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# Co-insurance clauses

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against the amateur crook, but not against the professional crook. The latter does not care to assume the risk of altering carefully prepared checks; he prefers to duplicate them. Any carelessness on the part of business men becomes the chief aid of the check crook. It is necessary, therefore, to add common sense to whatever other protective procedures may be employed in the handling of checks. Thoughtful attention should be given to the disposition of canceled and voided checks, the control of blank checks, the signing of checks, and the guarding of one's mail. In short, checks should be treated with as much care as the money which they represent.

## Co-Insurance Clauses

THE co-insurance clause is one of the most frequently used, most severely criticized, and most misunderstood of the insurance clauses in general use today. Yet it is the most reasonable and the most equitable of them all. In Europe the fairness of the co-insurance clause is well established, the majority of the countries making its use compulsory by law. In the United States its use is mandatory in some states, optional in others, and prohibited entirely in some western and southern states. However much has been said and written on co-insurance, there are still many, even some actively engaged in the insurance business as well as legislators and policyholders, who do not understand its purpose and operation.

Fire insurance is one of the great necessities of our business, social, and economic life. The expense of maintaining it should be distributed among the property owners of the country as equitably as is humanly possible. Insurance is in the nature of a tax. Just as taxes of the government are used to cover the expenses of running the government, so the tax of fire insurance companies is for the purpose of paying the fire loss of the country. Each policyholder pays his premium into a fund, which the fire insurance company distributes among those who suffer loss by fire. In the event insurance were to be provided by the state or national government it is practically certain that an assessment would be levied against all property subject to loss from fire in precisely the same manner as all other taxes are levied; that is, upon the full assessable value of the property to be protected. In fact, it is in this manner that the insurance tax in Germany is assessed.

Since insurance is a tax and since it is not obligatory in the United States to insure in total, it becomes necessary, therefore, to ascertain equitable principles of assessment. There should be no discrimination between individuals insuring risks of equal hazard, just as there should be no discrimination by a railroad between different shippers receiving identical service. Each risk should contribute its equitable proportion of the total sum collected for loss payments. This effect is secured by rating the several risks according to their individual characteristics, crediting each risk with its favorable features and charging it with its unfavorable features. Thus, efforts to reduce fire hazard are encouraged, and the consumption of national wealth by fire thereby is reduced. However, any such scientific system of rating is impossible without the feature of co-insurance.

If all losses were total, those who insured in total would receive their reward, while those who preferred to pay less in premiums would be penalized accordingly. However, the records of the leading insurance companies indicate that of all the losses sustained, about 65% (numerically) are $100 or less; about 30% are over $100 and less than total; and about 5% are total. The natural inclination, therefore, on the part

of the public, particularly on the less hazardous risks, is to under-insure and take the chance of not having a total loss; and this will generally be done except under special conditions.

That discrimination will result if an insurance company promises to pay all losses in full to the face of the policy while granting all policyholders the same rate per $100 of insurance regardless of the relative amount of insurance carried on the property, may be illustrated in the following example: Smith and Jones each own a building valued at $50,000. They each insure their building at the rate of 1% without a provision for co-insurance. Smith insures his building for $40,000, paying $400 premium therefor, while Jones insures his building for only $5,000 paying $50 premium. Suppose each suffered a loss by fire of $1,000. Smith and Jones would have equal rights to collect in full although Smith paid eight times as much premium as Jones; and this would be true for any loss up to $5,000.

Looking at it from the point of view of the insurer, Smith's company had a loss of 2½% of the policy and the company insuring Jones had a loss of 20% of the policy, yet each company received the same amount of premium per $100 insurance. It is quite evident that either Smith should have the benefit of a lower rate or Jones should have a lower loss collectibility. The latter feature can be regulated only by means of a co-insurance clause in the policy. Without some such provision to insure equity among a group of policyholders, all those who insure to a relatively high percentage will be contributing more than their share to the common insurance fund to pay the partial losses on policies taken out for a low percentage of the total value.

Another illustration of a slightly different type which illustrates the inequity which may exist between policyholders is as follows: Assume that Company A owns three different plants, situated in three different localities, each worth $100,000. Company B owns a single plant worth $100,000. From a fire insurance point of view, a fire in one plant of Company A will not affect the other two plants, so that Company A could protect itself fully by taking out a blanket policy of $100,000, covering all three plants. In order to secure full protection Company B also would have to take out a policy for $100,000. If rates are the same, and if losses are to be paid in full irrespective of the amount of insurance taken, it is evident that Company A is receiving practically three times as much protection as Company B for the same premium. To prevent large owners with numerous items of property from securing full protection at the expense of small owners, blanket policies now are written with a co-insurance clause.

Under a co-insurance clause the insured becomes co-insurer with the company unless his total insurance is equal to or greater than a stipulated percentage of the sound value of the property. A typical co-insurance clause reads as follows: "In consideration of the reduced rate for which this policy is issued, it is expressly stipulated that in event of loss this company shall be liable for no greater proportion thereof than the sum hereby insured bears to 80 per cent of the cash value of the property described herein at the time such loss shall happen. If this policy is divided into two or more items, the foregoing conditions shall apply to each item separately." An 80% co-insurance clause is customary, although any per cent may be inserted. The last sentence was added to prevent an interpretation inconsistent with the original intention of the co-insurance clause in connection with policies containing more than one item.

Co-insurance brings about an equitable distribution of risk under partial losses in a

manner which is automatically taken care of in total losses; that is, those who pay premiums sufficient to insure 80% or more of the sound value are protected fully, while those who prefer to pay small premiums must bear a proportionate share of the risk accordingly. A few illustrations of the operation of the clause should make this clear.

