Commercial Liability Insurance and Risk Management

Third Edition • Volume I

4 CPCU

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Volume 1

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Dedication

The American Institute for CPCU dedicates this edition of *Commercial Liability Insurance and Risk Management* to the memory of James E. Brennan, CPCU, CLU.

After receiving his CPCU designation in 1965, Jim served the American Institute for CPCU as an examination grader, as a member of the Board of Ethical Inquiry, and as a contributing author or reviewer of several CPCU textbooks. In his thirty years as a CPCU Society member, he served as the first Chairman of the Curriculum Liaison Committee and was President of the Connecticut Chapter, where he also served as a member of the Board of Directors, Education Committee, and Speakers Bureau.

After an extensive career at Massachusetts Mutual Life Insurance Company, Zurich American Group, and Hartford Insurance Group, Jim joined the University of Connecticut as Lecturer in Finance and Insurance and as Academic Advisor for Insurance Programs.

Jim's service ethic also extended to his community. He and his family sponsored many international exchange students through the Youth for Understanding program. Jim was also involved with the Visiting Nurse and Home Health Care Association of Manchester, Connecticut.

A graduate of Manhattan College and The Wharton School at the University of Pennsylvania, where he earned an MBA, Jim was selected as a Standard-Setter by the CPCU Society in 1994.

Jim was a friend as well as an advisor. This dedication is a tribute to his lifelong commitment to helping others learn.

Foreword

The American Institute for Chartered Property Casualty Underwriters and the Insurance Institute of America are independent, nonprofit, educational organizations serving the needs of the property and liability insurance business. The Institutes develop a wide range of programs—curricula, study materials, and examinations—in response to the educational requirements of various elements of the business.

The American Institute confers the Chartered Property Casualty Underwriter (CPCU®) professional designation on those who meet the Institute's experience, ethics, and examination requirements.

The Insurance Institute of America offers associate designations and certificate programs in the following technical and managerial disciplines:

Accredited Adviser in Insurance (AAI®)
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Certificate in Introduction to Property and Liability Insurance
Certificate in Business Writing

The Institutes began publishing textbooks in 1976 to help students meet the national examination standards. Since that time, we have produced more than eighty individual textbook volumes. Despite the vast differences in the subjects and purposes of these volumes, they all have much in common. First, each book is specifically designed to increase knowledge and develop skills that can improve job performance and help students achieve the educational objectives of the course for which it is assigned. Second, all of the manuscripts of our texts are widely reviewed before publication, by both insurance business practitioners and members of the academic community. In addition, all of our texts and course guides reflect the work of Institute staff members. These writing or editing duties are seen as an integral part of their professional responsibilities, and no one earns a royalty based on the sale of our texts. We have proceeded in this way to avoid even the appearance of any conflict of interests. Finally, the revisions of our texts often incorporate improvements suggested by students and course leaders.

We welcome criticisms of and suggestions for improving our publications. It is only with such constructive comments that we can hope to improve the quality of our study materials. Please direct any comments you may have on this text to the Curriculum Department of the Institutes.

Norman A. Baglini, Ph.D., CPCU, CLU
President and Chief Executive Officer

Preface

This volume contains the principal study material for Assignments 1 through 8 of the fifteen assignments for CPCU 4, one of the courses in the curriculum leading to the Chartered Property Casualty Underwriter designation. A complete list of required readings for CPCU 4 is shown in the CPCU 4 Course Guide. Persons planning to take the CPCU 4 exam can make sure that they have all of the CPCU 4 study materials, including the current course guide, by calling the Institute's Customer Service Department at 1-800-644-2101.

The contents of this volume can be summarized as follows:

- Chapter 1 reviews the risk management process, explores the concept of "legal liability," and describes common liability loss exposures.
- Chapter 2 describes the noninsurance technique of risk control and shows how it can be applied to common liability exposures.
- Chapters 3 through 8 examine various lines of insurance available for insuring businesses and other organizations against liability loss: commercial general liability, commercial auto, marine, and aviation. Auto physical damage insurance, marine hull insurance, and aviation hull insurance are described alongside the corresponding liability coverages for those lines.

