Coinsurance Clauses in Property Insurance Policies

by Ellen McCarthy, JD, RPLU[1]

Many property insurance coverage forms contain coinsurance clauses.[2] Basically, a coinsurance clause requires an insured to carry an amount of insurance equal to or greater than the stated coinsurance percentage of the insurable value of the covered property. However, despite their widespread presence, much confusion stems from these coinsurance provisions. Some brokers and many insureds do not understand the effect of coinsurance provisions on the ultimate recovery for a loss. As a result, the broker may be exposed to litigation relating to the ramifications of the coinsurance clause on a covered loss. Most commonly, brokers are accused of 1) failing to advise that the policy contained a coinsurance provision, 2) failing to advise as to how the coinsurance provision would affect claim payments, or 3) failing to advise an appropriate insurance limit so as to avoid any coinsurance penalty. This article will explain the basics of coinsurance, and then offer some tips to avoid E&O claims.

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. As a basic example, 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 that the overwhelming majority of losses are partial.

The typical formula for coinsurance is usually:

$$\frac{L}{V \times C} \times CL = LP$$

Where:
L = Limits
V = Value of the risk
C = Coinsurance percentage
CL = Covered Loss, and
LP = Maximum Loss Payment Available.

With respect to Client A above, if the policy has an 80% coinsurance clause (which is typical), the total paid for a $40,000 loss will be calculated as follows:

$$\frac{\$50{,}000}{\$100{,}000 \times 80\%} \times \$40{,}000 = \$25{,}000$$

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[2] Coinsurance clauses also apply in many business interruption policies as well as other commercial contexts.

**** The above example is provided by the program underwriter Swiss Re/Employers Reinsurance Corporation***

Therefore, in Client A's scenario, she would only get $25,000 of the $40,000 loss. Client A effectively becomes a coinsurer of the loss.

In contrast, if Client B had a policy with an 80% coinsurance clause, the result would be different:

$$\frac{\$100{,}000}{\$100{,}000 \times 80\%} \times \$40{,}000 = \$50{,}000$$

In this scenario, Client B would obviously not profit by getting $50,000 for a $40,000 loss. However, he would get the full amount of his loss, or $40,000. Therefore, by insuring the property to its full value, Client B has avoided being a coinsurer (other than any deductible).

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, brokers and their clients must pay careful attention to whether the limits of insurance are adequate at any point in time. 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.

We now turn to best practices to avoid E&O claims. First, brokers should advise each client in writing at the time of first purchase and at every renewal that the client's 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, brokers should emphasize that the replacement cost of a property can be quite different than the market value, and requires a separate assessment. Brokers should remind their clients that they should review the coverage limits to be sure they are adequate for the present, 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. In sum, the broker should encourage the insured 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. Such encouragement should be documented in writing. Brokers should avoid undertaking to assess property values or replacement costs unless they possess special skill and training. The client's declination to reassess the value should be similarly 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 emphasis in the above paragraph is on written documentation, which serves to create evidence that the broker explained coinsurance to the client in case the client testifies to the contrary, in effect making any E&O claim more easily defended. However, the above-referenced letters will generally not be as effective as a face-to-face meeting during which the broker explains the effect and operation of coinsurance. Taking a few extra minutes to give the client an example or two 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.

*** The above example is provided by the program underwriter Swiss Re/Employers Reinsurance Corporation***

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