In the following examples it is assumed that the sound value of the property is $100,000 and the policy contains an 80 per cent co-insurance clause or, in other words, $80,000 of insurance should be taken out to satisfy the co-insurance stipulation:

*Case No.* 1. Policy, $50,000 (50%); loss, $20,000. The policy is less than 80% of the sound value; hence, the insured is co-insurer for 3/8 of the losses and the company's liability is 5/8 of $20,000, or $12,500.

*Case No.* 2. Policy, $50,000 (50%); loss, $90,000. The insured is co-insurer to the extent of 3/8 of the losses, and the company's liability is 5/8. However, 5/8 of $90,000 is $56,250, which is greater than the face of the policy; hence, the loss collectibility is limited to the face of the policy, or $50,000, and in effect the co-insurance clause is inoperative.

*Case No.* 3. Policy, $20,000 (20%); loss, $70,000. The insured is co-insurer for 3/4 of the losses and the company's liability is 1/4 of $70,000, or $17,500.

*Case No.* 4. Policy, $80,000 (80%). The insured has met the 80% requirement; hence, the company is liable for 100% of all losses up to the face of the policy, or $80,000.

*Case No.* 5. Policy, $95,000 (95%). The property is insured for 95% of its sound value rendering the co-insurance clause inoperative. The company is liable for 100% of all losses up to the face of the policy, or $95,000.

It is evident that the co-insurance clause is not operative if the insurance carried is equal to or greater than the agreed percentage. It is equally true that the clause is ineffective if the loss is equal to or greater than the stipulated percentage of the sound value even though the insured has failed to comply with the requirements of the co-insurance clause. It is applicable only to cases of partial losses (less than 80% or the agreed percentage of the total value) and then only in case the insurance also is less than the percentage stated.

Many property owners have the impression that they cannot collect more than 80% of a loss under an 80% co-insurance clause regardless of the amount of insurance carried. This view is wholly erroneous. The insurance company is liable for 100% of all losses up to the face of the policy when 80% or any amount in excess of 80% is insured. Complete protection may be obtained by taking insurance for the full value of the property.

The effect of the co-insurance clause is to prevent those owners who wish to underinsure from shifting their burdens to others who desire to carry full protection. The fire loss is distributed more equitably among policyholders through the avoidance of rate discrimination. The operation of the clause furnishes an incentive to the policyholder to insure his property fully.

When the policy contains a co-insurance clause, it is important to take into consideration the changing values of the insured property. For example, take *Case No.* 4 above where the sound value of the property is $100,000 and insurance for $80,000 (80%) is carried. As long as the property value remains at $100,000, the loss collectible will be 100% up to the face of the policy. However, suppose the market value of the property increased to $150,000 and a loss of $80,000 takes place. The co-insurance clause specifies the basis to be "80 per cent of the cash value of the property at the time such loss shall hap-

pen." Eighty per cent of $150,000 is $120,000. Since the policy is for $80,000 only, the insured is co-insurer for ⅓ and the company's liability is ⅔ of $80,000, or $53,333. The policyholder should keep the insurance in force commensurate with the total value of the property insured.

The same principle is applicable where the policy containing a co-insurance clause not only covers the property of the insured but that of others as well. To illustrate, a proprietor of a picture and picture framing establishment had a valuable stock of his own. He also had in his possession in storage, framed pictures and other valuable property belonging to customers. His policies covered his own property and that of his customers as well. Both were damaged by fire originating in a part of the building not occupied by him.

The sound value of his own property and the loss thereon were ascertained readily, but it was necessary to determine the value of and the loss on customers' goods. Some of his customers were reasonable in their claims as to the value of their destroyed property; others were not. The claims of the latter group augmented the total value of the property, thus reducing the proprietor's loss collectibility. As a result of this experience he wisely decided that thereafter his own property and the property of his customers should be covered by separate policies. Other instances could be cited in which proprietors have been the victims of their own generosity either because the customers made unreasonable claims or the value of the customers' property happened to be unusually high at the time of the fire, reducing proportionately the amount recoverable on the loss suffered on the proprietors' stock.

Although co-insurance usually is considered in its relation to fire insurance, the use of the co-insurance clause is not restricted to this form of insurance. The principle of co-insurance is embodied in marine insurance the world over. It is used also in tornado, sprinkler and leakage, and other forms of insurance. Care should be taken to see that the stipulated percentage is applied to sound value of the total property insured and not to any other figure. For example, if the sound value is $100,000, $80,000 fire insurance will be required. Suppose tornado insurance is taken out on a 50% co-insurance basis, the amount required will be 50% of $100,000, or $50,000, and not 50% of the amount of fire insurance carried, or $40,000—a mistake frequently made in practice.

Through misunderstanding the co-insurance clause may be a source of loss to the policyholder either through under-insurance or through unforeseen relationships under different policies resulting in complicated adjustments. In principle, however, the co-insurance clause is fair to both insurer and insured. It is indispensable in securing equity among all the policyholders.

## Advertising That is Advertising

THE following incident is reprinted from *The Sabean* for April, 1923:

"An acquaintance went to a small florist shop upon request of his wife to purchase a plant. He lived in an apartment. Both he and his wife were city-bred and knew nothing about the proper care of plants. If all the plants they purchased had survived, a small greenhouse would have been required to house them.

"The florist asked, 'Do you live in a house or an apartment?' and on being told by my friend that it was the latter, he asked 'Do you have a porch?' The reply was in the negative.

"Then the florist surveyed his stock and