This eight-chapter volume is the retitled third edition of volume 1 of *Commercial Liability Risk Management and Insurance*, first published in 1978 and revised in 1986. The subtle change in the new title, *Commercial Liability Insurance and Risk Management*, affirms that the principal subject of the CPCU 4 text is insurance—viewed within the context of risk management. Examining commercial liability insurance in the context of risk management was the primary purpose of the previous two editions as well.

Many contributing authors and reviewers have enriched this text in its three editions. Although the acknowledgments that follow are limited to naming those who actively participated in the latest edition, we express our enduring gratitude to the contributing authors and reviewers of the first two editions of *Commercial Liability Risk Management and Insurance*.

Contributing authors for the current edition are Bob A. Hedges, Ph.D., CPCU, CLU, and Alexander T. Wells, Ed.D. Bob wrote the overview of

liability risk control in Chapter 2, and Alex updated and expanded his existing piece on aviation insurance, which appears as Chapter 8. Bob and Alex are acknowledged more fully on the page following this preface.

The professionals recognized below reviewed the manuscript for this volume to verify that the material was correct, complete, and at an appropriate educational level for CPCU studies. The authors owe them a great debt of thanks for their many helpful suggestions.

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The following employees of Insurance Services Office, Inc., reviewed the chapters of the manuscript dealing with commercial general liability forms and commercial auto forms. Their efforts were coordinated by Domenick J. Yezzi, Jr., CPCU, Assistant Vice President.

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In addition to the outside reviewers listed above, several employees of the American Institute for CPCU reviewed the manuscript to make sure it was technically correct and educationally sound. The authors gratefully acknowledge the assistance of the following Institute personnel:

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In addition to those recognized above, CPCU course leaders and students too numerous to name played an essential role in shaping this edition of the text by sending us their questions and comments on the previous edition. We invite you to help shape the next edition of the text by sending us your comments on the current edition. Please address your comments to the Curriculum Department of the Institute.

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Contents

Chapter 1

Liability Loss Exposures

All businesses and other organizations face liability loss exposures. A **liability loss exposure** is the possibility of experiencing a liability loss. A **liability loss** is the money that a person or organization pays as a result of a specific legal claim or suit against that person or organization.

For example, any business that holds its premises open to the public could be sued for injuries resulting from a dangerous condition (such as a slippery floor) on the business premises. The possibility that such a suit could occur is a liability loss exposure. If Harry, a customer of Speedy Shop, actually slips and falls on Speedy's slippery floor and sues Speedy to recover for his medical expenses and lost wages resulting from the accident, Speedy will experience a liability loss. Speedy's loss will include legal expenses (the cost of investigating and defending against the suit) and, if Harry wins the suit, the cost of paying damages to compensate Harry for his medical expenses and lost wages.

Liability losses can range from small "nuisance claims" to multimillion-dollar judgments. Improperly managed, liability loss exposures can prevent an organization from reaching its objectives or can even bankrupt an organization. Most organizations therefore try to prevent liability losses from occurring and to arrange the most efficient way to finance (raise the money to pay for) liability losses that cannot be prevented. These activities are part of the larger risk management process, which is examined in more detail in CPCU 3. The steps in the risk management process are summarized in Exhibit 1-1.

Exhibit 1-1
Steps in the Risk Management Process

1. Identify and analyze loss exposures
2. Examine the feasibility of alternative risk management techniques
3. Select the best risk management techniques
4. Implement the techniques
5. Monitor the program

The main risk management technique that most organizations use to finance liability losses is **commercial liability insurance**. Commercial liability insurance includes all types of insurance that pay for liability losses sustained by businesses or professionals. Commercial liability insurance also responds to the needs of nonbusiness organizations such as governmental entities, educational institutions, and religious and charitable organizations.

Other risk management techniques that organizations use to deal with liability loss exposures include the following:

- Risk control techniques, which prevent liability losses from occurring or reduce the amount of liability losses that actually occur. For example, restricting floor washing activities to hours when a store is closed can help to prevent liability losses resulting from slip-and-fall accidents. Efficient claim-handling procedures can minimize the costs of accidents that occur.
- Risk financing techniques in addition to insurance. For example, if an organization expects to experience a moderate number of relatively small liability losses, retaining (paying out of one's own pocket) the first $2,500 of each loss might be less expensive than buying full insurance for such losses.

