The ISO Classification System and the CGL Policy

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We have a need to classify stuff—including all living things. For example, the scientific approach to an orderly classification of plants and animals according to their presumed natural relationships is called taxonomy.[1]

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Remember middle school science classes? Animals (including humans) are classified by Kingdom, Phylum, Class, Order, Genius, and Species.[2] Oh, you were sick that day? Well, the point is this—classifying or grouping is very common—and is an important aspect of the Insurance Services Office, Inc. (ISO), commercial general liability (CGL) policy.

Purpose of the ISO CGL Classifications

Rule 25 of the ISO *Commercial Lines Manual (CLM)* is titled "Classifications," and it very succinctly describes the purpose of the classification system: "to group insureds into classifications so that the *rate* for each classification reflects the *hazards common* to those insureds." [Emphasis added.]

This is actually another way to describe the prime goal of the underwriting process—to match the hazard or exposure of an insured with the appropriate premium for that insured. In other words, at the foundation of underwriting process is the accurate classification of an insured to make sure the premium matches the exposure. Failure to use the appropriate classification results in a premium that is either too high or too low for that insured, leaving the insurer with a premium that is not competitive (when the premium is too high) or resulting in an underwriting loss (when premium is too low).

A Word on "Rates"

ISO does not actually publish "rates" for its member companies to use but rather publishes "loss costs" by classification. Loss costs are the portion of the premium intended to cover losses only—to calculate the full "rate" for each classification, the insurer must add to the loss costs its own costs of overhead.

To arrive at the final "rate," each insurer must increase ISO loss costs by a "loss cost multiplier"—a factor that needs (in most cases) to be filed and approved by each state's insurance department, as it increases ISO's loss costs by the insurer's overhead costs. Loss cost multiplier factors do vary by insurer, although usually not dramatically.

Applying the CGL Classification System

The ISO classification system starts with a 5-digit code that describes the *industry* of the insured—Manufacturing or Processing (Codes 50000 to 59999), Contracting or Servicing (90000 to 99999), Mercantile (10000 to 19999), Building or Premises—office or space leased to others (60000 to 69999), and Miscellaneous (40000 to 49999).

Stated differently, the 5-digit code included on all ISO classifications first tells the insured how the insurer views them in a general manner—that is, whether the insurer considers the insured to be engaged in manufacturing or processing, contracting or servicing, mercantile, etc.

Premium Basis

Each general classification described above has a different premium basis. For example, the premium for manufacturing or processing is developed by applying the rate to gross sales (the rate is per $1,000 of gross sales), contracting or services by applying the rate to payroll (the rate is per $1,000 of payroll), mercantile by applying the rate to gross sales (the rate is per $1,000 of gross sales), building or premises by applying the rate to area (per 1,000 square feet) or units, and miscellaneous is varied.

And, of course, there are certain classifications that use other premium bases. Two examples are "admissions," which include the total number of people admitted to an event, and "total cost," which is the cost of the work that is subcontracted to others using a rate per $1,000 of total costs.

Classification Descriptions

Each classification within the general industry classifications noted above also includes a written description of the classification. For example, a manufacturer's CGL policy declarations may include the following:

> 51370 Bicycle Mfg.—Not Motorized—$10 Million Gross Sales

As may be inferred from the classification description used in this example, this classification applies only to a manufacturer making nonmotorized bicycles. If this insured also made mopeds or motorized scooters with gross sales of an additional $5 million per year, a *separate* classification should be included on this insured's CGL policy:

> 57202 Motorcycle, Moped, or Motor Scooter Mfg.—$5 million Gross Sales

In other words, more than one classification may be added for *one business* that has separate operations—as this is consistent with matching the premium with the exposure.

ISO Classifications—Effect on Coverage

The classification code or class description generally does not have any effect on the coverage afforded by the ISO CGL policy. That is because the classification system is only for the purposes of matching premiums with exposures. More importantly, the insuring agreement, exclusions, limitations, or conditions of an unendorsed ISO CGL policy are usually *not* changed in any way by the classification code or description.

Missing Classifications

It is often wrongly assumed that no coverage applies if the policy does not include a certain classification code and description. This view is usually because the legal remedy available for material misrepresentation by an insured—which is rescission of the policy—is confused with the overall purpose of classification, which is to match exposure with the premium charged for the insured's business.

Put differently, there is no limitation in an *unendorsed* ISO CGL policy's insuring agreement, exclusions, limitations, or conditions that states that coverage applies only to those operations or activities that fall within the classification code and description.

The Challenge of Classifications

Properly classifying all of the business operations of an insured is no easy task. A great deal of underwriting judgment may be required. And, it should go without saying that every business does not fall fully or completely within a classification or classifications.

In how to assign classifications, the ISO *CLM* seems to implicitly recognize this fact. *CLM* Rule 25.C directs the user to "… choose the classification from section of the *Manual* which *best describes* the operation." [Emphasis added.] Of course, there is room for disagreement—but any such disagreement should not be grounds for seeking to deny coverage.

