insurer.

occurrence basis coverage. In most situations, bodily injury or property damage is apparent at the time of the accident or shortly thereafter. Therefore, if a covered accident occurs during the policy period, the claim will be covered, regardless of when the claim is submitted. For example, if the claimant was injured in an automobile accident caused by the insured only a few hours before the policy period expired, the resulting claim would be covered, despite the fact that it might be submitted after the policy expired.

Occurrence policies do not limit the time period during which a claim can be submitted. As long as the injury or damage occurs during the policy period, coverage applies even to claims made years later. From the insured's standpoint, this coverage offers valuable protection for unknown and unforeseen claims. For the insurer, however, occurrence coverage means that liability claims might surface long after a policy has expired. This particular problem contributed to the development of claims-made coverage.

Claims-Made Coverage

Claims-made coverage covers liability claims that are made (submitted) during the policy period for covered events that occur on or after the *retroactive date* and before the end of the policy period.

A **retroactive date** in a claims-made policy is the date on or after which injury or damage must occur in order to be covered.

Although personal liability insurance policies and most commercial general liability insurance policies are written on an occurrence basis, claims-made coverage is sometimes used to insure business organizations that face certain types of liability loss exposures. Under a liability policy that provides **claims-made coverage**, the insurer agrees to pay all claims that are made (submitted) during the policy period (or before the end of some extended period specified in the policy) if the covered event occurs on or after a specified date (called a **retroactive date**) and before the end of the policy period.

In theory, the claims-made approach is ideal. An insured buys a series of claims-made policies, and each succeeding policy becomes effective when the preceding one expires. Unless coverage lapses, the insured will never be without coverage, since there is always a current policy to provide coverage when a claim is presented.

The situation becomes more complicated in practice, however. Most claims-made policies contain a retroactive date. Claims due to injuries that occur before that retroactive date are not covered even if the claim is made during the policy period. Occurrence policies also do not cover claims arising from occurrences before the policy's inception date. Therefore, an insured who replaces a claims-made policy either with an occurrence policy or with a claims-made policy with a new retroactive date might face a gap in coverage.

Because of periodic renewals and the possibility that the insured will shift coverage from one insurer to another, maintaining continuous coverage without gaps is perhaps the greatest

difficulty with claims-made coverage. Thus, insurers, producers, and insureds must pay careful attention to the details of claims-made and occurrence basis policies.

Educational Objective 11

Explain how claim payments are affected by various limits and provisions in liability insurance policies.

What Factors Affect the Amount of Claim Payments?

Even when a liability claim is covered, an insurer does not necessarily pay the full amount of the judgment awarded to a claimant. The extent of the insurer's payment depends on the following types of policy provisions:

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

Policy Limits

It is difficult to predict the dollar amount of liability insurance needed to cover an insured's future claims. Legal obligations depend on uncertain future events in a changing legal environment. Still, it is necessary for the insured and the insurer to agree on some dollar amount of coverage. As with property insurance, policy limits help an insurer measure the extent of its obligation. Limits also give options to the insured, who must decide not only how much coverage is desirable but also how much is affordable. Liability insurance limits are generally round numbers such as \$100,000, \$500,000, or \$1,000,000.

Types of Limits

Limits are expressed in different ways, as follows:

- An **each person limit** is a specific upper limit on the amount an insurer will pay for injury to any one person. If several persons are injured in a given occurrence, this limit applies separately to each one.
- An **each occurrence limit** is a specific upper limit on the amount an insurer will pay for all covered losses from a single occurrence, regardless of the number of persons injured or the number of parties claiming property damage. There might be several different covered occurrences during one policy period.
- An **aggregate limit** is a specific upper limit on the amount an insurer will pay for *all* covered losses during the covered period, which is usually the same as the policy period.

An **each person limit** is the maximum amount an insurer will pay for injury to any one person for a covered loss.

An **each occurrence limit** is the maximum amount an insurer will pay for all covered losses from a single occurrence, regardless of the number of persons injured or the number of parties claiming property damage.

An **aggregate limit** is the maximum amount an insurer will pay for *all* covered losses during the covered policy period.

Split limits are separate limits that an insurer will pay for bodily injury and for property damage.

A **single limit** of liability is the maximum amount an insurer will pay for the insured's liability for both bodily injury and property damage that arise from a single occurrence.

Split Limits and Single Limits

Separate limits for bodily injury and property damage liability coverage are known as **split limits**. For example, a personal auto policy might provide bodily injury liability coverage with a \$100,000 limit for each person and a \$300,000 limit for each occurrence with a separate limit of \$50,000 for each occurrence for property damage liability coverage. A **single limit** applies to any combination of bodily injury and property damage liability claims arising from the same occurrence. For example, a \$300,000 single limit covers a bodily injury loss up to \$300,000, a property damage liability loss up to \$300,000, or any combination of bodily injury and property damage arising from a single occurrence up to \$300,000.

