Property and Casualty Insurance Solutions for Entity Owners

Plugging the Holes in Asset Protection Plans

By Tim O'Brien and Michael Markiewicz

An increasing number of Americans are transferring personal ownership of residential property to trusts, limited liability corporations (LLC), limited liability partnerships (LLP), and other entities designed to protect assets or take advantage of favorable tax treatment. Although transferring residential and other real property to an entity can provide numerous benefits, it might also result in an unintended lapse in insurance coverage for both the families transferring the property and their professional advisors. Although it is impossible to document with precision how many trusts and other entities are created each year for asset-protection or tax-advantaged purposes, a review of IRS records verifies past and projected growth in fiduciary tax filings (*Exhibit 1*).

'Personal Property and Casualty Insurance 101'

Much has been published on the proper use, design, and implementation of the tax and asset-protection benefits available to individuals who transfer residential property to entities. This article focuses on the need to properly structure the insurance policy that is used to protect the majority of residential properties—the common homeowner insurance policy.

An insurance policy is a legal contract in which one party agrees to indemnify another party against certain risks in exchange for an agreed-upon sum of money. Many advisors operate under the logical but false premise that the common homeowner insurance policy covers the actual home. In fact, the party that receives the benefit of coverage is the *named insured.*

The contract language used in homeowner policies was developed when people, not entities, owned homes. As a result, the definition of "insured" was carefully crafted to protect the interests of a very specific group of people. Although definitions used by carriers can vary in subtle ways, the insurance industry's leading supplier of statistical, actuarial, underwriting, and policy language, the Insurance Services Office (ISO), uses the following language in its commonly adopted broad-form homeowners policy to define an insured:

"Insured" means you and residents of your household who are:
a. your relatives; or

b. other persons under the age of 21 and in the care of any person named above. "You" includes the named insured and spouse if a resident of the same household.

The definition of "insured" has been tested many times in court to determine who is eligible to receive the benefits of coverage provided by a homeowner insurance policy. Regardless of the actual ownership interest in the property at the time of loss, in no known instance has a court required an unendorsed homeowner policy to provide coverage to any party other than those defined by the insurance contract.

Given this background, one can see that when residential property is transferred from a person to an entity, the insurance policy that protected the individual owners is not structured to protect the new entity owner of the property. When asset protection is among the primary reasons for transferring the property, the resulting absence of insurance protection is an especially problematic unintended consequence.

Critical Form of Asset Protection: Liability Insurance

Although often overlooked, the very broad liability coverage provided by a homeowner insurance policy serves as a critical form of asset protection. Indeed, homeowner policies not only provide protection against many forms of suits alleging bodily injury or property damage associated with residential premises, but protection is also extended to the named insured for acts arising away from the home. In addition, regardless of the merits of such legal actions, the liability protection provided by a homeowner policy obligates an insurance carrier to provide the insured with a legal defense for covered losses.

Compared to other causes of loss, liability losses occur with far less frequency than those that result in damage to the home (*Exhibit 2*). Because liability losses have a low overall impact on total loss costs, carriers apply only a small charge for the liability coverage on a homeowner policy. Liability claims are infrequent, but the costs to settle the few losses that do occur can be high. Compounding this concern is the fact that carriers find it challenging to understand and underwrite the true purpose and scope of all entities that own residential property. Consider, for example, the situation in which an entity that owns a residence is named in a lawsuit alleging damages sustained far away from the insured home. The broad liability coverage provided by a homeowner policy may obligate the insurance carrier to pay defense costs and related damages. Given this potential for severe losses, insurance carriers have not been eager to provide liability coverage to entities, which may present a far greater exposure to lawsuits than individuals.

Avoiding Hidden Gaps in Coverage

To avoid potentially disastrous gaps in coverage, individuals and their advisors must take steps to ensure that insurance policies are structured to protect the interests of all parties that have an insurable interest (i.e., something to lose) in the event of a property or liability claim. This may include a number of different individuals and entities, such as a trust (including beneficiaries, trustees, and grantors); an LLC (and its members); and a family limited partnership (FLP, and its managing partners and limited partners); as well as the individuals who occupy the residence.

Protecting the insurable interests of all parties that have a risk of loss connected to a residence requires considerable expertise. Consider the following example of an actual claim that occurred in the southeastern United States, for which coverage was denied: An extended family owned a large property consisting of 140 acres,

EXHIBIT 1
Past and Projected Growth in Fiduciary Tax Filings

Year	Individual Returns	Growth	1041 Returns	Growth
1980	93,196,100	—	1,881,800	—
1990	112,596,000	20.82%	2,680,900	42.46%
2000	128,049,000	13.72%	3,456,000	28.91%
2010	140,522,200	9.74%	4,003,200	15.83%
10-year avg.		14.76%		29.06%

EXHIBIT 2
Homeowner Insurance Losses by Cause, 2001–2004
(Percentage of Losses Incurred)

Cause of Loss:	2001	2002	2003	2004
Property Damage				
Fire, lightning, and debris removal	30.8%	32.6%	31.8%	20.5%
Wind and hail	21.7	20.7	25.5	51.2
Water damage and freezing	22.3	21.5	21.9	15.7
Theft	4.7	4.5	3.3	2.2
All other property damage	13.2	12.3	10.7	6.1
Liability				
Bodily injury and property damage	6.5	7.3	5.8	3.7
Medical payments and other	0.7	0.8	0.8	0.7
Credit card and other	0.2	0.3	0.2	0.1

Source: Insurance Information Institute divided into 15 different sublets. Some lots were owned by family members, others were owned by LLCs controlled by family members. The property was divided for mixed use. Portions of the property were covered by a commercial policy, others by a homeowner policy. One family member's employee died while landscaping a residential property. The LLCs with ownership interests were not listed as named insureds on either the commercial or homeowner policies. Suits were filed against the family and the LLC that owned the property where the fatality occurred. Although the family's personal assets were protected by the homeowner policy, the family had to retain counsel to defend the LLC, because it was not covered by the homeowner policy. A long period of litigation followed, and the family that formed the LLC was required to pay substantial legal fees, as well as an undisclosed judgment against the LLC.

