



SIXTH  
EDITION

# Risk and Insurance

JAMES L. ATHEARN  
S. TRAVIS PRITCHETT  
JOAN T. SCHMIT

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Sixth Edition

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# Risk and Insurance

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To

Mary B. Pritchett and  
the memory of Harvey E. Pritchett  
and  
Geraldine C. Schmit and  
the memory of Harry J. Schmit

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# Preface

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As the most recent fire, flood, earthquake or automobile crash demonstrates, individuals and organizations live in a risky world. Your financial security depends to a considerable extent on your ability to handle risk. This book can help you begin to acquire the knowledge and skill you need.

The book is operational. It is concerned with what you need to know and what you need to do. As you proceed chapter by chapter, you learn how to manage risk and make the best use of insurance and other risk handling techniques. Both insurance and your risk situation are complex; therefore, we discuss fundamental principles first and then apply them to real-world situations. To keep the book a reasonable length for an introductory course, only topics that meet one or both of the following tests are included:

1. Is this essential for the reader's understanding?
2. Will this help him or her as a risk manager and consumer of insurance products?

Because the field of risk and insurance is broad and dynamic, you won't know all there is to know about it when you finish this book. You will, however, have a great deal of knowledge and skill that will help you as a consumer and provide a foundation for further study.

**Key Terms** at the beginning of each chapter indicate some of the vocabulary that will be developed during the chapter. A review of these terms after you have studied a chapter is a test of whether you understand the material. If you can recall the meaning of the terms you probably have a good start on mastering the material.

**Consumer Applications** at the end of each chapter demonstrate how to use what you learned from it. For example, after the chapter on buying insurance, we discuss how to find a superior agent and settle a claim. After the chapter on managing home risks, we discuss how to shop for home insurance and how to reduce your home insurance costs.

**Discussion Questions** for each chapter provide the basis for class discussion that at times ranges beyond material included in the text. Short Cases offer an opportunity to practice using what you have learned from the chapter.

Specimen insurance policies are included in Appendixes A through

D for reference as you read about them in the text. Addresses and telephone numbers of state insurance departments are listed in Appendix F so you can call or write for help when you have an insurance problem. The Glossary provides a handy reference for insurance terms you need to know.

This book lists three authors, but it is the product of countless suggestions and a great deal of help from many people. Important suggestions were made by: Larry Cox, University of Georgia; Mark Cross, Louisiana Technical University; William O. Cummings, Virginia Polytechnic Institute and State University; Albert A. Freeman, Asheville-Buncombe Technical Institute; Larry Gaunt, Georgia State University; J. Smith Harrison, Jr., The Seibels Bruce Companies; Robert A. Hedges, Temple University; Thomas L. Heflin, California State University-Sacramento; Frank Hodges, Georgia Southern College; Thomas Luck, Mississippi State University; Angela M. McLain, University of Mississippi; Mary Q. Milling, Colonial Life and Accident Insurance Company; Phyllis Schiller Myers, Virginia Commonwealth University; M. Moshe Porat, Temple University; Clarence C. Rose, Radford University; and Allan Paul Waters, University of South Florida. Some reviewed the entire fifth edition; others commented on drafts of the sixth edition.

Many of the chapter cases contributed to the fourth edition by Professors John H. Thornton of North Texas State University and Terrence E. Williamson of the University of South Dakota appear in this edition, some in modified form. Frederick W. Schroath contributed a chapter on international insurance to the fifth edition. Some of this material has been integrated into the current edition. Ms. Kay Dillard, Lisa M. Fairchild, L. Paige Fields, Betty C. McLees, Katherine L. Phelps, Ellen Roueche, and Vicki R. Shealy of the University of South Carolina were immensely helpful in manuscript typing, index revision and administrative tasks.