Commercial liability insurance is the primary subject of this text. Risk control techniques and risk financing techniques other than insurance are also examined, since they are frequently used in combination with insurance as part of the risk management process. The Associate in Risk Management (ARM) program and the Associate in Loss Control Management (ALCM) program, both offered by the Insurance Institute of America, give more attention to the noninsurance techniques of risk management.

Most commercial insurance programs include both liability and property insurance. Thus, this text handles only approximately one-half of the broader subject of "commercial insurance." The other half of the subject is handled in the text for CPCU 3, *Commercial Property Insurance and Risk Management*. One exception to this division of subject matter is that property coverages for automobiles, watercraft (vessels), and aircraft are discussed in the CPCU 4 text along with the corresponding liability coverages.

This first chapter of the text examines the concept of legal liability and surveys the principal liability loss exposures faced by businesses and other organizations. Understanding legal liability and the various types of liability loss exposures is an essential first step on the way to determining the proper treatment of loss exposures with insurance, risk control, or noninsurance financing techniques.

Legal Liability

Legal liability is what a person making a liability claim or suit must fix on the alleged wrongdoer in order to recover monetary damages or obtain some other legal remedy from the wrongdoer. If the claimant cannot establish that the alleged wrongdoer is legally liable, the claimant cannot legally compel the alleged wrongdoer to pay damages. Thus, anyone who wishes to evaluate an organization's liability loss exposures must be able to understand the various ways in which the organization could become legally liable.

The concept of legal liability is also important to those who work with liability insurance. Under most liability insurance policies, the insurer is obligated to pay damages on behalf of the insured only if the insured is *legally liable* to pay damages to a "third party" that has made claim against the insured. A common task of liability claim representatives is determining whether insureds are legally liable to pay damages for injuries alleged by third-party claimants. In many cases, insurers pay liability claims following the claim representative's determination that the insured was legally liable, and the claim never goes to court. (Of course, the claim must be covered under the policy in all other respects, and the claimant and the insurance company must agree on the amount of damages payable.)

Legal liability is ordinarily based on torts, contracts, or statutes. Each of these general sources of legal liability is examined below.[1]

Legal Liability Based on Torts

A **tort** is a wrongful act or omission that invades a legally protected right. Examples of such protected rights include the right of an individual to liberty, the right to be secure in one's own property and reputation, and the right to privacy. If wrongful invasion of a protected right causes the holder of the right to suffer harm, the law provides a remedy in the form of an action for damages.

Civil Law and Criminal Law

The discussion of legal liability that follows describes matters of civil law—rather than matters of criminal law. **Criminal law** applies to acts that society deems so harmful to the public welfare that government takes the responsibility for prosecuting and punishing the perpetrators. **Civil law** applies to all other legal matters not governed by criminal law. Civil law basically protects rights and provides remedies for breaches of duties owed to others.

Risk management is concerned with both criminal and civil liability, because either type of liability can prevent an organization from reaching its objectives. However, insurance is not a viable risk management technique for handling criminal liability loss exposures. Encouraging or rewarding the commission of crimes is obviously not in the public interest. Therefore, any type of insurance that would cover a criminal for the commission of a crime is void, because it is contrary to public policy. (Insurance can be used to cover the *civil consequences* of a criminal act, such as a tenant's civil suit against a landlord for damages resulting from criminal acts of the landlord's employee against the tenant.)

An objective of most organizations is to operate legally. Fulfilling this objective requires that the organization stay informed of all applicable laws and do all in its power to comply with those laws. Doing those things can be viewed as using "risk control" to reduce the organization's exposure to criminal liability. The organization may also have *noninsurance* risk financing measures in place in order to be prepared to (1) defend itself against criminal actions and (2) pay fines if found guilty of criminal conduct.

Thus, the elements of a tort are as follows:

1. A legally protected right
2. A wrongful invasion of that right
3. Damages as a proximate, or direct, result of that invasion

The person committing a tort is called a wrongdoer or tortfeasor. When two or more persons unite in causing the tort, they are called joint tortfeasors.

The numerous torts recognized by law can be classified into three broad types: (1) negligence, (2) intentional torts, and (3) strict liability torts. In actual practice, the lines between these three categories are often blurred. As long as that reality is kept in mind, the three broad categories provide a useful framework for conveying the general nature of more specific kinds of torts. Exhibit 1-2 clarifies the relationship among the three categories of torts and the other two (non-tort) bases for legal liability.