

Insurable Interests and Interests Insured in Property Insurance

December 2007

John Doe and three partners purchased a building for \$100,000. Each partner had an equal \$25,000 ownership. Mr. Doe took out a property policy to insure the building, and his name appears as sole named insured. No other interests are identified in the policy. The building burns, fire is an insured peril, and the loss is considered total.

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The insurance adjuster agrees the value of the loss is \$100,000. Mr. Doe receives a \$25,000 settlement check from the insurer. Whether the policy limit was \$25,000 or \$100,000, has Doe received an equitable settlement from the insurer? Yes, as his insurable interest in the building was \$25,000: 25 percent of \$100,000.

What about the three other partners? Unless each was a named insured in this property policy, there would be no coverage for them. While they did have an insurable interest in the building, their interests were not identified—only John Doe appeared as a named insured. Could this situation happen? Yes.

Many risk management professionals spend considerable time on coverage comparison and premium negotiation but spend insufficient time understanding the appropriate interests to be insured in a property policy. Since Doe had insured the building for \$100,000, he and his partners may attempt to convince the insurer to correct the policy and add the other interests after the loss. The insurer may take the position that it underwrites not only the pre-loss exposure characteristics of the building (i.e., construction, occupancy, protection) but the moral character of the owners as well. An attempt to reform the policy *after loss* is an arduous, expensive task and one ripe for failure. In this example, let's assume the three partners are left uninsured due to lack of named insured status. How did this happen? Mr. Doe and partners forgot to think of the "who" when building insurance was first considered.

Considering the "Who"

Exposure identification is the cornerstone of the risk management process. A flaw in this first step of the property risk management process may result in mistakes on how to appropriately manage the risk through use of risk control or risk transfer including the use of insurance. Direct damage exposure analysis must begin with not just "what can happen" but equally important "who can it happen to." When the "who" of a direct damage exposure is understood, then the analysis of indirect damage (i.e., loss of business income and increased operational expense) can be conducted. Sometimes, the "who" may not be obvious to the risk management professional when damage or destruction is thought of only in terms of *owned* building and contents.

Property insurance, whether building or contents, begins with insurable interest. An individual or entity needs to demonstrate insurable interest *at time of loss* to receive the benefit of property insurance. What is insurable interest? To paraphrase a definition found in *Oran's Dictionary of the Law* (3d ed.): insurable interest is a person's or entity's real financial interest in an object; the interest being the fact the person or entity will suffer financially if the insured object is damaged or destroyed. Insurable interest needs to be established not just by meeting this definition but in the majority of U.S. states, "insurable interest" is specifically defined by statute. Insurable interest is *not* limited to simply an ownership interest. There are several ways insurable interest can be established when one does not own the object to be subject to insurance.

Insured: Named and Additional

An insured is the written identity in the policy of the person or entity that has an insurable interest in the object subject to insurance. An insured may have an insurable interest in all buildings and contents covered by a property insurance policy or it may be a specified object, such as a leased machine. While an insured is typically thought of in terms of being the owner of the object, it can include a person or entity that does not own the object but is legally responsible for it such as found in many tenant/landlord and bailment relationships.

A bailment is when a person or entity (the bailee) does not own an object but is responsible for damage to or destruction of the object while it is in his custody. The bailee's responsibility for the object creates the bailee's insurable interest, such as in the following common bailment situations: dry cleaner, repair shop, or

an outside processor used by an unrelated manufacturer. An insured can include a person or entity with an insurable interest in a nonowned object if damage to or destruction of the object *will cause consequential financial damages* to the insured. This consequential or contingent exposure can be thought of in terms of a manufacturer that purchases critical components from an unrelated supplier: the manufacturer's assembly process will stop if the supplier is unable to ship components critical to final assembly of the manufacturer's product if damage (insured peril) occurs to the supplier's building or contents. The lack of incoming supplies will result in a business interruption loss to the manufacturer even though it did not suffer the direct damage to either building or contents. The manufacturer has suffered a contingent business interruption loss.

Is a named insured and an additional insured the same thing? Essentially, but one must read the policy to determine if either term is actually defined in the policy. A "named insured" is the person or entity identified as such in the policy declarations or supplemental declarations if there is more than one named insured. A named insured will have the broadest insurable interest in covered property and business interruption coverage and is the person or entity that purchases the policy and pays the premium.

What is an additional insured in property insurance? An additional insured may be unrelated to the named insured and may appear as a person or entity that has a specific insurable interest in a specific insured object, building, or contents, such as "ACME Leasing Company as additional insured as respects copier equipment." A named insured and additional insured will have insurable interests in the same object but for different reasons.

ABC Manufacturing Company is a named insured in a property policy and leases a copier from ACME Leasing Company. By contract with ACME, ABC will be held responsible for any damage to the copier. ACME owns the object and thus has an obvious insurable interest.

