The Specialist

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Message from the Editor

by Eric A. Fitzgerald, J.D., CPCU

Greetings to all of our section members and wishes for a Happy New Year. We have a focus on directors and officers coverage this quarter, with some interesting articles and tips for risk management. We are also pleased to present a piece on interpreting insurance policies, which previously appeared in the CPCU Society's Consulting, Litigation, & Expert Witness Section's newsletter, *CLEWS*. Finally, a brief look at apportioning defense costs in matters involving covered and uncovered claims. Courts in a majority of states are handling some standard insuring language in excess and surplus policies in a very non-standard way.

As many of you may know, the E/S/SL Section Committee met at the Annual Meeting in Seattle. A number of programs and initiatives are in the works. We will have a summary in our next issue, together with a review of reaction to the E/S/SL table at the Interest Sections Lunch and Learn. Enjoy. ■

Creative New Insurance Products:

LMU, Rep & Warranty, and Contingent Tax Insurance

by Daniel A. Bailey

Editor's note: *This article originally appeared in* The ACE Report*—Issue No. 41, April 2001, and is reprinted here with permission.*

The ACE Report *is a periodic publication distributed to policyholders and other interested parties as a service by ACE. Its purpose is to address insurance concerns worldwide, as well as present timely information on current developments in liability issues surrounding directors and officers.*

In response to the insurance industry's recent profitability challenges and increased commitment to creative risk management techniques, many insurers are now offering three types of new insurance products that can provide significant benefits to a company. Each are briefly described below.

A. Loss Mitigation Underwriting

Many insurers are now willing to issue policies insuring existing or imminent litigation or loss that is otherwise uninsured or inadequately insured. Frequently referred to as loss mitigation underwriting (LMU), this type of risk transfer arrangement presents to insurers and insureds both significant underwriting challenges as well as tremendous potential benefits. Examples of situations where LMU insurance may be useful to a company include the following:

Strategic Transaction A desirable strategic transaction (such as an acquisition of the company, a securities offering, or a debt restructuring) may not be possible unless the company conclusively contains a potentially catastrophic lawsuit or loss exposure. But the company may not be able to negotiate and finalize a settlement with plaintiffs or to quantify the loss within the limited time frame of the strategic transaction. LMU insurance can contain the risk exposure, thus allowing the strategic transaction to proceed.

Stock Price When a company faces a potentially catastrophic lawsuit or loss, the market price of its stock may be suppressed, thereby creating discontent among shareholders, impairing the company's financing alternatives, and projecting a false image of fundamental financial distress. This market response frequently is an over-reaction based on a false impression that the claim is worse than it really is. An LMU can provide comfort to the securities market that the perceived catastrophic exposure is

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quantified and contained, thereby allowing the company's stock price to return to its true value.

Unreasonable Plaintiff The plaintiffs in a lawsuit may have grossly unreasonable expectations regarding the value of the claim, thus forcing defendants to defend the case up to and perhaps through trial. In large cases, plaintiffs frequently use the threat of a "runaway" jury verdict to coerce an excessive settlement from defendants. An LMU can allow defendants to contain their financial exposure from the claim sooner rather than later and can potentially assist in settlement negotiations with plaintiffs by showing that the defendants are no longer concerned about a large jury verdict. In addition, in some instances the LMU insurer may be able to assert greater leverage over plaintiffs and may be able to more persuasively negate plaintiffs' threat to take the claim to trial. For example, the insurer may have a large number of cases with the plaintiffs' counsel and may be able to more convincingly say "no" to an unreasonable settlement offer from a plaintiff.

Tax Issues Insurance premiums generally are deductible for federal income tax purposes. However, many settlements, judgments, and other losses are not deductible. For example, costs incurred to resolve a shareholder class action arising out of the company's sale of securities may be a capital expenditure that cannot be fully deducted in the year incurred. In some instances, an LMU may enable a defendant to convert a non-deductible loss into a deductible insurance premium.

