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EDITOR'S NOTE

"Gap filler." It was an early and well-earned nickname for the insurance protection more formally known as Difference in Conditions (DIC) coverage. Well earned because DIC's versatility enables a business owner to protect against losses that are either not covered in a standard property policy or not covered adequately.

The versatility and the flexibility that DIC policies offer, however, have also created a lack of uniformity in how they are worded, structured and applied. The consequent misunderstanding or even unawareness of the coverage has resulted in too many commercial insureds not taking advantage of the valuable "gap-filling" protection a DIC policy can provide.

In this issue of Adjusting Today, *insurance expert Robert Prahl explains the key components of DIC coverage — including what it is, what's covered, where it can be most useful, who needs it and how a policy is structured. He goes even further, discussing such specifics as limits, deductibles, court cases involving DIC and the importance of proper wording and careful review when a DIC policy is put in place.*

It's information that could be critical to the recovery or even survival of your business should a major loss occur.

Sheila E. Salvatore
Editor

Photo Credit: Mike Brulo

Difference in Conditions Coverage — What Is It and Who Needs It?

By Robert J. Prahl, CPCU

A Difference in Conditions (DIC) policy is a form of property insurance that is purchased in conjunction with an underlying commercial property policy. Its purpose is to obtain coverage that is not provided in the underlying property policy, most notably for the perils of flood and earthquake. Some insurers offer DIC *endorsements* to their commercial property policies which serve the same purpose.

Originally, a DIC policy was referred to as a "gap filler," because it provided coverage against *all risks* of loss (now more aptly referred to as *open perils* or *causes of loss special form*) and was written along with a property policy that limited its loss situations to those caused by specific named perils. A DIC policy can still be used for that purpose, but since it is more common today for property insurers to provide coverage on an all-risks basis, DIC policies are bought primarily by firms with a significant flood or earthquake exposure.

In addition to providing coverage for flood and earthquake losses, a DIC policy may also be used to provide excess limits over flood and earthquake coverages that may be provided by endorsement in a commercial property policy, or through the National Flood Insurance Program (NFIP). For example, a primary commercial property policy may only offer $500,000 in flood or earthquake coverage, so the DIC will be used to write coverage excess over the primary limit.

It also may be used to cover other exposures that may not be covered in commercial property policies, such as property in transit or business interruption claims stemming from a transit loss. It also is noteworthy that some commercial insureds purchase DIC coverage to cover property at overseas locations. In standard commercial property insurance, the insured's property is covered only while it is located within the United States (including its territories and possessions), Puerto Rico, or Canada. Commercial insureds that ship property to or receive property from foreign countries need broader territorial limits. In addition to limits for flood and earthquake, some DIC policies include an "all other perils" (AOP) limit.

"Who needs it? Any business that needs more protection than that provided by standard property insurance, especially with regard to the flood and earthquake perils."

Who needs it? Any business that needs more protection than that provided by standard property insurance, especially with regard to the flood and earthquake perils. This could include contractors, manufacturers, retailers, or a variety of service and professional businesses. Since flood or earthquake losses can be catastrophic, no one insurer may be willing to write a DIC policy with the limits requested or needed by the insured. In such cases, two or more insurers may be willing to share the risk on a layered basis or through a quota share (an agreed-on percentage) approach.

A DIC policy is sometimes likened to an umbrella policy that provides coverage for property exposures not covered by standard forms. DIC insurance is a non-filed class of inland marine insurance in most states. Being a non-filed line means that insurers do not have to file rates for approval with state insurance departments and have greater flexibility in setting rates and drafting policy language. Insurers are often willing to negotiate coverages and limits with insureds.

Losses caused by flood or earthquake are excluded in commercial property policies. Although endorsements are available to add flood and earthquake coverage to a commercial property policy, some insurers are reluctant or unable to provide this coverage because of the catastrophic exposure associated with these perils. But there are other insurers that specialize in insuring firms with a high risk exposure to flood or earthquake. A DIC policy will be purchased when an insured has a significant flood or earthquake exposure and the commercial property insurer does not offer flood and earthquake coverage, cannot provide full limits for these perils, or offers this coverage at premiums that are prohibitive from the insured's standpoint.[1]

No Standard Form

It is important to note that there is no standard DIC coverage form, although Insurance Services Office (ISO) and the American Association of Insurance Services (AAIS) offer DIC policy forms in their non-filed inland marine guides. Companies may use and amend the AAIS and ISO forms as needed. Insurers that write DIC coverage may draft their own forms as well. Although this offers considerable flexibility in drafting coverage, it also can result in a variety of forms being in use with little or no uniformity, thus creating potential coverage gaps between the commercial property insurance and the DIC. Consequently, it is imperative that these forms be carefully reviewed when DIC insurance is written and when a claim under the policy is made.