This edition continues to reflect our belief that knowledge and skill are most readily acquired when complex matters—such as risk and insurance—are presented in an uncomplicated format. We have endeavored to keep up with what is most important for the beginning student in a constantly changing field, provide the amount of material that can be dealt with effectively in one term, add depth and discuss each topic in terms that are relevant for the reader.

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# Risk and Insurance

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# Contents

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Preface	xiii
1 Risk	1
Introduction	1
Nature of Risk	2
Characteristics of Pure Risks	3
Reactions to Pure Risk Awareness	6
Methods of Handling Risk	7
Consumer Applications: The Academic Risk	13
2 Risk Management	19
Introduction	19
What the Risk Manager Does	20
Family Risk Management	22
Professional Risk Management	28
Consumer Applications: The Risk Management Process	41
3 Insurance	49
Introduction	49
Nature of Insurance	50
How Insurance Works	52
Ideal Requisites for Insurability	55
Nature of Self-Insurance	60
Nature of Reinsurance	61
Consumer Applications: How to Make Insurance Function Well	65
4 The Insurance Institution	71
Introduction	71
Development of Insurance	72
Types of Insurance	77

	Private Insuring Organizations	79
	Government Insuring Organizations	86
	Careers in Insurance	88
	Consumer Applications: Pursuing a Career in Insurance	97
5	Fundamental Doctrines	103
	Introduction	103
	Requirements of a Contract	104
	Distinguishing Characteristics of Insurance Contracts	105
	Agency Law	118
	Consumer Applications: Identifying Your Firm's Insurance Problems	121
6	Insurance Contracts	127
	Introduction	127
	Declarations	128
	Insuring Clauses	130
	Exclusions and Exceptions	133
	Conditions	136
	Endorsements and Riders	138
	Miscellaneous Provisions	139
	Consumer Applications: Examining the Insurance Transaction	141
7	Buying Insurance and Settling Claims	147
	Introduction	147
	Insurance Buying Principles	148
	The Insurance Market	150
	Selecting an Agent	155
	Selecting a Company or Companies	158
	Selecting Coverages and Comparing Costs	164
	Settling Losses	164
	Consumer Applications: Finding a Superior Agent and Settling a Claim	166
8	Managing Life and Health Risks	173
	Introduction	173
	Family Life and Health Risks	174
	Handling the Risks	175
	Income Continuation for the Dowd Family	175
	Estate Planning	189
	Business Life and Health Risks	196
	Consumer Applications: Estate Tax Reduction Techniques	198

9	Life Insurance	203
	Introduction	203
	How Life Insurance Works	204
	Types of Life Insurance Contracts	209
	Consumer Applications: Considering Different Types of Life Insurance	226
10	Variable Life, Annuities, and Special Contracts	235
	Introduction	235
	Variable Life Insurance	236
	Annuities	242
	Special Contracts	250
	Consumer Applications: Adjusting Life Insurance for Inflation	257
11	Life Insurance Policy Provisions	263
	Introduction	263
	Major Provisions	264
	Special Provisions for Interest-Sensitive Policies	276
	Other Provisions	277
	Life Insurance Riders	279
	Consumer Applications: Choosing Options in a Life Insurance Policy	284
12	Evaluating Life Insurance Costs	291
	Introduction	291
	Traditional Net Cost Method	292
	Interest-Adjusted Surrender Cost Method	293
	Interest-Adjusted Net Payment Cost Index	295
	Yearly Price Method	296
	Rate of Return	300
	Comparing Term Policy Costs	302
	Comparing Whole Life Policy Costs	303
	Comparing Universal and Current Assumption Whole Life Costs	305
	Consumer Applications: Comparing Policy Costs and Term Versus Cash-Value Life Insurance Decisions	307
13	Health Insurance	315
	Introduction	315
	Medical Expense Coverages	316
	Major Medical and Comprehensive Insurance	319
	Disability Income Coverages	323

Limited Contracts	329
Health Insurance Policy Provisions	330
Consumer Applications: Buying Health Care Insurance	335