Although there is an infinite number of LMU variations, the most frequent LMU structures include:

1. Additional insurance coverage directly in excess of the company's existing insurance. Because this structure simply increases the total amount of insurance available for the subject claim without creating any structural barriers to accessing the new coverage, this approach is at times less attractive to insurers than other alternatives.
2. High-level additional insurance coverage that is excess of both the company's existing insurance and a large self-insured retention (SIR), which applies once the existing insurance is exhausted. By placing a large SIR between the existing coverage and the new coverage, the insureds retain a strong economic incentive to minimize loss from the subject claim and the plaintiff cannot directly reach the new insurance without first exhausting the large SIR through recovery from the insured's own assets. Insurers typically favor this structure because it minimizes the risk of the LMU changing the insureds' and the plaintiffs' litigation settlement strategies, expectations, and behavior.
3. The insurer's complete assumption of the entire claim, including full claims control. The insurer's rationale for this extraordinary assumption of risk is the belief that the insurer can successfully negotiate an acceptable settlement with the plaintiff by utilizing the insurer's vast resources, experiences, and perceived leverage over the plaintiff. Unlike the insureds, the insurer probably has a large "inventory" of claims with plaintiffs' counsel, thereby potentially giving the insurer greater credibility and leverage in settlement negotiations. Obviously, because this structure involves the greatest amount of risk transfer, this structure typically involves the largest amount of premium.
4. Insurance coverage only for judgments, not settlements or defense costs, in the lawsuit. Because the vast majority of claims that are subject to LMUs are settled rather than tried to judgment, this structure arguably transfers to the insurer less risk while still providing the insureds with desirable catastrophic loss protection in the event of a large judgment. This structure may also facilitate more reasonable settlements by showing to plaintiffs that defendants are not

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afraid to try the case if necessary. As a practical matter, this structure may also afford coverage for large settlements since the insurer may conclude that it is in the insurer's best interest to make a voluntary contribution to a settlement in order to facilitate such a settlement, thereby eliminating the risks associated with a trial of the claim.

LMU policies are usually manuscripted to address the unique features of each situation. Typically, an LMU provides very broad coverage for the specified claim(s) or loss, frequently subject to a co-insurance provision, and either a return premium or additional premium provision depending on whether the insurer ultimately pays any loss under the LMU. The LMU coverage can be either following form to existing underlying insurance or broader than existing underlying insurance. Typically, LMUs have relatively few exclusions. The most common include fraud, illegal profit, costs to comply with non-monetary relief, fines and penalties, and, with respect to professional liability coverage, bodily injury, property damage, and claims by insureds.

LMUs are difficult, time-consuming, and expensive to evaluate and negotiate. Insurers must conduct a thorough due diligence investigation, which frequently includes retaining outside experts, extensive document review, and interviews of various key witnesses. An underwriting fee is often charged by insurers even if the LMU is never bound, both to offset the insurer's large transactional cost and to confirm at an early date the insureds' level of interest in the proposed policy.

Insureds who have an interest in exploring a potential LMU should understand and commit to the following principles at the beginning of the process:

- Retain the services of insurance brokers, financial advisors, and legal counsel knowledgeable and experienced in this type of unique insurance product.
- Be prepared and willing to provide to the insurer full access to all relevant documents, material information and company officers, employees, and outside advisors.
- Allow significant time for the insurer's due diligence and the negotiation of the policy terms.
- Do not treat the LMU as a commodity by shopping it to numerous insurers. Select the insurers like any other strategic partner, not through an auction of the policy.
- Establish a relationship of trust, candor, and full cooperation with the insurers.
- Thoughtfully structure the insurance program to address both the needs of the insureds and the interests of the insurers.

LMUs involve high costs to insureds and high risk to insurers, but under the right circumstances can deliver enormous benefit to the insureds and a healthy profit for insurers. The challenge for all parties to an LMU is to determine when and how this classic win-win scenario can be achieved.

