

SPECIAL REPORT

THE THREE DEADLY SINS OF PROPERTY INSURANCE: COINSURANCE, PROTECTIVE SAFEGUARDS & VACANCY PROVISIONS

(01-13-09)

This Special Report was written by Daniel P. Hale, J.D., CPCU, ARM, CRM, LIC, AIC, AIS, API of Marsh & McLennan Agency LLC. Mr. Dan Hale can be contacted at 734-525-2429 or dhale@mma-mi.com. More Special Reports are available at www.mma-mi.com.

Our furnace malfunctioned last week causing smoke damage to our building, machinery and inventory. We already paid our deductible, but now the insurance company is telling us that they will only pay for one-half of the damages.

My building burned down last month, but now the insurance company refuses to pay for the fire loss because the fire sprinkler valve was not chained and locked in the full-open position.

My company occupies three offices in our building and has placed the remaining nine offices up for rent. Yesterday we discovered that a pipe had broken over the weekend and water leaked through all three floors. Our insurance company refuses to pay the claim since the building was not “sufficiently occupied” at the time of the loss.

INTRODUCTION

Many insureds are surprised to learn that their insurance policies include hidden penalty clauses buried deep within the fine print. Insurance companies are quick to invoke these clauses in order to reduce or deny coverage following a loss.

The purpose of this Special Report is to review the three main penalty clauses found in most property policies and discuss how these clauses ultimately affect coverage.

COINSURANCE

What do you mean the insurance company is only going to pay for one-half of the damages?

A coinsurance clause allows the insurance company to automatically reduce the amount of their property loss settlement if, in their opinion, you did not maintain adequate insurance values at the time of a loss.

Most policies that include a coinsurance provision will display a coinsurance percentage on the declarations page (usually 80%). At a minimum, this percentage is the proportion of the replacement value that the insured promises to maintain.

Put another way, the insured is promising the insurance company that it will maintain insurance values of at least 80% of the actual replacement cost of the property. As long as the insured keeps their promise, there is no penalty.

On the other hand, if the insured did not maintain an insurance value of at least 80% of the actual replacement cost, the insurance company will reduce the amount of their loss settlement in proportion to the amount they were underinsured.

Since a pre-loss replacement cost value is nearly impossible to calculate with any degree of certainty, the insurance company will always try to reduce their loss payment based on their own post-loss assessment of the replacement cost.

By way of example, assume that you suffer a \$300,000 fire loss under a property policy that has a building limit of \$500,000. After the loss, the insurance company determines that the actual replacement cost of the building was \$1,000,000, not the \$500,000 that you insured. In this case, the policyholder only insured 50% of the actual replacement cost when they should have maintained at least 80%. The insurance company will then reduce their loss settlement by the amount the policyholder was underinsured). For a \$300,000 fire loss, the insurance company would only pay \$187,500.

The standard coinsurance provision reads as follows:

Coinsurance:

If a Coinsurance percentage is shown in the Declarations, the following condition applies.

a. **We will not pay the full amount** of any loss if the value of Covered Property at the time of loss times the Coinsurance percentage shown for it in the Declarations is greater than the Limit of Insurance for the property. Instead, we will determine the most we will pay using the following steps:

- (1) Multiply the value of Covered Property at the time of loss by the Coinsurance percentage;
- (2) Divide the Limit of Insurance of the property by the figure determined in Step (1);
- (3) Multiply the total amount of loss, before the application of any deductible, by the figure determined in Step (2); and
- (4) Subtract the deductible from the figure determined in Step (3).

We will pay the amount determined in Step (4) or the limit of insurance, whichever is less. For the remainder, you will either have to rely on other insurance or absorb the loss yourself.

But my insurance agent told me that I don't have a coinsurance clause and my policy says that I have a "blanket limit." Does this mean I am covered?

Instead of a coinsurance provision, some policies include what is called a "margin clause." This language can be quite deceiving in that it often leads the insured to believe that they have a blanket limit of insurance that can be applied to any location. This is not the case.

A margin clause allows the insurance company to limit the amount of coverage available for each location by a certain percentage, despite any appearance of a blanket limit. For example, if the policy shows an insured value of \$300,000 and it actually costs \$500,000 to rebuild the structure, the most an insurance policy with a 20% margin clause will pay is \$360,000 (i.e. 120% of 300,000) even if there is a \$2,000,000 blanket limit.

The standard margin clause is as follows:

Margin Clause:

With respect to property that is subject to a Blanket Limit of Insurance, **we will determine a maximum loss payable for each building** and for the contents of each building or the contents at each premises. **The maximum loss payable is determined by applying the applicable Margin Clause percentage** indicated in the Schedule to the value of the property as shown in the latest statement of values reported to us. If the statement of values does not state individually the value of each building and the value of contents at each building or premises, we will determine individual values as a part of the total reported values prior to application of the Margin Clause percentage.

Actual loss payment will be determined based on the amount of loss or damage subject to all applicable policy provisions including the Limits of Insurance Condition, Coinsurance, Deductible and Valuation Conditions. But the actual loss payment, for each building, for the contents of each building or for the contents at each premises, will not exceed the maximum loss payable as described above and will not exceed the Blanket Limit of Insurance.

The Margin Clause does not increase the Blanket Limit of Insurance.

