Post-Claim Underwriting:

The Intersection of Claims, Litigation, and Underwriting

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At the intersection of claims, litigation, and underwriting lies the concept of post-claim underwriting. Regarded by some legal scholars as per se evidence of bad faith, post-claim underwriting occurs when an insurer underwrites a risk after a claim has been made. This article briefs two seminal cases from Wyoming and Mississippi, explains why commercial property insurance is a sophisticated underwritten product that requires significant pre-inception underwriting, and identifies the factors involved in commercial property risk quantification and underwriting. Lastly, it examines insurtech that can improve commercial property risk quantification and underwriting and eliminate post-claim underwriting.

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Post-claim underwriting is exactly what it sounds like: underwriting a risk after a claim has been made.

When policyholder advocates allege that an insurer engaged in post-claim underwriting, they cite the industry's use of aleatory contracts—legal agreements in which the rights and obligations of all parties are conditioned on the occurrence of a fortuitous event.[1]

Policyholder advocates argue that the timing of aleatory contracts is problematic because policyholders always perform first by paying premiums, and insurers always perform last by adjusting and indemnifying claims. A policyholder has no way of testing an insurer's performance before a claim is filed;[2] in other words, they have no way of knowing whether an insurer will engage in post-claim underwriting.

Two Telling Court Decisions

The Supreme Court of Wyoming decided *Harper v. Fidelity and Guaranty Life Insurance Company* in 2010.[3] The court stated that post-claim underwriting occurs when an insurance company "fails to perform any actual underwriting until after a claim has been made" and cited a law review article concluding that post-claim underwriting is per se evidence of bad faith.

The plaintiff in *Harper* applied for a $63,000 life insurance policy with Fidelity and represented that he was 5 feet, 11 inches tall; weighed 275 pounds; never sought or received treatment, advice, or counseling for the use of alcohol; and was currently taking medication for high blood pressure and cholesterol. The plaintiff also denied diagnoses of circulatory diseases; disorders of the veins or arteries; and diseases or disorders of the liver, stomach, pancreas, or intestines.

Fifty days after Fidelity issued the $63,000 life insurance policy to the plaintiff, he died from cardiac arrest, hypertensive cardiovascular disease, and hypertriglyceridemia. Fidelity denied the plaintiff's life insurance claim and insisted that he misrepresented his health and health history.

The court described Fidelity's life insurance products as "simplified underwritten product[s]," for which Fidelity should rely on only the information in a life insurance application and a single report from the Medical Information Bureau (MIB).

During litigation, it was discovered that Fidelity's senior underwriter noted a weight discrepancy: The MIB recorded the plaintiff's weight at 305 pounds, not 275 pounds. Instead of investigating the weight discrepancy, the senior underwriter "let it go"—and did the same after several other confounding observations.

After the plaintiff's death, Fidelity conducted an investigation within its two-year contestability period. It learned that the plaintiff had a history of alcohol abuse; received advice from his doctor to stop drinking alcohol because his liver tests were abnormal; was hospitalized in March 2000 for an episode of heart fluttering and chest pains; and, as evidenced by his death certificate, weighed 350 pounds.

The plaintiff's wife insisted that Fidelity ignored red flags; however, the court stated, "In the simplified underwriting process…used in [the plaintiff's] case, the [senior] underwriter is to rely on [only] the health questionnaire and the MIB, which is what happened in this instance."

Essentially, the court held that "lax and sloppy underwriting" is permissible for simplified underwritten products because insurance companies are entitled to rely on the representations made by their applicants. Fidelity did not have a duty to investigate, and a reasonable basis existed for denying the plaintiff's life insurance claim.

Comparatively, significant pre-inception underwriting is required with complex underwritten entities, such as commercial buildings. For example, when an underwriter inspects the roof of a commercial building, these conditions are examined: granular loss, curling/cupping, surface cracking, blistering, past hail damage, patching, staining, vertical racking, unevenness, loose/worn flashing, and ventilation concerns.

In *New Hampshire Fire Insurance Co. v. Kochton Plywood & Veneer Co.*, the insurer forfeited its opportunity to deny losses to commercial buildings for poor construction and inferior hardware materials because it "collected a total premium of $1,912.98" and "had the right to examine [the commercial] buildings before [it] wrote the insurance and accepted the premium." If New Hampshire Fire Insurance Company had examined the commercial buildings *before* it wrote the insurance and accepted the premium, it "could have declined to write the insurance and…avoided the consequences…."[4]

Unlike the Supreme Court of Wyoming, the Supreme Court of Mississippi took a pro-policyholder stance and held New Hampshire Fire Insurance Company responsible for its lax and sloppy underwriting.

As is seen with *Harper* and *Kochton Plywood & Veneer Co.*, the presence of clear authority on post-claim underwriting depends on what type of underwritten product is being litigated and "whether insurance companies 'want' a precedent from a given court on a given matter at a

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particular…time."[5] What is the case with life insurance is not the case with commercial property insurance. And what is the case in Wyoming is not the case in Mississippi.