Policy Approach

Though the primary use of a DIC is to cover flood and earthquake losses, a DIC policy can cover loss from other perils as well. It, therefore, is important to compare the exclusions of the DIC with the exclusions in the underlying property policy to determine what additional coverage is provided by the DIC. Losses that are excluded under the commercial property policy, but not excluded under the DIC, ordinarily will be covered by the DIC.

The following is the insuring agreement in the AAIS DIC policy:[2]

> **AGREEMENT**
>
> In return for "your" payment of the required premium, "we" provide the coverage described herein subject to all the "terms" of the Difference in Conditions Form. This coverage is also subject to the "schedule of coverages" and additional policy conditions relating to assignment or transfer of rights or duties, cancellation, changes or modifications, inspections, and examination of books and records. Endorsements and schedules may also apply. They are identified on the "schedule of coverages."

The reference to the "schedule of coverages" is important. The "schedule of coverages" typically contains check boxes to indicate the nature and extent of the coverage. For example, the schedule will provide the following information:

- whether the policy is written on a blanket or scheduled basis;
- types of coverages;
- name of underlying property insurer and policy number;
- whether the policy is written on a primary or excess basis;
- National Flood Insurance Program policy number, if applicable;
- flood and earthquake limits;
- coverage extensions (e.g. debris removal, limited fungus coverage, etc.);
- supplemental coverages (foundations, pilings, underground pipes, newly acquired buildings, ordinance or law, pollution cleanup and removal, property in transit);
- whether the policy is written on a replacement cost or actual cash value basis;
- deductibles; and
- any optional coverages that may be purchased.

The ISO Declarations section has spaces to indicate the location number, address and limits of insurance for buildings and business personal property, property at unnamed locations and all covered property in any one occurrence. It also has boxes to check as to whether replacement cost coverage applies. The DIC policy covers direct physical loss or damage to covered property caused by any covered cause of loss. The building and personal property coverage in the ISO form is similar to that provided by the AAIS policy.

The following Property Covered section is an excerpt from the AAIS DIC form:[3]

PROPERTY COVERED

"We" cover the following property unless the property is excluded or subject to limitations.

1. Coverage — "We" cover direct physical loss to covered building property and business personal property (as described below) caused by a covered peril.

2. Coverage Limitation — "We" only cover building property and business personal property at "covered locations."

3. Building Property — Covered building property means buildings and structures including:

   a. completed additions;
   b. fixtures, machinery, and equipment that are a permanent part of a covered building or structure;
   c. outdoor fixtures;
   d. personal property owned by "you" and used to maintain or service a covered building or structure or its premises. This includes air-conditioning equipment; fire extinguishing apparatus; floor coverings; and appliances for refrigerating, cooking, dishwashing, and laundering;
   e. if not covered by other insurance:

      1) buildings and additions to buildings under construction, alteration, and repair;
      2) materials, equipment, supplies, and temporary structures, on or within 1,000 feet of "covered locations," used for the construction, alteration, and repair of buildings or additions to buildings;

"A DIC policy will be purchased when an insured has a significant flood or earthquake exposure and the commercial property insurer does not offer flood and earthquake coverage, cannot provide full limits for these perils, or offers this coverage at premiums that are prohibitive from the insured's standpoint."

f. building glass;
g. the following property if it is located on or within 1,000 feet of a covered building or structure:

   1) radio and television towers, antennas, satellite dishes, masts, lead-in wiring, and guy wires. This includes foundations and any other property that is permanently attached to any of these types of property;
   2) awnings or canopies; and
   3) fences;

h. signs, attached to covered buildings, or structures.

Coinsurance

DIC policies ordinarily do not contain a coinsurance provision. Actually, a coinsurance requirement could have a serious adverse effect on the insured at the time of loss. In actual practice, DIC policies often provide coverage at limits that are much less than the full value of the property because full coverage for flood and earthquake exposures simply may not be available. With a coinsurance or insurance to value requirement, the insured would likely incur a significant penalty for not meeting the insurance to value requirement. The reality is that in many cases, the limit of insurance will reflect only a partial value of the property because this is all that can be obtained. DIC policies usually do not contain a coinsurance clause for this reason.