Since replacement costs vary depending on the construction costs and material availability, property policies should never include a coinsurance provision or a margin clause.

But my insurance agent promised me that the margin clause would not apply to certain properties even though the policy seems to say otherwise.

In Michigan, the insurance agent is the agent of the policyholder, not the insurance company. *AutoOwners Ins Co v Michigan Mut Ins Co* 223 Mich App 205 (1997). Statements made by insurance agents on behalf of the insurance company are not binding on the carrier. Regardless of what the insurance agent may have said, the policy must be enforced in accordance with its terms. *Farm Bureau Mut Ins Co of Michigan v Nikkel*, 460 Mich 558 (1999); *Devillers v. Auto Club Ins Ass'n*, 473 Mich 562 (2005).

PROTECTIVE SAFEGUARDS

Do not be fooled. The policyholder is not the one being protected by a “protective safeguards provision.”

A protective safeguards provision allows the insurance company to deny coverage if certain conditions are not satisfied at the time of loss. For example, if the fire sprinkler system does not operate properly, there is no coverage. If the burglar alarm system does not go off, there is no coverage. If the smoke detectors do not work, there is no coverage, and so on.

A common protective safeguards provision that is included in most property policies is included below.

Protective Safeguards:

We will not pay for loss or damage caused by or resulting from fire if, prior to the fire, you:

1. Knew of any suspension or impairment in any protective safeguard listed in the Schedule above and failed to notify us of that fact; or
2. Failed to maintain any protective safeguard listed in the Schedule above, and over which you had control, in complete working order.

If part of an Automatic Sprinkler System is shut off due to breakage, leakage, freezing conditions or opening of sprinkler heads, notification to us will not be necessary if you can restore full protection within 48 hours.

In *Burmac Metal Finishing Co. v. West Bend Mut. Ins. Co.*,¹ the insurance company denied coverage for damage caused to the insured's building after a natural gas explosion based on the insured's failure to properly maintain its automatic sprinkler system as required by the protective safeguards endorsement to the policy.

In other cases, insurance companies have attempted to deny coverage if the water valve for the fire suppression valve was not chained in the full open position prior to the loss.

¹ 356 Ill. App. 3d 471, 292 Ill. Dec. 235, 825 N.E.2d 1246 (2d Dist. 2005).

You should never have a protective safe-guards endorsement on a property insurance policy.

VACANCY

A vacancy clause allows the insurance company to reduce or deny coverage if the structure was not sufficiently occupied at the time of a loss.

Most vacancy clauses limit coverage as follows:

Vacancy:

a. Description Of Terms

(1) As used in this Vacancy Condition, the term building and the term vacant have the meanings set forth in (1)(a) and (1)(b) below:

(a) When this policy is issued to a tenant, and with respect to that tenant's interest in Covered Property, building means the unit or suite rented or leased to the tenant. Such building is vacant when it does not contain enough business personal property to conduct customary operations.

(b) When this policy is issued to the owner or general lessee of a building, building means the entire building. Such **building is vacant unless at least 31% of its total square footage is:**

- (i) **Rented** to a lessee or sub-lessee and used by the lessee or sub-lessee to conduct its customary operations; and/or
- (ii) **Used by the building owner to** conduct customary operations.

(2) Buildings under construction or renovation are not considered vacant.

b. Vacancy Provisions

If the building where loss or damage occurs has been vacant for *more than 60 consecutive* days before that loss or damage occurs:

(1) **We will not pay for** any loss or damage caused by any of the following even if they are Covered Causes of Loss:

- (a) Vandalism;
- (b) Sprinkler leakage, unless you have protected the system against freezing;
- (c) Building glass breakage;
- (d) Water damage;

- (e) Theft; or
(f) Attempted theft.
- (2) With respect to Covered Causes of Loss other than those listed in b.(1)(a) through b.(1)(f) above, **we will reduce the amount we would otherwise pay for the loss or damage by 15%.**

In *Mallett v Farm Bureau Ins Co*, the insurance carrier denied all coverage since the rental property was vacant for more than 60 days prior to it being destroyed in a fire. Under the terms of the policy the property owner was not entitled to insurance benefits because the policy did not offer coverage for properties vacant for over 60 days.

In *Alexander 1776, LLC v St. Paul Travelers*, the insurance company denied coverage for an \$800,000 water damage claim from a pipe break since less than 50% of the total square footage of the building was occupied at the time of the loss.

You should never have a vacancy clause on any property policy.

CONCLUSION

Insurance companies often rely on the fine print of obscure penalty clauses in order to reduce or deny the coverage after a loss. Some insurance companies will waive these clauses if the agent requests it. If the insurance company refuses, the policyholder should consider it an indication of how that carrier will respond to any claim brought under the policy.

This document is not intended to be taken as advice regarding any individual situation and should not be relied upon as such. Marsh & McLennan Agency LLC shall have no obligation to update this publication and shall have no liability to you or any other party arising out of this publication or any matter contained herein. Any statements concerning actuarial, tax, accounting or legal matters are based solely on our experience as consultants and are not to be relied upon as actuarial, accounting, tax or legal advice, for which you should consult your own professional advisors. Any modeling analytics or projections are subject to inherent uncertainty and the analysis could be materially affective if any underlying assumptions, conditions, information or factors are inaccurate or incomplete or should change.