Because insurance coverage law is not created through a top-down and rationalized process, navigating post-claim underwriting is complicated. To avoid complications, insurance companies must prudently quantify and underwrite commercial property risks and retain experienced panel coverage counsel.

The Art of Quantifying Commercial Property Risk

Commercial properties present more complex insurance risks than residential properties. While homeowners insurance primarily assesses the hazards, terms, and values of single-family dwellings, commercial property insurance addresses a wide array of building and coverage types.

Commercial properties are generally larger than residential properties, covering more square footage. And with the larger size comes greater values, requiring more significant commitments of insurance capacity and additional demands associated with utilities (heating, cooling, electricity bandwidth, plumbing, and so on), efficient human movement (elevators, ingress and egress, and walkways, for instance), and various activities (such as offices, restaurants, industrial facilities, warehouses, marinas, airfields, and parking lots).

Yet, commercial properties don't need to be large to have complex insurance needs.

When quantifying a commercial property's future insurable losses, underwriters should focus on these attributes, also known as COPE factors: construction type, occupancy type, protection, and exposure. Let's examine each one more closely:

- Construction type—Unlike residential properties, which are primarily wood-framed and built using masonry construction, commercial properties exist in a wide array of construction types. Various combinations have naturally emerged as a result of tradeoffs among construction costs, durability, and local geographies.

  Wood-frame structures, although economical and flexible, are combustible and can fail at moderate vertical severity loads. Most building codes in the United States do not allow structures greater than four stories tall to be constructed with wood frames because of the increased likelihood of failure with moderate vertical severity loads.

Commercial properties present more complex insurance risks than residential properties

  Masonry structures, such as those made with brick and stone, are desirable for their fire resistance and ability to withstand wind but are brittle during ground shaking caused by earthquakes, sinkholes, landslides, and construction vibrations. Joisted masonry structures combine wood-frame interiors and masonry exteriors. Such exteriors make structures slightly more fire resistant but render shells unable to withstand horizontal loads from ground shaking.

  Building codes and engineering practices have evolved over time to increase the durability of commercial properties. While newer construction meets modern building codes and is built using engineering practices that reduce loss frequency and severity, older construction poses greater risk of loss from standard perils and requires additional insurance capacity from ordinance or law coverages.

- Occupancy type—This refers to how a commercial property is used. Questions underwriters should ask to help determine the occupancy type of a commercial property include:
  - What is being done within and around the property?
  - Is any machinery involved?
  - Are open flames present?
  - Who has access to the property?
- Protection—Protection encompasses the risk management mechanisms in place to prevent and mitigate damage and loss. Examples include fire-suppression systems (such as sprinklers, fire alarms and extinguishers, and so on), security features (fencing, guards, alarm systems, and so forth), and maintenance practices (for instance, regular inspections and upkeep). Underwriters

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should ask, What activities must occur to prepare for severe, catastrophic weather events? and How often do the occupants practice fire drills?

- Exposure—Exposure concerns the surrounding environment and potential external threats. Commercial properties are generally classified into three exposure categories: buildings or other structures, the contents of a building or other structure, and revenue and income resulting from a building or other structure. Unlike residential properties, most commercial properties involve at least two of these categories. Accordingly, underwriters should ask:
    - Is the commercial property near flood plains, areas prone to wildfires, hazardous material sites, earthquake fault lines, or hurricane or tornado zones?
    - What is the construction type of nearby commercial properties?
    - What activities take place in nearby commercial properties?
    - What burglary risks exist based on statistics in the immediate area?

The subtle art of quantifying commercial property risk hinges on an underwriting team's ability to acquire information with which it can segment a wide array of building and coverage types into finely delineated categorical patterns of estimated loss frequency and severity. Quantifying estimated loss frequency and severity requires as much information as possible.

Because many uncontrollable scenarios can cause damage and loss, it's incumbent on an underwriting team to examine every possible causal link for commercial properties, especially if the team is in the market with an open perils Special Form insurance policy. Ultimately, underwriting teams that can acquire detailed information will sustain a competitive advantage in loss forecasting.

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Guidelines for Sound Commercial Property Underwriting

To achieve strong financial returns, an underwriting team adheres to specific, comprehensive guidelines. Underwriters and marketing staff must have a thorough understanding of these guidelines so they can communicate them to outside stakeholders, such as agents and brokers.

First, the underwriting team must know the market segments in which it has an information advantage. Such an advantage usually exists if the underwriting team can uniquely differentiate loss frequency and severity across exposures at a distinguished level compared with its competitors.

Second, the underwriting team must seek risks with favorable returns, considering how much exposure to them and allocated capital surplus can be absorbed.

Third, the team must generate enough business through its distribution channels to create an optimal portfolio—one that can adequately support the capital surplus that backs this portfolio.

In addition, practicing good underwriting requires answering these questions:

- Does the underwriting team need forensic engineering or accounting reports?
- How thoroughly can the business that's purchasing commercial property insurance itemize its contents?