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Policy Wording of Covered Perils and Exclusions

Especially watch for definitions of terms, particularly "flood" and "earthquake" if they are defined in the policy, as DIC policies may define these terms differently, that is, in a more restrictive manner from what is typically covered in a flood policy. For example, some DIC policies exclude seepage or leakage or sewer backup as a part of a water damage exclusion. Mudslide or mudflow may be excluded in an earth movement exclusion as well as in a flood exclusion.[4] This could result in a no-coverage situation under the DIC for a loss that would normally be covered by the National Flood Insurance Program (NFIP) policy or earthquake endorsement to the commercial property policy. Should this restriction be caught in a policy review, the definition should be clarified or changed so that it provides the broader flood or earthquake coverage.

Also as discussed previously, the exclusions in a DIC policy should match the wording of the perils covered in the underlying or complementary standard property form. It is advisable to review the standard policies and the DIC policy in a side-by-side comparison to ensure that there is coordination of the policy language. By reviewing the wording of exclusions in the DIC policy, unanticipated exclusions may be recognized and negotiated out of the form so as to avoid a more serious conflict when a claim is made.

Limits of Insurance

Typically, a DIC policy contains separate limits for flood and earthquake coverages. The AAIS form has three separate limits: an aggregate limit; a catastrophe limit; and an occurrence limit, and these limits apply separately to earthquake coverage and flood coverage. In the AAIS form, there are also separate limits for all other perils (AOP) other than earthquake and flood.

Many DIC policies will only have an occurrence limit and an aggregate limit, and some only have an aggregate limit that applies to flood and earthquake exposures.

Although some DIC policies contain separate limits for business income loss, this is not always the case. When the limit applies to all covered losses, that is, both direct damage and consequential damage (business income loss), the income loss exposure must be considered when selecting limits.

Once again, it is imperative that these forms be carefully reviewed because there is no uniform or standard DIC policy. The ISO form Declarations page contains spaces to indicate the sub-limits of insurance in any one policy year for earthquake and flood.

Joint/Disputed Loss Agreement

It is possible that a loss may be covered in part by the commercial property policy as well as the DIC policy such as when an earthquake causes a fire. A joint/disputed loss agreement endorsement[5] is designed to facilitate the adjustment of a loss in the event of a disagreement between the property insurer and the DIC insurer over whether a loss is covered by both policies, or how the loss is to be apportioned. For this to be effective, the commercial property policy must include a joint or disputed loss provision that is substantially the same as the DIC provision. If there is a dispute about joint coverage being available, adjusters should check to see if such provisions are included in the policies.

Deductibles

In most all cases, DIC policies contain separate deductibles for flood and earthquake and for all other perils. The flood and earthquake deductibles ordinarily are larger than those for all other perils as well as those found in commercial property policies. This is because they apply to catastrophic losses rather than recurrent smaller losses.

"In most all cases, DIC policies contain separate deductibles for flood and earthquake and for all other perils."

In addition to a dollar deductible, DIC forms use percentage deductibles for loss by earthquake when the exposure is particularly high. These can vary somewhat and usually range from two to five percent. Percentage deductibles apply not to the loss but to a certain percentage of the value of the property. They might be written to apply to a percentage of the total values of property at all locations, or a percentage of the value of each building, the business personal property in each building, or otherwise. It is advantageous for the insured to have a percentage deductible that applies to each unit or each building rather than a deductible that applies to the total values at all locations, as the latter would be a much higher deductible.[6] It is also fairly common to see DIC policies with a percentage deductible for earthquake along with a dollar minimum.

A DIC policy written for a business in a high risk flood zone will likely contain a provision that its flood coverage applies only as excess over a NFIP underlying policy. The NFIP policy for commercial insureds currently provides $500,000 coverage for building and $500,000 for contents. This provision functions like a flood deductible of $500,000 and, in effect, requires the insured to purchase flood coverage under the NFIP in order to activate the DIC coverage in the event of flood damage.

Both the AAIS and ISO forms indicate that all earthquake shocks that occur within 168 hours after the initial quake are considered a single event. In most DIC forms, the "all other perils" deductible is subtracted not from the limit of insurance, but from the loss or adjusted loss as it is in standard commercial property insurance. If more than one deductible applies, most DIC policies apply only the highest deductible to the loss.