B. Representation and Warranty Insurance

Representation and warranty insurance covers loss resulting from breaches of representations and warranties made by the parties to a variety of business transactions, including mergers, acquisitions, stock or assets sales, and leases. The insurance is most frequently purchased in connection with mergers and acquisitions (M&As). Like LMUs, this is a relatively new and creative insurance product that can provide valuable benefits to both parties to the business transaction.

What Are Representations and Warranties? The buyer in an M&A transaction cannot identify and evaluate before the acquisition every potentially material fact or circumstance relating to the purchased assets or their value. Therefore, buyers typically request from the seller and the seller typically gives to the buyer in the purchase agreement (Purchase Agreement) various representations and warranties (R&Ws), in which the seller in essence promises to the buyer that various facts about the purchased assets are true. These R&Ws are usually the subject of extensive negotiations between the parties and therefore each transaction has its own unique set of R&Ws.

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Some of the topics frequently addressed by R&Ws include the accuracy of the company's financial statements; compliance with various laws, including tax, employee benefit, and employment laws; existence of threatened or pending litigation; lack of environmental hazards; and ownership and non-infringement of specified intellectual property.

If the R&Ws are subsequently shown to be materially false, the buyer may be entitled to assert a claim against the seller for damages incurred by the buyer as a result of the false R&W. In order to assure the buyer that a source of recovery for such a claim will exist, the parties frequently agree to escrow or holdback at closing a portion of the purchase price for a period of time or agree to an offset provision in the buyer's promissory note. The buyer can apply that escrow or holdback or can invoke that offset if there is a material breach of the R&Ws. Although not common, claims for breach of R&Ws can be significant and can materially change the economic results of a transaction.

What Is Covered? An R&W insurance policy generally affords coverage for legal fees and the amount owing for breach of the insured R&Ws. Each of the insurers who offer this coverage have their own unique insurance policy form and many of the policy provisions are negotiable under certain circumstances. The following summarizes some of the more important provisions of a typical R&W insurance policy:

Insured The policy can be purchased by and can insure either the seller or the buyer in the M&A transaction. If the insured is the seller, then the policy affords liability coverage for claims by the buyer alleging breaches of the covered R&Ws, thereby protecting the seller from paying back to the buyer some of the purchase price due to R&W breaches. If the insured is the buyer, the policy affords first-party coverage, reimbursing the buyer for damages caused by the R&W breaches, thereby enabling the buyer to recover its losses without having to locate and pursue the seller and its assets.

Exclusions Typically, the R&W insurance policy contains a minimal number of exclusions. Some of the exclusions contained within the standard R&W insurance policy form include tax liability; closing or balance sheet adjustments; breaches about which the insured had actual knowledge at closing; projections; environmental matters; and failure of the insured to fulfill a condition precedent in the purchase agreement.

Deductible The deductible can be a rather modest amount, thereby providing coverage for most of the loss incurred by the insured, or can be quite large, thereby providing more catastrophic coverage for the insured. Generally, as the deductible gets significantly larger, the premium becomes smaller and the coverage terms become broader (i.e. fewer and narrower exclusions).

Subrogation The insurer will be subrogated under the policy to any rights of recovery that the insured may have for the loss paid by the insurer. For example, if the insured is the buyer, the insurer may be able to assert a subrogation claim against the seller for the R&W breaches. Similarly, if the insured is the seller and the R&Ws that were breached were made by the seller based on advice from its lawyers, accountants, or other professionals, then the insurer may be able to assert subrogation claims against those professionals.

When considering the value of an R&W insurance policy, one should primarily focus upon the strategic and economic advantages that this type of policy can afford the insured. A simple cost/benefit analysis that compares the likelihood and magnitude of a covered loss with the policy premium will usually result in the erroneous conclusion that the policy should not be purchased. R&W losses infrequently occur, but can be very large when they do occur. Accordingly, insurers must charge a premium for these types of policies that may initially appear excessive in light of the perceived risk being insured.