Examples of Split Limits and Single Limits

Split Limits

Jessica has a personal auto policy with the following split limits:

Bodily Injury

\$100,000 each person

\$300,000 each occurrence

Property Damage

\$50,000 each occurrence

Jessica is liable for a covered auto accident resulting in injuries to Richard, the driver of the other car, and Marcy, his passenger. When the case went to trial, the court awarded \$200,000 in bodily injury damages to Richard and \$150,000 to Marcy. In addition, the damage to Richard's car amounted to \$10,000, which Jessica was also ordered to pay. Jessica's insurer would pay \$110,000 to Richard (\$100,000 each person limit for bodily injury plus \$10,000 for property damage) and \$100,000 to Marcy (the each person limit). Thus, the insurer would pay a total of \$210,000 for this accident (plus Jessica's defense costs, which are paid in addition to the policy limits in a personal auto policy). Jessica would have to pay the remaining bodily injury damages of \$150,000 from her own pocket.

Single Limit

If Jessica's personal auto policy had a single limit of \$300,000 in lieu of the split limits shown above, her insurer would pay a total of \$300,000 to Richard and Marcy for both bodily injury and property damage (plus defense costs) in the above accident. (A determination of exactly how much each party receives would depend on the circumstances of this particular claim.)

In this situation, Jessica's insurer would pay more under the single limit policy than the split limits policy, but such is not always the case. For example, if three people had had bodily injury of \$150,000 each plus the \$10,000 property damage, the

insurer would have paid a total of \$310,000 under the split limits policy (\$100,000 bodily injury for each person plus \$10,000 property damage); under the single limits policy, the insurer would pay only \$300,000, the maximum payable for any one occurrence.

Defense Cost Provisions

Most liability policies place no dollar limit on the defense costs payable by the insurer. The only limitation is that the insurer is not obligated to provide further defense once the entire policy limit has been paid in settlement or judgment for damages.

Stated differently, defense costs are usually payable *in addition to* the policy limits, and policy limits include only payment for damages. Practical limitations, however, tend to restrict defense costs. For example, an insurer is not likely to spend \$100,000 defending a claim for \$10,000 in damages.

Certain policies exist, however, that place defense costs within the overall policy limit. In such policies, for example, if the policy limit is \$100,000 and the insured has a covered claim involving damages of \$90,000 and defense costs of \$30,000, the insurer would pay a total of \$100,000 for both the damages and the defense. The insured would be responsible for paying the additional \$20,000.

"Other Insurance" Provisions

In some cases, more than one policy or coverage might cover the same claim. As with property insurance, liability insurance policies contain "other insurance" provisions to resolve this problem and preserve the principle of indemnity. Several approaches are used, and the applicable approach depends on the wording of the particular policy and on the situation.

Educational Objective 12

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 discusses liability loss exposures and the liability policy provisions that deal with those exposures. Liability loss exposures are based on the concept of legal liability. By holding individuals and business organizations responsible for their conduct, the legal system protects the rights of individuals and businesses. The legal system in the United States derives essentially from the following:

- The Constitution, which is the source of *constitutional law*
- Legislative bodies, which is the source of *statutory law*
- Court decisions, which is the source of *common law*

An important distinction exists in the U.S. legal system between criminal law and civil law. Criminal law imposes penalties on those who commit wrongs against society. Civil law provides a means to settle disputes among individuals and to determine responsibility for injuries or damage.

Liability loss exposures involve the following elements:

- The legal basis of a claim by one party against another for damages
- The financial consequences that might occur from a liability loss

Many legal principles can serve as a basis for holding one party responsible for another's injury. Most liability cases rely on tort law, which allows an injured party to sue for damages if the other party's negligence, intentional tort, or absolute liability (from an inherently dangerous activity) caused the injury or damage. Liability can also arise from a breach of contract, which allows one party to seek relief in court from the other party to a contract. Statutes, such as workers compensation laws, also impose liability on certain parties when a legislative body has determined that it is in the interest of society to hold those persons liable.

A liability loss occurs only if an insured causes another person to suffer some definite harm. A liability claim can lead to compensatory damages, consisting of special damages (for medical expenses, lost income, and rehabilitation expenses) as well as general damages (for pain and suffering). Many liability claims also lead to defense costs, including legal fees, investigation expenses, and other expenses to defend the claim.

Innumerable activities and situations can create liability to someone else. These include owning or operating an automobile, owning or occupying property, conducting business operations, manufacturing or selling products, advertising, polluting the environment, selling or otherwise providing alcoholic beverages, and practicing a profession.

Liability insurance policies cover damages for which the insured becomes legally obligated to pay and that arise out of the activities covered by the policy. The following questions must be answered in the provisions of liability insurance policies:

- What parties are insured?
- What activities are covered?
- What types of injury or damage are covered?
- What costs are covered?
- What time period is covered?
- What factors affect the amount of claim payments?