Valuation Clause

Valuation provisions in DIC forms can vary, but the insured usually will have the option of obtaining coverage on a replacement cost or actual cash value basis. As a general rule, the DIC policy should provide coverage on the same basis as that of the underlying commercial property policy to minimize the chance of a misunderstanding in adjustment of the claim.

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Business Interruption

Commercial insureds that carry business interruption or business income coverage in their commercial property policy also need to purchase the coverage in their DIC policy to respond to flood or earthquake losses. Many DIC forms do not include coverage for business income loss, rental value, or extra expense. In many forms, there is an exclusion for loss due to delay or loss of business income. Business interruption coverage must be specifically added to the DIC policy if that coverage is considered necessary or desired.

The AAIS program offers two income coverage options:

1. Earnings, rents, and extra expense.
2. Earnings and extra expense.

Ordinance or Law

The ordinance or law exclusion can be especially troublesome for insureds that sustain a serious property loss. The exclusion precludes coverage for loss due to the enforcement of laws that regulate demolition, repair, etc., after a loss to a building. The law or ordinance may require the demolition of a building that has been badly damaged and the reconstruction to be in compliance with current building codes, and this is especially true in areas that have a high exposure to flood or earthquake. Without ordinance or law coverage, the policy would not pay for the loss of the undamaged portion of the building, demolition expenses related to the undamaged portion of the building, or the increased cost of bringing the newly constructed building up to code.

The exclusion also affects business income and extra expense coverage if the DIC policy includes that coverage. The income coverage would pay for lost income incurred only for the time required to rebuild, but not necessarily for the time required to demolish the undamaged portion of the building.

Insureds should seriously consider adding ordinance or law coverage to the DIC policy and make sure that coverage applies for direct damage as well as to income loss.

Subrogation

Subrogation provisions can vary considerably in DIC policies. Some forms give the insured the right to waive subrogation against a party that may have caused or contributed to a loss, while others do not. Some provisions are more restrictive than others.

Ordinarily, since both floods and earthquakes are acts of nature, there will not be anyone to subrogate against. However, particularly with regard to floods, it's conceivable that a third party may have contributed to or did something to cause a flood. An example where subrogation might have been possible is the case of *Safeco Ins. Co. of America v. Guyton, 692 F. 2d 551 (9th Cir. Cal. 1982)*, where a loss from flooding was caused by a negligently constructed flood control wall.

> *"Business interruption coverage must be specifically added to the DIC policy if that coverage is considered necessary or desired."*

Subrogation provisions in a DIC policy should be reviewed since DIC insurers are generally willing to amend the policy, for example, to include the insured's right to waive recovery against another party if such a provision is not already in the policy.

Court Decisions Involving DIC Coverage

Court decisions involving DIC coverage often center around disputes between agents, brokers and insureds concerning whether the proper coverage was purchased. The case of *Zinsel Company, Inc. v. J. Everett Eaves, Inc., 749 So. 2d 798 (Ct. of App. of Louisiana 1999)*[7] involved a dispute between a flood insurance insured and its agent. After doing business for many years, the agency relationship was terminated at renewal, except for the flood policy which had a different expiration date. The insured carried a "Write Your Own" flood policy. When flood insurance became available in the 1970s, the maximum limits available to business firms were $100,000 for buildings and $100,000 for contents. In the 1980s, Congress raised these limits to $200,000 for buildings and $200,000 for contents, which were purchased by the insured. These were the limits of the flood policy at the time the insured moved its other business from the agent. In late 1994, Congress again raised the limits to $500,000 each for building and contents. In response to this change, the insurer mailed a notice to all of its insureds who were carrying the lower limits notifying them of the increased limits now available. The same notice was sent to its agents. The agent relied on the insurer's letter to the insured as being sufficient notice of the increased limits, and planned to discuss the subject of increased limits with the insured at renewal.

