Property & Casualty Insurance

Procurement & Litigation

Ten Recurring Themes Every Lawyer Should Know

Over the course of my career of 35 years as a local insurance agent, a regional, national and international retail broker, a wholesale broker, an insurance underwriter and a reinsurance executive, the last five years as a risk management consultant and expert witness, I have found ten problematic and recurring themes that often lead to litigation. Attorneys dealing with insurance procurement litigation issues and insurance buying clients may want to consider these ten themes and corresponding important lessons regarding each:

1. There are important differences between an insurance agent, an insurance broker, a wholesale broker and a Managing General Agent (MGA). An insurance agent is an authorized representative of an insurance company by contract and represents the insurance company to the buyer. An insurance broker is not an authorized representative of an insurance company, rather, the representative of the buyer to an insurance company. Both agents and brokers may be paid a commission by an insurance company but the nuanced relationship can become very important, particularly in a retail situation versus a wholesale situation.

A wholesale broker is commonly considered an agent or brokers' broker. A wholesale broker has little or no direct dealing with the end-buyer of an insurance policy and deals entirely with the retail agent or broker, splitting commissions with the retailer. An MGA is also a wholesaler but is an authorized representative of the insurance company and acts beyond that of an agent, providing the underwriting function of an

insurance company that has subcontracted those functions of the insurance company to the MGA. An MGA can act as a retailer or a wholesaler but is generally considered a part of the wholesale marketing system.

The marketing distribution system for insurance can be confusing to those outside the business. There are basically three systems. The first is what is called the "American Agency System"– this is the local independent agent who is an authorized representative for a number of different insurance companies, but also include the larger regional, national and international broker firms such as Marsh, AON, Willis (to name the top three); all of these act as retailers and deal directly with buyers of insurance. The second is the "Direct Writer System," which has come to dominate the personal lines insurance industry in America, but is a distribution system used by Liberty Mutual (the largest) in the commercial marketplace. Agents for Direct Writers are employees of the insurance company and cannot generally write coverage outside their own company's products. The third is the wholesale market, which includes excess and surplus line carriers, wholesale brokers and MGAs.

Lesson #1: An in-depth understanding of the roles, relationships, responsibilities, and marketing distribution systems in-play is important in litigation dealing with insurance procurement issues.

2. Premium payment is the basis of which all other obligations follow.
Paying premiums to an agent of an insurance company is ordinarily the same as paying the insurance company. Is the person for whom your client is buying the insurance an agent or a broker? This information is usually not on the proposal. An insurance buyer needs to be sure the premium is paid to the insurance company or the company's authorized representative (i.e., Agent) and not to a broker, who is not an authorized representative of the insurance company. The cases of brokers taking premiums from their clients and not conveying the

money to the insurance company is, unfortunately, more common than one might expect and for this reason, payment to the insurance company is preferred.

Lesson #2: Your client (the *Insurance buyer) knows they have purchased insurance if they have paid for it – so the buyer needs to make sure the premiums are paid to the insurance company.*

3. There needs to be a clear understanding of the coverage purchased. Agents, brokers and underwriters are often cautioned not to answer questions about coverages in writing by their superiors and their professional (Errors & Omissions) liability insurance companies. The fear is that the agent will somehow, inadvertently, change the meaning of the insurance policy and/or later be accused of practicing law without a license. There is nothing improper when a purveyor of insurance states their understanding of how a policy would be interpreted in a claims scenario; in fact, it is completely proper and demonstrates a greater degree of care. In addition, the customer will (hopefully) learn that they have purchased what they thought they have purchased. Agents, brokers and underwriters sell thousands of contracts of insurance everyday. Are they really not supposed to know how they would be interpreted in a claims situation? If the agent or broker will not do it, then ask the underwriter to explain. Refusal to do so should arouse suspicion and other agents or brokers need to be contacted.

Lesson #3: Your client (the Insurance buyer) can and should ask questions in writing and get answers in writing.

4. All insurance buyers are not created equal. A large business or wealthy individual/family have much different insurance needs than a small to medium-sized business or a low to middle-income individual/ family. One size does not fit all and insurance companies are no longer

all things to all insurance buyers. Insurance companies have become very specific in their target markets. Insurance should be purchased from an agent experienced in providing coverage for the size and type business or household of the buyer's size or situation. Agents who do not have the requisite knowledge of the industry and the client should not sell the coverage. The agents cannot be the sole decision-makers on these matters; their legal ability to write a policy does not necessarily mean they are qualified to write it from the buyers' perspective.