<b>14</b>	<b>Health Care Cost Containment</b>	<b>345</b>
	Introduction	345
	Cost Containment in Traditional Plans	346
	Health Maintenance Organizations	352
	Preferred Provider Organizations	354
	Managed Care	356
	Consumer Applications: Choosing Between Traditional Health Insurance and an HMO Option	358
<b>15</b>	<b>Life and Health Insurance Provided by Social Security</b>	<b>365</b>
	Introduction	365
	Definition of Social Security	366
	Coverage	367
	Eligibility	367
	Types of Benefits	368
	Amount of Benefits	372
	Financing of Benefits	376
	Administration	377
	Social Security Issues	377
	Consumer Applications: Estimating Your Benefits and Covering Medicare Gaps	381
<b>16</b>	<b>Property Insurance</b>	<b>389</b>
	Introduction	389
	Characteristics of Property Exposures	390
	Deductibles	391
	Coinsurance	392
	Other Insurance Provisions	395
	The Standard Fire Policy	396
	Consumer Applications: Protecting Against Consequential Losses	401
<b>17</b>	<b>The Liability Risk</b>	<b>407</b>
	Introduction	407
	Nature of the Liability Risk	408
	Defenses to and Modifications of Liability	411
	Significance of the Liability Risk	413

- 
- Major Sources of Liability 416
  - Liability Issues 422
  - Consumer Applications: Becoming Liability Risk Conscious 426
- 
- 18 Managing Automobile Risks 433
    - Introduction 433
    - Need For Auto Insurance 434
    - Auto Insurance Issues 434
    - Types of Automobile Policies 441
    - Personal Auto Policy 442
    - Consumer Applications: Shopping for Auto Insurance 460
- 
- 19 Managing Home Risks 467
    - Introduction 467
    - Homeowners 76 Policy Forms 468
    - The Special Form (HO-3) 471
    - Endorsements 488
    - Other Risks 490
    - Personal Umbrella Liability Policies 492
    - Consumer Applications: Shopping for Home Insurance and Reducing Costs 494
- 
- 20 Business Property and Liability Insurance 501
    - Introduction 501
    - Property Loss Coverages 502
    - Business Liability Risks 507
    - Businessowners Liability Coverage 512
    - Umbrella Liability Policy 514
    - Commercial General Liability Policy 515
    - Other Liability Risks 518
    - International Exposures 520
    - Consumer Applications: Cutting the Cost of Business Insurance 525
- 
- 21 Workers' and Unemployment Compensation 531
    - Introduction 531
    - Workers' Compensation Laws and Benefits 532
    - Workers' Compensation Insurance 538
    - Self-Insurance 540
    - State Funds 541
    - Second-Injury Funds 541
    - Workers' Compensation Issues 542