Although precise coverage needs vary widely based on many factors (especially the use of the residence), the following characteristics outline the most common risk profiles when residences are owned by an entity:

■ An entity is established to replace the private ownership of a personal residence;
■ The family that has transferred ownership of the residence to the new entity continues to reside there;
■ A family retains personal ownership of the household possessions in the home; and
■ The family occupants are often closely connected to the entity (as trustees, grantors, or beneficiaries of a trust, or as members of an LLC).

Exhibit 3 identifies the insurable interests of each party for this common risk profile.

EXHIBIT 3
Insurable Interests of Each Party for Common Risk Profile

Party with insurable interest	Coverage required for…
Trust (LLC)	■ Dwelling owned by the trust ■ Other structures owned by the trust ■ Premises liability; trust can be named in a lawsuit
Trustee (LLC member)	■ Premises liability; trustee can be named in a lawsuit
Beneficiaries (LLC member) and those residing as occupants	■ Contents owned by occupants ■ Additional living expenses (loss of use); occupants would incur costs to reside elsewhere after a covered loss ■ Liability; occupants' negligence may cause them to be named in a lawsuit; coverage required for this location and elsewhere

EXHIBIT 4
Sample "Additional Insured" Contract Endorsement

Additional Insured—Residence Premises

Name and address of person or organization:

The definition of insured in this policy includes the person or organization named above with respect to:

Coverage for Damage to Your Property
Dwelling and Other Structures; and

Coverage for Liability and Medical Payments to Others
The person or organization named above is covered for Liability and Medical Payments to others but only with respect to the residence premises and only where the person or organization is held liable for an act or failure to act by any insured.

Cookie-Cutter Solutions and Other Pitfalls

The insurance industry offers no universal approach to address the protection needs of residential properties owned by all kinds of entities. ISO, which assists most insurance carriers in developing policy language, makes the *Residence Held In Trust HO 05 43* endorsement available to carriers that use its services. This endorsement is not intended to address the coverage needs of entities other than trusts; it is not available from all carriers; and it deems certain residential properties to be ineligible. Furthermore, even in instances where this endorsement offers an ideal solution, it is used so infrequently that many insurance agents neglect to recommend it. The lack of a well-focused and standardized approach to effectively address the coverage needs of all parties presents a real dilemma.

To better meet the protection needs of each party, an experienced independent insurance agent or broker can access effective coverage solutions through carriers with experience writing customized policies for entity-owned personal residences. *Exhibit 4* provides a sample of one carrier's "additional insured" contract endorsement. Carefully crafted solutions such as this enable experienced insurance professionals to structure coverage to properly protect the insurable interests of each party as described in the common risk profile.

The most common pitfall when structuring coverage for entity-owned residential property is issuing a homeowner policy with the entity as the named insured. Although commonly prescribed, such "solutions" often neglect the needs of one or more parties. In this instance, those residing in the home would have no insurance protection for liability claims filed by third parties, first-party losses to their personal possessions, or additional living expenses should they need to live elsewhere due to a loss.

Another common pitfall is neglecting to add the new entity as an additional insured to a personal excess (umbrella) liability policy. Like a homeowner policy, personal excess liability policies cover individuals, not entities. Coverage for the entity must be properly endorsed so that an entity can receive the benefits of this important form of liability coverage.

Clearly, structuring coverage that effectively protects all parties with an insurable interest requires a thorough understanding of each situation. To secure the risk-specific coverage particular individuals need, advisors should encourage them to seek specialized assistance from insurance professionals with expertise in entity-owned residential properties. The following are important questions to examine before deciding how coverage should be structured to protect all parties with an insurable interest:

- Who will occupy the residence?
- Is any business conducted at the premises?
- Has the trust, LLC, or other entity been created for purposes other than owning the residence?
- Does the entity own other real property?
- Who are the parties to the trust, LLC, or other entity?
- Do other forms of liability protection cover the property?

Integrate Property and Casualty Expertise into Wealth Advisory Process

Traditional homeowner policies can represent a hidden danger to entities that own real property but lack access to specialized property and casualty expertise. Finding professionals with the needed expertise can be difficult because the insurance industry has become very specialized. Compounding this challenge is the fact that insurance agents often view an invitation to provide risk advisory assistance as an opportunity to sell insurance, regardless of whether new coverage is needed. Meanwhile, it can be dangerous to assume that clients' current property and casualty insurance agents are properly addressing their risk-management needs. While developing a relationship with an insurance professional who can provide substantive and objective risk management advice requires research, doing so can yield significant benefits. Accountants who provide clients with access to prequalified third-party risk-management specialists are providing an extra level of client service that can help to positively differentiate their advice. ❑

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