Lesson #4: Your client (the insurance buyer) should make sure the agent is experienced in writing policies of the size and scope of the policy being purchased from them.

5. An agent, more often than not, has a duty to advise (his clients). In the 2007 study **"**INSURANCE AGEN*TS' DUTY TO ADVISE***"**, The Hassett Law Firm, P.L.C., of Phoenix, AZ, dealt with this question in an article by the same name. Two-thirds of the states' case law indicates that, yes, agents do have a duty to advise their clients, at least on a case-by-case basis. This duty may be difficult to establish in 13 states, and agents are considered simply "order takers" in five states (AL, MT, RI, UT, WV). Attorneys need to check their specific state statutes and case law on this issue. As regards the precise scope of this duty, variances do exist between each state.

Lesson #5: Agents (in most cases) have a duty to do more than to just place coverage and have a responsibility to use their special knowledge to the benefit of their clients.

6. The insurance application process now requires more attention. There was a time, in the not too distant past, when most applications for property and casualty insurance did not require the signature of the insurance buyer. Agents routinely completed applications and

underwriters readily accepted them without anyone's signature on the application. This custom and practice is no more. Insurance applications have become more than just tools to gather underwriting information to determine the eligibility of the applicant for coverage and for premium determination purposes. The necessity for thoroughness and precision has greatly increased. It is more than appropriate and appreciated by the underwriter for the applicant to provide supplemental answers and explanations along with the standardized application. These relatively recent changes in the usual and customary practices of making an application for insurance can make the difference between having a claim covered and not having it covered. An ambiguity or misunderstanding can become an allegation of misrepresentation, which can lead to no coverage at all, rather than just a possible increase in premiums. Policy rescission and voiding policies *ab initio* are on the rise, along with underwriters using application information as "Warrants" thereby making the application a part of the policy (which has always been the case with life insurance policy applications). These developments make providing accurate information to underwriters more than just important. Accurate information becomes the basis for the existence of the contract itself and adds an increased threshold to the concept of "utmost good-faith" which is the traditional basis of all insurance relationships.

However, "utmost good-faith" is a two-way street. Insurance companies sometimes attempt to deny coverage based on conditions and exclusions that are not, and never were intended, appropriate to the situation or the claim at hand. Some prohibitions were intended to exclude coverage because the hazard is better transferred by another type of policy, not to be used to exclude an otherwise covered claim. This type of unfair claims settlement practice is rare and usually caused by poor attention to detail in the filing of a claim and/or inexperienced claims adjusters. The insurance buyer needs to be equally diligent and vigilant as to the accuracy of applications of insurance and in the filing of a claim under an insurance policy.

Lesson #6: Insurance applications are more important than they once were. Have your client (the insurance buyer) plan and prepare in a careful, thorough manner, before submitting an application for insurance or filing a claim.

7. Understand Uninsured/Underinsured Motorist (UM) coverage before it is needed. This coverage acts as the liability coverage for persons who injure you, your family, your employees or anyone driving your car with your permission when the person who causes injury either does not have liability insurance or is underinsured. Various states handle the issue of UM coverage differently, and apart from the 12 states that provide so-called 'no-fault" coverage with Personal Injury Protection (PIP), insurance buyers seldom purchase adequate Automobile UM Liability Limits. With this in mind, the minimum limit an automobile policy provides is typically woefully inadequate. It is estimated that 15 percent of all drivers on the road are without insurance and even more have minimum limits. In some states, this average percentage can be doubled.

There are very legitimate reasons that commercial entities do not increase their Uninsured/Underinsured limits. Many provide other insurance that would cover employees, such as workers' compensation insurance and certain employee benefit coverages that would act as primary coverage before Uninsured/Underinsured coverage would come into play.

Lesson #7: Although this increased coverage will also increase the automobile liability premiums, the increase in coverage and premium should, at least, be considered.

8. Property values matter and vary based on the purpose of the valuation. Although this issue seems easy, there is more contention at the time of a property claim on this issue than practically any other issue. The problem is usually the misunderstanding on the part of property insurance buyers as to the relationship between "Market Values," which is usually how much they paid for the property, versus an insurance contract's definition of property value. In a property insurance policy, usually there are two ways and sometimes three ways of purchasing the correct value. The first is "Replacement Cost," which is the cost of repairing or replacing the property with like or similar materials or paying cash for up to the replacement cost designated on the policy. The second is "Actual Cash Value" meaning replacement cost minus depreciation and the third is "Stated Amount Value" meaning an agreement is made up-front with the insurance buyer and the insurance company as to how much the property is worth and the valuation basis at the time of a claim.