Unfortunately, the insured sustained a flood loss, which would

> “Insureds should seriously consider adding ordinance or law coverage to the DIC policy and make sure that coverage applies for direct damage as well as to income loss.”

have been fully covered had the higher limits been purchased. The insured testified that the first time it saw the notice of increased limits was when the agent produced it after the loss. The insured sued the agent for not giving notice of the availability of the increased limits and providing an opportunity to purchase the coverage. It was also alleged that the agent was derelict in not informing the insured of the availability of DIC coverage which would have provided coverage for flooding. The court held that the agent was not to blame in the case. It said that the agent did not breach the duty to inform the insured of an increase in flood limits. It also held that the agent’s alleged failure to advise the insured to obtain a DIC policy did not damage the insured because, while a DIC policy can be written excess of flood coverage available from the NFIP, the insured must first purchase the maximum available limits ($500,000) before the DIC policy is triggered. As an aside, it is important to note that currently, the NFIP program does not offer business interruption coverage, and it is advisable that insureds give serious thought to including this coverage when purchasing a DIC policy.

In *Archer Daniels Midland Co. v. Phoenix Assur. Co. of New York 975 F. Supp. 1129 (S.D. Ill. 1997)*, the insured sued its insurers under DIC policies, seeking coverage for increases in its transportation and raw material costs following substantial flooding along the Mississippi River. The Court applied Illinois law and found that the insured’s DIC policies did not provide “sue and labor” coverage for costs of protecting the insured’s grain barges while stalled on a flooded river, where the coverage extended only to “property insured.” (A “sue and labor” clause requires the insured to protect damaged property from further loss once a loss has occurred.) The Court found that only property at scheduled locations met the policies’ definition of property insured, and the barges were not at scheduled locations.

The case of *Daniel James Insurance Agency, Inc. v. Floyd West of Louisiana, Inc., 145 F. 3d 1330 (6th Cir. Oh. 1998)* involved a flood loss and an allegation that the agent did not ask for extra expense coverage on a DIC policy that was obtained by an excess and surplus lines broker. The agent sought protection under its errors and omissions policy since the agent had requested extra expense coverage on the primary policy, but neglected to request it on the DIC policy. The agent's errors and omissions insurer paid most of the insured's extra expense loss, and the agent paid the remainder. Then the agent sued the broker, alleging the broker should have reviewed the agent's coverage requests and notified it when the requests for extra expense coverage were dissimilar. The court, in an unpublished opinion, held that the broker had no duty to review the agent's work, and thus the broker was not responsible for any contribution toward the insured's loss.

Builders Risk DIC Policy[8]

Oftentimes the project owner (or general contractor) will purchase a builders risk policy on a project that is not as broad as that which the general contractor or subcontractor ordinarily would purchase, or perhaps it has a much higher deductible than the general contractor (or subcontractor) would have. In such cases, the general contractor (or subcontractor) can purchase a *builders risk DIC policy* that covers any loss that is excluded or that is under the deductible of the owner's or general contractor's policy. The coverage, of course, would be subject to the exclusions and deductible in the DIC policy.

Conclusion

A DIC policy provides coverage that is typically not available in standard property insurance and excess coverage for losses covered by a primary property policy. Now that it has become quite common for property forms to provide coverage on an all-risks basis, the need for DIC coverage to fill coverage gaps has decreased somewhat. Nevertheless, DIC coverage serves a useful purpose, most notably for insuring flood and earthquake exposures and certain specified losses such as those stemming from transit or property losses overseas, and business interruption losses resulting from floods. The latter is especially important considering that currently, the NFIP program does not offer business interruption coverage.

As a caution, keep in mind that there is no standard DIC policy, so whenever a policy is in play, it must be reviewed carefully. That includes upfront when a policy is purchased and most assuredly when a loss involving a DIC policy occurs and a claim is made.

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[1]Linda G. Robinson, Jack P. Gibson, Difference in Conditions Policies, Copyright 2010 International Risk Management Institute, Inc., Dallas, Texas, p. VII. D. 1.
[2]Copyright, American Association of Insurance Services, Inc., 2007.
[3]Ibid.
[4]Linda G. Robinson, Jack P. Gibson, Difference in Conditions Policies, Copyright 2010 International Risk Management Institute, Inc., Dallas, Texas, pp. VII. D. 3, 4.
[5]Ibid, p. VII. D. 16.
[6]Ibid, p. VII. D. 29.
[7]Donald S. Malecki, "Flood, DIC and Agents E&O," Rough Notes magazine, June 2000.
[8]Glossary of Insurance and Risk Management Terms, Eighth Edition, p. 20, International Risk Management Institute, Inc., Dallas, Texas. See definition of "all risks, Difference-in-Conditions (builders risk)."

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