The true value of an R&W insurance policy to the insured is realized only if the

policy becomes a part of the insured's overall strategy for the subject transaction, and the cost of the policy is built into the negotiated purchase price so that the other party to the transaction effectively funds the policy's premium. The following summarizes some of the strategic and negotiating advantages available to either the seller or the buyer from an R&W insurance policy:

Advantages of Seller Policy An R&W insurance policy purchased by the seller can afford true closure for the seller regarding the transaction. For example, the policy can:

- Virtually eliminate the seller's contingent liability exposure for potential breaches of R&Ws;
- Eliminate the need for the buyer to hold back or place into escrow a portion of the purchase price, thereby allowing the seller unlimited use of the full purchase price immediately after closing.

Advantages of Buyer Policy An R&W insurance policy purchased by the buyer can create the following benefits:

- Afford to the buyer a competitive advantage over other bidders for the seller's assets by enabling the buyer to pay the full purchase price to the seller at closing (without any hold back or escrow);
- Create for the buyer an easily accessible source of collection for future breaches of R&Ws in lieu of pursuing the seller.

In other words, an R&W insurance policy can facilitate the negotiation of a transaction by bridging a gap between the parties and can allow the seller to immediately access the full purchase price. Therefore, the cost of such a policy should be evaluated primarily based on the policy's importance to the transaction and the seller's cost of capital.

The scope of the insurer's underwriting analysis for an R&W insurance policy varies depending upon the insurer, and the type of transaction and R&Ws that are being insured. Because the facts underlying the insured R&Ws exist at the time the policy is underwritten, insurers can, with sufficient due diligence, quantify to a large extent the risks being assumed under the policy. Therefore, like LMUs, the underwriting process for this type of insurance policy is frequently more comprehensive than under many other types of insurance policies. Because the insurer's underwriting process can be quite extensive, a prospective insured should begin discussions with the insurer about a potential R&W insurance policy at an early stage of the underlying transaction and should be willing to fully cooperate and share information with the insured and its counsel throughout the underwriting process. Like LMUs, an R&W insurance policy should not be viewed as a commodity that is auctioned to the lowest bidder. Instead, insureds should select, through the assistance of experienced insurance brokers, an appropriate insurer with whom a mutually beneficial partnership arrangement can be established.

C. Contingent Tax Liability Insurance

A contingent tax liability insurance policy potentially can address one or both of two different tax exposures.

First, the policy can serve as a type of R&W insurance policy by covering a breach of tax-related representations and warranties in a transaction agreement. Frequently, insurers underwrite and insure tax-related R&Ws separate from other types of R&Ws because of the unique nature of the tax exposure and the need for special policy terms and conditions.

Second, the policy can cover loss resulting from the taxing authority denying the insured's tax treatment of a particular transaction. For example, if a company attempts a tax-free spin-off of a subsidiary but is unable for a variety of reasons to obtain a revenue ruling from the IRS prior to closing, the company may be able to purchase a contingent tax liability insurance policy to cover the risk that the IRS subsequently determines the spin-off did not qualify for tax-free treatment.

Because this type of policy is similar in many respects to an R&W insurance policy, the same cautions and guidelines discussed above for R&W insurance equally apply to this type of policy. Some of the specific aspects of a contingent tax liability insurance policy include the following:

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- Coverage frequently applies to the insured's liability for taxes, interest, and penalties if there is a final determination that the intended tax consequences are unavailable. Costs incurred in contesting the challenge by the taxing authority may also be covered, as well as any "gross up" payments (i.e. any payments that are necessary to reimburse the insured for its additional tax liability associated with receipt of payments under the policy).
- Frequent exclusions include (i) the inability of the insured to benefit economically from the intended tax benefit, (ii) application of an alternative or minimum tax, (iii) the insured's failure to follow proper tax procedures, and (iv) state or local taxes.
- Often, the policy is premised upon and indirectly insures the accuracy of a tax opinion obtained by the insured from its outside tax advisors. In those situations, the insurer may have a subrogation claim against those advisors if the opinion is wrong. ■

Courts Abandon Reason When Enforcing Reasonable Defense Appointment Clauses

by Eric A. Fitzgerald, J.D., CPCU, ARe

A common policy clause in directors and officers (D&O) and errors and omissions (E&O) policies addresses the apportionment of defense costs in lawsuits involving covered and uncovered claims. A representative clause goes something like this:

> If some, but less than all, of the allegations in any claim give rise to any loss for which this policy provides coverage, the insureds and the underwriter shall use their best efforts to arrive at a fair and appropriate allocation of any fees, costs, and expenses and settlement amounts based on relative exposure incurred in connection with such claim.