Confusion often arises for two reasons: First, over the difference between the Replacement Cost Value (what it would cost to repair or replace with like materials) or Actual Cash Value (replacement cost minus depreciation) of a structure and its market price. Market price has nothing to do with the insurable value and is based on a completely separate set of criteria. Primarily, it is based on location and real estate market forces; secondly, the amount borrowed from a lender to purchase the structure and the lenders' contractual requirements for purchasing coverage to protect their interest.

It is also important to note the operative words: *their interest* and what the policy says. *"*Their" interest and the owner's interest are often confused and the property owner sometimes gets the impression that the amount of insurance they should buy on a purchased building is whatever the lender requires of them. This is incorrect. It is a difficult lesson to learn after a claim occurs and there is a misunderstanding how the claims adjuster will value the property.

***Lesson #8: Have your client (the insurance buyer) request a "Stated Amount" Endorsement to the policy, which is an agreement between the insurance buyer and the insurance company as to what the value is and* how it will be adjusted, overriding any policy provisions to the contrary in the actual policy.**

9. Coinsurance is one of the most common insurance purchase misunderstandings. The coinsurance clause/penalty is a stated understanding and agreement within most property policies that requires the property owner to purchase insurance for a certain percentage of the full value of the property. The trade-off is, if the property is insured to the required value, the insurance company will use the lowest possible rates for calculating premiums. However, if the property is not insured to the required amount, then partial claims (versus total losses) will be paid in a ratio of the amount insured divided by the amount that should have been insured multiplied by the partial loss. The Co-Insurance Penalty formula is: the amount insured, divided by the amount required to be insured, multiplied by the partial loss amount, equals the claim payment amount.

Example: Property is purchased for $120,000 (includes the land, which is not insured). The building on the property is 25 years old and has a replacement cost value of $100,000. There is a mortgage on the property for $50,000, and the mortgage company requires fire insurance coverage of at least that same amount. The owner buys a fire insurance policy with a limit of $50,000 and the policy has an 80% coinsurance clause. During the policy period, a fire occurs causing $20,000 in fire damage. How much will the insurance company pay? Answer: $12,500 (not $20,000.) Why? Amount insured ($50,000) divided by the minimum amount for which it should have been insured for ($80,000, which is 80% of $100,000) multiplied by the amount of the partial fire loss ($20,000) equals $12,500. This is a relatively easy

calculation but a concept that is almost never understood by a claimant at the time of a loss.

Lesson #9: Do not allow your client (the insurance buyer) to confuse the price paid or the market value of property owned with the amount of insurance that should be purchased. If your client is not sure of the replacement cost or actual cash value on the property, have the insurance company determine it. Again, there are ways to circumvent this problem. Your client may negotiate "Stated Amount Valuation" on the property coverages and have the "coinsurance clause" eliminated by endorsement.

10. Business Interruption, Income, Extra Expense and other time element coverages are unique to business entities and are seldom purchased correctly. These coverages are extremely important in that they are practically the only insurance coverages that will cover the future earnings of a business. Businesses that fail to purchase the coverage seldom fully recover after a major loss occurs. However, the process of purchasing the coverage is wrought with misunderstanding due to the use of what appears to be accounting terms, but are actually insurance terms. This causes confusion on the part of both insurance professionals and accounting personnel normally asked to complete the application forms. There are very few agents, brokers, or underwriters who can accurately assist in the application process, yet the actual process of buying coverage (not necessarily the correct coverage) is easy and often handled in a very cavalier manner. Very few insurance professionals within the industry have enough experience with business interruption and time-element coverage claims to understand the claims adjusting process. This makes misunderstandings common between buyers and insurance companies, which can lead to litigation.

Lesson #10: Have your client's accountant work directly with the underwriter on this coverage procurement, if at all possible. The

accuracy of the application for this coverage is paramount. Again, ask questions, make sure you understand how the coverage will respond in a loss scenario, follow-up in writing, and document answers.

Conclusion: Just like poor legal advice, poor understanding of insurance procurement issues can be very expensive for your client!

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