While ACME could carry property insurance on this object for itself as a named insured, it may find that it is easier and less expensive to have its insurable interest insured in ABC's policy as an additional insured. An additional insured must be as diligent in *properly* insuring its insurable interest as if it was the named insured itself. The additional insured must be concerned about more than just its name appearing as "additional insured."

Is there be a difference in policy treatment of a "named insured" and "additional insured" in a property policy"? Yes, but one has to read the policy to determine if the difference is in coverage, in administration of the policy or both. Let's look to Insurance Services Office, Inc. (ISO), "Common Policy Conditions" form, IL 00 17 11 98, to answer this question. Similar verbiage may be used by other insurers when their property policy is not an ISO-filed form.

The policy conditions in IL 00 17 11 98 state that the insurer makes the first named insured agent for all other insureds for policy administrative issues: cancellation, policy changes, and premiums. The first named insured can cancel the policy and make any coverage change to the policy with only the consent of the insurer. While the named insured may have a contractual responsibility to procure a minimum level of coverage for the additional insured, this contract is only between these two parties—it does not create an obligation for the insurer.

The "Common Policy Conditions" is only between the insurer and named insured. The "Common Policy Conditions" allows the first named insured great latitude in his actions for administration of the policy that can affect coverage for all other insureds in the policy. There is clearly an advantage to being the first named insured. Each additional insured in the policy must make sure that its interests are correctly identified. Can an additional insured obtain some protection from the named insured and insurer that its interests will be protected? Yes.

Loss Payee

An additional insured is a loss payee as respects its insurable interest in the object subject to policy coverage. Even without being specified as a loss payee, it is understood that the additional insured has this status if an object of its insurable interest is damaged or destroyed. The additional insured can require that not only its identity will be added to the policy as an "additional insured," but its status as loss payee will be demonstrated through an endorsement such as ISO form "Loss Payable Provisions" (CP 12 18 06 95). This form provides certain rights to the loss payee that may not have been provided if its interest was simply identified as an additional insured. The loss payee needs to protect its rights for settlement and payment of claim, continue coverage for its interests if the policy is void at time of loss due to act of the named insured (arson), and to receive advance written notice of the insurer's intent of policy cancellation.

But, even with use of this endorsement, the additional insured may not have the same rights as the named insured. The named insured can still elect to cancel the policy or make changes in coverage, and the insurer is not obligated to provide advance notice to the loss payee of either the impending cancellation or change

in coverage. The additional insured must require advance notice of cancellation or change in coverage in its contract with the named insured and then follow up to ensure that the named insured has had the insurer make the proper amendments.

The name insured obtains a benefit as well when the additional insured defines its specific insurable interest in the policy. By specifying the extent and location of the insurable interest, the named insured limits the potential for the loss payee to be added as a party to all claims settlement. Sometimes an additional insured is added to a property insurance policy, and the interest is shown simply as "as their interests may appear" (ATIMA). This approach may lead to a situation where, in a total loss, the additional insured appears on the overall claims settlement while its interest is simply a piece of insured contents, such as a photocopy machine.

A more efficient claims settlement process for the named insured and additional insured is to have one check made out to these two parties strictly for the cost of the copier, not everything that is damaged or destroyed. The named insured must review its policy at least annually and remove any additional insured that no longer has an insurable interest in any objects that remain insured in the named insured's policy. This type of policy due diligence will limit the possibility of erroneous insureds to be considered during the claims settlement process.

When a building is used as collateral for a loan, the mortgagee as holder of the mortgage has an insurable interest in the building. This insurable interest should be obvious: damage to or destruction of the building will cause a decrease in the value of the collateral. It is normal to have a property policy endorsed to identify a mortgagee and protect its rights through an appropriate mortgagee endorsement.

Sometimes a mortgagee will not only want its status as mortgagee identified as respects the building pledged as collateral but will also require loss payee status as respects the business income coverage. This is a puzzling request as it is not clear that a mortgagee has an insurable interest beyond the building itself and may not be entitled to be a loss payee for business income coverage. This position is best summarized by statement attributed to Robert J. Brennan and Laura C. Company, in *Business Income Insurance Coverage*, 32-SUM Brief 65, 66 (2003):

A claimant seeking business interruption coverage must have an insurable interest in the business in question. Merely possessing an interest in the property, such as that possessed by a mortgagee, is insufficient to create an insurable interest in the business for which coverage is sought.

Claims settlement can become problematic since the mortgagee will appear as a payee on all business income settlement checks. Any request by a mortgagee to be included as loss payee for business income coverage should be reviewed by appropriate legal counsel prior to loan closing.

Omnibus Clause

Many risk management professionals seek to broaden the named insureds in a policy through an omnibus clause as a means to safeguard overlooking an entity to be included for coverage. The omnibus clause, when properly structured, is an acceptable way of extending policy coverage to many insureds without identifying each by specific name. But coverage for each insured within the omnibus clause will only apply to the extent that other terms and conditions of coverage apply to such person or entity. A broadly worded omnibus clause will not help provide coverage if a location is overlooked and not scheduled in the policy. It is equally important that when the "who" is considered, the "where" is considered as well.

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