Sound reasonable? To industry members familiar with this language, the clause is anticipated to resolve a sticky issue in a non-litigious manner between an insurer and (presumably) a sophisticated insured. However, a number of court decisions nationwide have held differently.

Let's take a step back. Fundamental principles of insurance law dictate that where a complaint filed against an insured contains some allegations of conduct that are covered by the policy and some that are not covered by the policy, the insurer is obligated to defend all of the allegations. The rule holds true even where 99 percent of the allegations in the complaint are not covered. E&O and D&O policies are more prone to these apportionment problems because the policy initially covers all "wrongful acts," and then limits this coverage through various definitions and exclusions.

In anticipation of a mandatory defense for uncovered claims in these situations, certain underwriters include clauses such as the one above to ensure that the insurer will be reimbursed for defense costs incurred in defending against allegations that the policy will not ultimately provide coverage. With some limited exceptions, courts have not been favorable to claims for reimbursement without specific language providing for the same.

However, underwriters and claim representatives should be aware that even these clauses are potentially disregarded in coverage litigation. In *Safeway Stores, Inc. v. National Union Fire Insurance Company of Pittsburgh, Pa.*, 64 F.3d 1282 (9th Cir 1995) a federal court used a completely different standard for apportioning these costs. The court held that "in evaluating whether defense costs should be allocated between the corporation and the insured directors and

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officers, courts have adopted the 'reasonably related test' * * * . Defense costs are thus covered by a D&O policy if they are reasonably related to the defense of the insured directors and officers, even though they may have been useful in defense of the uninsured corporation." Id.

The "reasonably related" test is troublesome. The policy, which is a contract whose terms have been mutually agreed upon by the insurer and the insured, calls for an apportionment of fees based upon "relative exposure incurred in connection with such claim."

However, the test set forth by the *Safeway* court employs a completely different test. Under the *Safeway* test, so long as the defense of the uncovered allegations is "reasonably related" to the covered allegations, then all of the defense costs are covered under the policy and the insurer is not entitled to any reimbursement or offset. The *Safeway* test has absolutely no connection to a "relative exposure" standard. It is not difficult to anticipate that a court willing to disregard mutually accepted language in a policy issued to a sophisticated insured will also determine that most, if not all, of the defense costs in a single lawsuit are "reasonably related."

For example, imagine a complaint with four causes of action against an insured. The insured is alleged to have misappropriated funds. Three of the causes of action allege that the insured intentionally misappropriated funds. One cause of action alleges that the insured negligently allowed the funds to be misappropriated. The policy has an exclusion for intentional misconduct. The case ultimately settles without a determination of whether the conduct was intentional or negligent.

Under the relative exposure test, the reasonable apportionment of defense costs would be 75 percent uncovered, and 25 percent covered. Under the "reasonably related" test, however, the insured would be able to argue that the same conduct at issue under the negligence cause of action also gave rise to the three intentional conducts causes of action. In this case, it is likely that 100 percent of the costs would be covered.

Although this clause has not been the subject of extensive litigation, most courts examining the issue have adopted this test. *See, e.g., Raychem Corp. v. Federal Ins. Co.,* 853 F.Supp. 1170 (N.D. Cal. 1994); *Continental Casualty Co. v. Board of Education of Charles County,* 302 Md. 516, 489 A.2d 536 (Md. 1985); *Harristown Development Corp. v. International Insurance Co.,* 1998 U.S. Dist. Lexis 12791 (M.D.Pa. 1988). One federal district court has gone so far as to hold that a D&O policy provision entitling the insurer to withhold payment of defense costs until final judgment is "unconscionable" and unenforceable. *See, Little v. MGIC Indemnity Corp.,* 649 F.Supp. 1460 (W.D. Pa. 1986). Again, it must be stressed that these are not personal insurance policies issued to homeowners or motor vehicle owners. These are sophisticated policies covering sophisticated risks and issued to sophisticated insureds.

