# The Caveats with Coinsurance

Many property insurance coverage forms contain coinsurance clauses. Coinsurance clauses also apply in many business interruption policies as well as other commercial contexts. Basically, a coinsurance clause requires an insured to carry an insurance amount equal to or greater than the stated coinsurance percentage of the insurable value of the covered property. However, despite their widespread presence, coinsurance provisions create confusion.

Some agents and many insureds don't understand the effect of coinsurance provisions on the ultimate recovery for a loss. As a result, the agent may be exposed to litigation. Most commonly, agents are accused of 1) failing to advise that the policy contained a coinsurance provision, 2) failing to advise how the coinsurance provision would affect claim payments or 3) failing to advise an appropriate insurance limit so as to avoid any coinsurance penalty.

The reason for coinsurance clauses is rather simple. The coinsurance clause serves to encourage insureds to carry an appropriate amount of insurance in relation to the value of their property, especially on replacement cost policies. If insureds look to save premium dollars by insuring less than the specified coinsurance percentage of the subject risk, they effectively become coinsurers for any loss. (See sidebar.)

What's the best strategy to avoid coinsurance-related E&O claims? First, agents should advise each client in writing at the time of first purchase and at every renewal that the policy contains a coinsurance clause. The letter to the client should explain that property (and contents) should be insured to their full depreciated value (ACV) or reconstruction/replacement cost (RCV) in order to avoid reduced loss payments. On RCV policies, agents should emphasize that the replacement cost of a property can be quite different than the market value, and requires a separate assessment. Agents should remind their clients that they should review the coverage limits to be sure they are adequate, and to advise immediately in writing if the client acquires additional property or if the values change significantly so that limits can be adjusted accordingly.

The agent should encourage the insured—in writing—to routinely assess the insured risk's ACV or RCV, as appropriate, every year and to obtain coverage that is at least 80% (or whatever the coinsurance percentage is for that policy) of that amount. Agents should avoid assessing property values or replacement costs unless they possess special skill and training. The client's declination to reassess the value should be documented. Finally, if you are able to offer higher limits on a risk, but the client chooses to maintain lower limits, you should confirm the client's decision in writing, and include the amount of additional premium required to acquire the higher limits.

The key is written documentation, which creates evidence that the agent explained coinsurance to the client in case the client testifies to the contrary, which makes defending E&O claims easier. However, written communication will generally not be as effective as a face-to-face meeting explaining the effect and operation of coinsurance. Taking a few extra minutes to give the client an example of what the bottom line would be with a coinsurance clause will go a long way toward educating the insured about how adequate her limits are. Then, when your letter begins, "As we discussed…," you can be sure that your client understands the insurance she purchased, and that a jury will be likely to believe that you explained everything thoroughly to your client. IA

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## Calculate Coinsurance Costs

If Client A has a property with a rebuilding cost of $100,000 but only purchases $50,000 in replacement cost coverage, any losses will be subject to a coinsurance calculation. On the other hand, if Client B with identical property buys $100,000 in replacement cost coverage, this client's losses will be paid at 100% up to the policy limit. Thus, the carriers have encouraged their insureds to purchase coverage on the total risk despite the fact the overwhelming majority of losses are partial.

It is important to note that the value of covered property, whether by actual cash value or replacement cost value, is determined at the time of the loss. Therefore, with property and rebuilding costs continuing to rise in many markets, agents and their clients must pay careful attention to whether the limits of insurance are adequate. Even if Client B's property was insured to full value in 2002, Client B may face a problem if the property would now cost $250,000 to rebuild. Using the formula above, Client B would only get $20,000 on a $40,000 loss if the limits were not adjusted properly.

—E.M.

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