Unemployment Compensation 544

Consumer Applications: Reducing Workers' Compensation  
Costs 548

**22 Employee Benefits 555**

Introduction 555

Employer Objectives 556

Welfare Plans 557

Pension Plans 567

Group Deferred Profit-Sharing Plans 580

Other Retirement Plans 582

The Flexibility Issue 583

Multinational Employee Benefit Plans 586

Consumer Applications: Getting the Most From Employee  
Benefits 588

**23 Insurance Regulation 595**

Introduction 595

Consumer Needs and No Regulation 596

Criteria for Competition 597

Legal Basis for State Regulation 599

Nature of State Regulation 600

Availability and Affordability 608

Administration 610

Is State Regulation Adequate? 611

International Insurance Barriers to Trade 612

Consumer Applications: Regulators and the Consumer 614

**Appendixes:**

A. Sample Life Insurance Policy 621

B. Personal Auto Policy 641

C. Homeowners Policy 655

D. Businessowners Policy 673

E. CSO Tables 701

F. State Insurance Commissioners 703

**Glossary 709**

**Index 737**

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# Risk

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# 1

## INTRODUCTION

**Risk** is a *state* in which *losses* are *possible*. You are surrounded by innumerable risks from birth to death. They are as pervasive as the air you breathe. Air itself even involves risk because its pollutants can cause somewhat unpredictable illnesses that in turn can cause loss to both your ability to earn income by working and your ability to enjoy life in its fullest. Risk also exists when part of your family or business income can be wiped out by death or disability. Likewise, assets can be destroyed by earthquake, flood, fire, tornado, being held legally liable for damage to someone else, and a host of other causes of loss. Risk and methods of managing risk are of major importance in both your personal and professional lives. Although you are aware of much of the risk in your environment, all too often its more crucial aspects escape your attention or you fail to appreciate its significance. As background for later discussion, and to help you become risk conscious and develop a risk point of view, we discuss the following in this chapter:

1. The nature of risk
2. Characteristics of pure risk
3. Reactions to pure-risk awareness
4. Methods of handling pure risk

## KEY TERMS

**Risk**  
**Loss**  
**Pure risk**  
**Speculative risk**  
**Exposure**  
**Peril**  
**Hazard**  
**Uncertainty**  
**Risk averse**  
**Avoidance**  
**Loss prevention**  
**Loss reduction**  
**Retention**  
**Transfer**



## NATURE OF RISK

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The concept of risk becomes clear as you understand the way in which we are using each of the key terms in the definition. When we say “risk is a state,” we mean it as a *state of the world*. Risk exists irrespective of awareness. We now are well aware, for example, that exposure to asbestos creates risks of ill health and an associated loss of earning power. Yet, when a typical person worked with asbestos in shipyards and other locations forty or fifty years ago, he or she had essentially no awareness that this hazardous material was increasing the chances of developing asbestosis. Asbestosis was then an unidentified disease, which we now know results in reduced breathing capacity and susceptibility to other cancers. Employers, insurers of their workers’ compensation benefits, and even the manufacturers of asbestos knew little about the ultimate financial liability associated with this substance. Their lack of knowledge, however, did not influence the dimensions of risk associated with asbestosis even from the inception of its use.<sup>1</sup> The risk was as great or greater during the days of its first use (before 1930) as it is today. Thus, risk is an objective matter.

Risk has no meaning without **loss** being the outcome of concern. Loss consists of a disappearance or reduction in value.<sup>2</sup> Most of the discussion in this book will be about situations that involve potential for economic loss. Consequently, there is an implication that loss must be capable of being expressed in an easily measurable economic unit, such as dollars. Many losses, however, cannot be measured or described in economic terms.<sup>3</sup> For example, the death of a family pet may be felt as a great loss but not be measurable totally in economic terms. We may know what the cost would be to buy another pet of the same breed, but this is not the only diminution in value. Throughout your life, you will need to cope with situations that concern the potential loss of friendship, love, and other noneconomic matters. Although we concentrate on economic loss, you will find some of the risk management techniques introduced in this chapter (and developed in Chapter 2) to be equally useful in managing risk of noneconomic losses.

For risk to exist, it must be *possible* for loss to occur. Loss may or may not occur under risk, but no risk exists when the probability of loss is zero or one because the outcome is certain. When losses are possible,

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1. The dimensions of risk include the uncertainty and risk aversion that accompany awareness. We will discuss these concepts later in this chapter. Mathematical dimensions of risk such as the probability of loss and its standard deviation will be discussed in Chapters 2 and 3.

2. This usage probably evolved from the insurance practice of paying funds upon the occurrence of a specified event. In most cases, the obligation of the insurer is stated in dollars, and you are presumed to have suffered a loss equal to or greater than the dollars received from the insurer under the terms of the insurance contract. From the insurance point of view, defining loss as a reduction or disappearance of value is understandable.

3. Risk theorists are also interested in the effect of risk on our utility. Utility involves both economic factors and emotional reaction to risk.