What's an underwriter to do? The usual answer to judicial interventionism is to draft policy language that expressly addresses the terms of the adverse court decision and distinguishes or rejects these terms or standards. Another possibility is to simply anticipate the likelihood of a "reasonably related" apportionment when these clauses are litigated, and to underwrite accordingly. For a claims representative, defense cost apportionment negotiation should be conducted with the knowledge that if litigated, all defense costs ***could*** be awarded under the policy if the "reasonably related" test is imposed. Either way, it is important to be aware of these decisions and their potential impact upon policy interpretation. ■

116 Commonwealth Condominium Trust v. Aetna Casualty & Surety Company

2001 WL 118258 (SJC-08288 Feb. 13, 2001)

by William A. Schneider

Editor's note: *Information from this article originally appeared in "D&O Policy: No Coverage for Claims for Injunctive Relief," which was published in the Fall 2001 issue of a Morrison, Mahoney & Miller, LLP newsletter.*

Since 1990 one of the more perplexing issues facing insurers and their counsel involved liability coverage for claims against insureds seeking injunctive relief. Generally, while such relief did not fall squarely within the typical liability policy's definitions of "bodily injury," "property damage," or "personal injury," it usually involved redress to stop an insured from engaging in some activity that resulted in one or more of the aforementioned categories of injury. Thus, where an insurer had doubt about whether a claim sought injunctive relief or damages compensable under the policy, prudence would dictate that it err on the side of caution and accept the claim in order to avoid the prospect of costly coverage litigation.

The blurred distinction between injunctive relief and compensatory damages was highlighted in the case of *Hazen Paper Co. v. United States Fid. and Guar. Co.*, 407 Mass. 689 (1990). *Hazen Paper Co.* addressed whether a claim to recover cleanup costs incurred in response to the demand of government agencies constituted "damages" where the release of hazardous substances caused property damage. The court ultimately held that such cleanup costs did in fact constitute damages where the term damages was not defined in the policy.

In *116 Com. Condominium Trust*, the Supreme Judicial Court considered whether claim for preliminary and permanent injunctive relief were covered under a directors and officers liability insurance policy. Besides seeking the injunctive relief, the complaint against Aetna's insured also sought costs and attorneys' fees. It did not, however, request money damages.

Aetna ultimately denied coverage for the claims on the grounds that it did not seek damages to which the insurance applied. Contrary to the holding in *Hazen Paper Co.* that the damages, left undefined could be ambiguous as to whether it included injunctive or equitable relief, the court in *116 Com. Condominium Trust* found no such ambiguity. Rather, it found that the word "damages" clearly required an expression of the plaintiff's alleged injury in dollars and cents. The court distinguished its decision *Hazen Paper Co.* by recognizing that while expenses incurred in cleaning up existing conditions would typically constitute damages, that expenses incurred in complying with an injunction against future activities would not be deemed "damages." Further, the court ruled that the D&O policy in question had no duty to defend in light of policy language stating that Aetna "will not be called to assume charge of the defense of any claim or suit."

The decision in *116 Com. Condominium Trust* provides a clear benchmark for an insurer to evaluate its duty to defend an insured in any particular case where the plaintiff seeks only injunctive relief and not money damages. However, where a complaint alleges multiple theories of recovery, including mixed claims for property damage, bodily injury, and or injunctive relief, an insurer most likely will have a duty to defend all of the claims. *See Simplex Technologies, Inc. v. Liberty Mutual Ins. Co.*, 429 Mass. 196 (1999). Nonetheless, the insurer should not forget to reserve its rights regarding its indemnity obligation to the insured for injunction-related costs, and take appropriate steps to protect its interests. ■