Role of Premium Audit

Most CGL policies are subject to premium audit, which gives the insurer an opportunity to "compute all premiums for this Coverage Part in accordance with our rules and rates." So, if the insurer is following ISO, its rules are the ISO *CLM* rules, including Rule 25 Classifications, which would permit a better or an additional classification to be added, if warranted—including retrospectively for that policy period.

In our example of the bicycle and moped manufacturer, presume that the business decided during the policy period to open a wholesale-type outlet that sold its bicycles directly to the public, including offering servicing of those bicycles sold. The classification that best describes this operation is a mercantile classification:

> 10150 Bicycle Stores—Sales and Servicing

Certainly, the insurer would want to know about the sale of bicycles, but failing to immediately add the classification code and description would not exclude from the insured's CGL coverage any claims related to the bicycle sales or servicing operations. On the other hand, the insurer would be justified at the time of premium audit to add the bicycle sales classification, including the gross sales reported on this new operation, and charge based on the gross sales from the date the operation began.

ISO Classifications—Effect on Coverage—Exceptions

Following are some exceptions to the ISO classifications and their effect on coverage.

Classification Limitation Endorsement

Some surplus lines (nonadmitted) insurers use a non-ISO endorsement titled "Classification Limitation Endorsement." This endorsement essentially *adds an exclusion* to the CGL policy. The insuring agreement no longer applies to:

> "… bodily injury," "property damage," "personal injury" or "advertising injury" arising out of any classification(s) which is (are) not scheduled in the Commercial General Liability Coverage Part Declarations and for which you have not paid a premium.[3]

In our previous example as respects the bicycle manufacturer, if its CGL policy included this "Classification Limitation" endorsement, all coverage would have been excluded for the bicycle sales and services, as the proper classification on the CGL policy was not scheduled. Coverage would not have been provided unless and until the bicycle sales and services classification was added to the CGL policy with a corresponding premium charge.

This endorsement may be very onerous to the insured—as all of its operations may not fall neatly into a classification description, a substantial amount of uncertainty is introduced as to whether the CGL policy will provide any coverage. Even the most experienced insurance underwriters are not always absolutely positive as to *exactly* which operations or activities are included within any particular classification code and description. Possibly more importantly, how is the insured to understand the scope of the coverage provided?

Most policyholders do not have access to the *CLM* or other underwriting aides used to determine the exposures included and not included within any particular set of classifications listed on their CGL policy.

Consider this real-life example. A landlord with a similar classification limitation endorsement was sued for its alleged failure to protect patrons of the tenant. Did the "lessors risk only" classification description include this potential exposure of the landlord? There was considerable doubt. Coverage was resolved against the landlord but based on a different CGL exclusion—an assault and battery exclusion.

Other Exceptions—ISO

Certain ISO classifications require the attachment of an exclusionary endorsement. For example, the ISO Classification Fuel Oil or Kerosene Dealers 13204 directs the user to exclude failure to supply by the attachment of endorsement CG 22 50. However, unlike the classification limitation endorsement, if the insurer has filed or otherwise elects not to attach the "Exclusion—Failure to Supply" via CG 22 50, the CGL insuring agreement is not changed by the classification code and the description alone. Thus, the insured would not be subject to the failure to supply exclusion.

Limits

Other classifications change how the CGL limits may apply. For example, many classifications state that the "Products/Completed Operations are included," referencing the CGL definition of "Products-Completed Operations Hazard," specifically that the "Products or operations for which the classification, listed in the Declarations … states that products-completed operations are subject to the general aggregate limit."

The "Products/Completed Operations are included" wording is included in the classification for bicycle rentals:

> 10151 Bicycles—Rented to Others
>
> Products/Completed Operations are included

So, even if the above bicycle rental shop does have an incidental product or completed operations exposure (such as adjusting the brakes on a bicycle the insured owns prior to rental), any resulting bodily injury or property damage is still covered by the CGL policy—but *all* claims are subject to the general aggregate limit and not the separate products-completed operations aggregate limit.

Conclusion

The overall purpose of the ISO Classification System used with the ISO CGL policy is to match the exposure with the premium. By grouping like businesses with like exposures, ISO is able to develop loss costs that allow the matching of exposures with premiums. However, it should be recognized that classifying businesses for the purpose of a CGL policy is more art than science, requiring judgments by underwriters as to the classification that *best* describes the operations of an insured.

As a general matter, the ISO classification codes and descriptions *do not* restrict the CGL coverage. Coverage in a CGL policy is restricted only by actually changing the insuring agreement, exclusions, limitations, or conditions—and the classifications (with the exceptions more fully described above) do *not* change any of the CGL policy wording.

Finally, classification limitations endorsements are particularly onerous in that coverage is restricted (due to adding exclusionary wording to the CGL policy), but exactly how the restriction will apply is not usually known until after a claim—when a determination is made as to the exposures the insurer asserts are and are not included within a particular classification code and description.

[1]Merriam-Webster Online Dictionary, copyright © 2015 by Merriam-Webster, Incorporated.

[2]© 2010 Encyclopedia Britannica, Inc.

[3]IRMI, *Commercial Liability Insurance,* 01/01/15 © International Risk Management Institute, Inc.

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