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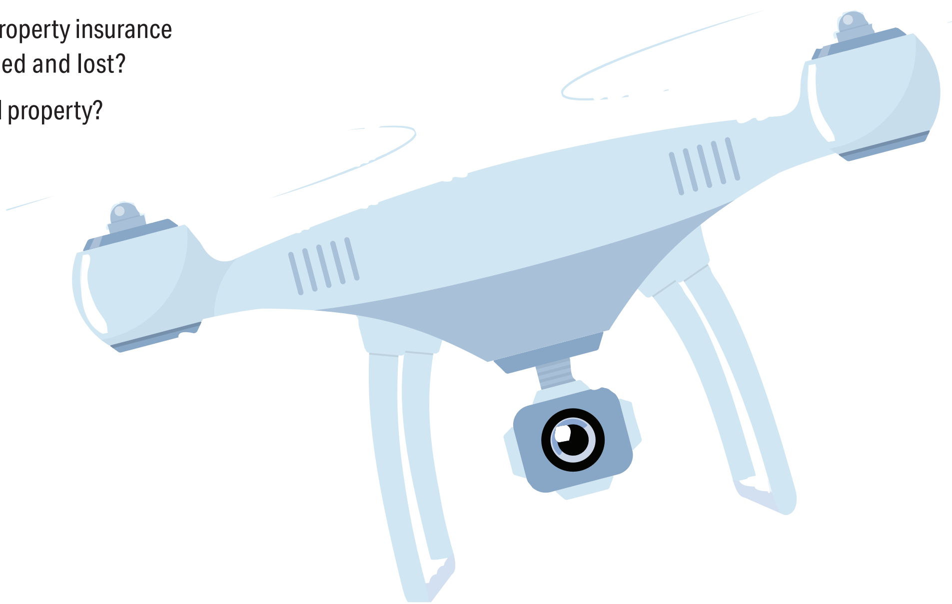
- Can the business that's obtaining commercial property insurance detail its revenue, expenses, and income earned and lost?
- What's the prior claim history of the commercial property?
- Does the applicant have a history of negligence or a strong risk management ethos?

Finally, superlative underwriting communication requires awareness and emphasis of the imprudence of post-claim underwriting.



Why Post-Claim Underwriting Is Imprudent

Post-claim underwriting can wreak havoc on an insurer's financial condition. The foundation of the insurance industry rests on the statistical confidence that the future insurable losses of a portfolio of many exposures can be adequately quantified.

In quantifying the risk of individual exposures and how they correlate with one another in a portfolio of many exposures, uncertainties will persist. And post-claim underwriting is guaranteed to introduce even more potential uncertainties, such as:

- Poor exposure selection—If the COPE factors are poorly understood, an insurer could be insuring a commercial property exposure that it clearly lacks the authority or expertise to insure.
- Rate inadequacy—If an insurer is not underwriting its exposures correctly, the rates associated with the risk of its exposures won't be commensurate. An insurer could theoretically negate any pricing issues in a marketplace where it expected an equal distribution of overpriced and underpriced commercial property exposures to balance out—but that's not how the insurance marketplace operates. An overproportion of underpriced commercial property exposures is likely because alternative and correctly underpriced market options will be available for any mistakenly overpriced commercial property exposures. However, erroneously underpriced commercial property exposures will likely be a final market option, as policyholders aggressively seek the most economical options.
- Capacity inadequacy—The absence of significant pre-inception underwriting increases the chances of inaccurate valuations. This, of course, becomes an issue when claims are adjusted. Even if an insurer acts in good faith, the potential conflict may become a source of contention and instigate litigation.
- Violations of reinsurance treaty obligations—Reinsurance companies look unfavorably on insurers that manage their portfolios imprudently. Post-claim underwriting falls into the imprudent category and may create a legal conflict between the two parties, as well as jeopardize future reinsurance arrangements between them.

> *Insurtech tools that use artificial intelligence can improve commercial property risk quantification and underwriting and eliminate post-claim underwriting*

The philosophy of "We will catch it at claim time" exposes insurers to claims they may be unable to pay, rates they may be unable to retroactively price for, exposures they never wanted to insure in the first place, and the possibility of a diminished reputation in the reinsurance marketplace. The preceding scenarios are endemic under post-claim underwriting and create existential burdens for insurers.

Insurtech to the Rescue

Underwriting teams may decide not to employ a considerable pre-inception underwriting process because of the complexity of a commercial property exposure or cost or time constraints. Over the past decade, a surge in technology solutions developed specifically for insurance-related issues has occurred, offering improved accuracy and efficiency as well as cost reductions.

Insurtech tools that use artificial intelligence, such as drones and aerial and satellite imagery, can improve commercial property risk quantification and underwriting and eliminate post-claim underwriting.

Drones, for example, enable real-time, quick, and safe inspections of hard-to-reach areas (such as roofs and tall structures) and capture high-resolution images and videos of commercial properties, helping underwriters identify deterioration, decay, wear and tear, and structural damage. And aerial and satellite imagery offers comprehensive views of large areas, which can help underwriters assess environmental risks—such as flood zones, wildfire-prone areas, and land subsidence—and monitor changes over time.

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