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How To Analyze Insurance Policies

by Thomas H. Veitch, J.D., CPCU, CIC

Editor's note:
This article originally appeared in the August 2001 issue of CLEWS, *the CPCU Society's CLEW Section newsletter.*

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In a previous article, we discussed how rules of construction impact insurance policy coverage analysis. This article focuses on some techniques you can use in your analysis. Being able to analyze and understand insurance policies is a necessary prerequisite for CLEW members serving as consultants or expert witnesses. If you don't understand how the policy fits together, you will never be able to understand the coverage. Most insurance policies contain a number of interrelated sections and provisions, which must be read in their entirety in order to make a proper determination. You cannot read isolated portions of the policy and reach proper conclusions. Therefore, since most insurance policies are lengthy and tedious to read, knowing what you are looking for and where to look will save lots of time. A majority of property and casualty forms are fairly standardized, which makes the job much easier once you get the basic format. However, nonstandard forms must be thoroughly studied on a case-by-case basis.

Dissecting the Policy by Sections

All standard form property and casualty policies and most nonstandard forms consist of a few definite policy sections. Therefore, one useful approach to property and casualty insurance policy analysis is to identify, locate, and understand the purpose of each of the applicable policy sections. The following is a discussion of each of these policy sections.

Policy Declarations Page

The declarations are statements as to the parties insured, property covered, policy period, perils covered, and premium cost of the contract. This information is generally contained in the first page of the policy commonly referred to as the "declarations page."

Start first with the declarations page in order to determine who is insured, what is insured, and how much insurance exists.

Coverage Provided

This is the heart of the insurance contract and contains the insurer's fundamental promises. In liability forms, this information will be found in the insuring agreements. In many property policies, the information is provided in the "causes of loss" section of the policy. The extent of coverage will depend on whether the basic, broad, or special causes of loss form is attached to the policy.

A typical insuring agreement in an automobile liability insurance policy states:

> We will pay damages for bodily injury or property damage for which any covered person becomes legally responsible because of an auto accident. Property damage includes loss of use of the damaged property. We will settle or defend, as we consider appropriate, any claim or suit asking for these damages. In addition to our limit of liability, we will pay all defense costs we incur. Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted.

This section of the policy also proceeds to define a "covered person." The foregoing wording is an example of the use of the "readable language" that has become prevalent in insurance policies in recent years. Many policies now contain a Table of Contents entitled "Where to Find It," which is very useful.

Exclusions from Coverage

In property insurance policies, the policy exclusions may take the form of specific loss exclusions or may exclude certain property from coverage. The typical policy will have a section entitled "exclusions," and another section entitled "property not covered." In effect, both of these sections constitute exclusions from coverage. Loss to excluded property is not covered even if the loss is caused by a covered peril.

Most liability policies, including auto insurance policies, contain a rather extensive list of standard exclusions for each part of the policy.

Conditions

These further explain the contract terms regarding specific items such as suspension of coverage, voidance of the policy, loss

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provisions, and cancellations. The typical property insurance policy contains a form entitled "Commercial Property Conditions" and the applicable coverage form also contains loss conditions, which is a carryover of the conditions found in the old 165-line Standard Fire policy.

The conditions provisions in many standard personal auto policies are now scattered throughout the policy. However, Part F, entitled "General Provisions," also imparts many of the policy conditions.

Endorsements

The purpose of endorsements is to amend or modify the coverage provided in the basic contract forms. These attachments may limit, expand, or clarify coverage, which provides flexibility to fit varying situations. Therefore, pay particular attention to policy endorsements in conducting any policy review.

Endorsements are commonly referred to as "riders" in life and health insurance policies.

Terms and Definitions

Most property insurance policies contain a very limited section on definitions. Conversely, however, virtually all liability policies contain extensive sections on definitions. Major medical and other health insurance policies generally contain a definitions section, as do life insurance policies on a more limited basis.

Special Clauses

Some policies, especially life and health insurance policies, do contain some rather standard clauses affecting coverage in special circumstances. For example, suicide clauses, incontestable clauses, and other such provisions are included in virtually all life insurance policies.

The Question-and-Answer Approach to Policy Analysis

Due to the complexity of most insurance policies, it is easy to get bogged down in the "fine print." The question-and-answer approach will guide you as you proceed through the policy rather than blindly stumble along. This is accomplished by asking the key questions: who, what, where, when, and how. You may even occasionally inquire why. Use the following checklist as a helpful guide in your next policy analysis.

Checklist: Questions for Insurance Policy Analysis

Method: Use the following questions to determine how the policy impacts the claims question involved.

Step #1—Who?

Who is insured? Who is covered? Who is the beneficiary?

- Review the insured's name on the policy.
- Look for mortgagee and lienholder endorsements.
- Does the policy contain any additional insured endorsements?
- Review the named insured portion of the policy.
- Review policy definitions of "insured."
- Distinguish coverage variations between named insured, insured, and mortgagee.
- In life insurance policies, review policy provisions to determine who is the policy owner. Who is the insured? Who is the premium payer? Who is the beneficiary?
- In some claims, it may also be important to determine who is the company. Who is the agent? Who is the general agent? Who is the reinsurer? Being able to identify who did what may govern who is responsible.
- Determine who is excluded from coverage.
- To whom do you report the claim?

Step #2—What?

What is covered? What is excluded?

- What property is specifically identified in the policy?
- What extensions of coverage are provided?
- What locations are covered?
- What perils are named in the policy to provide coverage?
- What obligations does the insured have under the policy?
- What obligations does the company have?

- What limitations of coverage apply?
- What policy exclusions apply?
- What are the limits of coverage?
- What is the effect of the policy "other insurance" clause?

Step #3—Where?

- Where is the property or insured covered?
- Where is the property or insured not covered?
- Where does the insured report the loss?

Step #4—When?

- When does the policy take effect?
- When does the policy terminate?
- When does the loss occur?
- When must the insured report notice of loss and proof of loss?
- When must the insured file suit?
- When must the insured perform its obligations?
- When must the company perform its obligations?
- When is a loss covered?
- When is a loss not covered?
- When must the insurance company make payment?

Step #5—How?

- How do the policy exclusions take away coverage?
- How do the policy limitations affect coverage?
- How do the policy provisions expand coverage?
- How much coverage is applicable under the policy?
- How much does the insurance company owe for the loss?

As you ask and answer these and other questions in your policy analysis, the thrust and intent of the policy become clearer. As you can see, not every question applies to every policy or loss nor does this checklist encompass every question that can be asked. Modify the checklist to add some standard questions of your own.

Nonstandard Policies

As previously discussed, all insurance policies will not necessarily be the same or standard as to every particular point. Although the majority of property and liability forms are standardized, you will find substantial variation in life and health policies, inland marine coverages, and special risk policies.

- **Surplus lines policies**—Surplus lines policies are usually written by specialty companies not doing business in the state as admitted carriers. Usually such policies are marketed by local representatives such as managing general agencies or surplus lines brokers. High-risk policies and policies involving risks of an unusual nature are covered in this manner. Annual mortality insurance, crop insurance, dynamite manufacturing, and other such dangerous, hard-to-place, or unusual exposures are all written in this manner. As a consequence, these policies may be much more limited in coverage than the standard policies.
- **Manuscript policies**—Occasionally you may encounter a manuscript policy, which is specially designed and drafted for the risks and exposures to be covered. These policies need to be thoroughly reviewed and consideration should also be given to the requests made by the insured. In some instances, the insured may not find out until loss occurs that they do not have the coverage they requested or expected.

It is, indeed, a challenge to master the many concepts, terms, and legal principles that are unique to insurance law and insurance policies. It is hoped that the preceding ideas will help you to better traverse the "jungle" of insurance policy language without slipping into the "quicksand." As a final tip, make sure you have a complete and accurate policy to review when you conduct your analysis. ■

Mark these dates on your 2002 calendar!

May 29-June 1	Leadership Summit	Las Vegas, NV
October 20-22	Annual Meeting & Seminars	Orlando, FL

In this issue . . .

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