

THE UNDERWRITING PROCESS OF LIABILITY INSURANCE IN SOUTH AFRICA

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Abstract

Liability risks may embody far-reaching financial consequences for individuals, business enterprises and professional people. This paper focuses on the underwriting process which should be taken into consideration by short-term insurers when they are underwriting the main types of liability insurance, which include employer's, householder's, personal, product, professional and public liability insurance.

The improvement of financial decision-making by short-term insurers when underwriting liability insurance represents the objective of this research. A study of secondary data was done to identify the existing literature, which formed the basis for compiling a questionnaire to obtain primary data. The top 10 short-term insurers which are the market leaders of liability insurance in South Africa and who received more than 85% of the annual gross written premiums for liability insurance in South Africa, represented the sample of the empirical study.

This paper highlights the importance of the underwriting factors concerning liability insurance, how often the stipulations of insurance policies should be adjusted by the short-term insurers to account for the underwriting factors, as well as the problem areas which the underwriters may experience when they are underwriting liability insurance. Possible solutions to solve the problem areas were also addressed.

Keywords: Employer's Liability Insurance, Householder's Liability Insurance, Personal Liability Insurance, Product Liability Insurance, Professional Liability Insurance, Public Liability Insurance, Underwriting Process

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1. Introduction and Objective of Research

Business enterprises, professionals and individuals are exposed to various types of risks, of which liability risks are important with probable far-reaching detrimental financial consequences. This research focuses on the underwriting factors of the main types of liability insurance, viz. employer's, householder's, personal, product, professional and public liability insurance. The application of the judicial system towards negligent business

operations, professional conduct and individuals has become very strict and a single claim may even lead to the bankruptcy of the defendant. It is, however, a fact that not all risks are avoidable and short-term insurers therefore provide financial assistance to business and professional enterprises as well as individuals. It should however be borne in mind that liability insurance will also have some exclusions which will not be covered by the short-term insurer (Ingram, 2009:123-130).

According to Wagner there is a complex interaction between liability insurance and the tort law (2006:277). A tort is a wrongful act which a

person has done against another person or against the property of another person (Mehr *et al.*, 1985:65). While mentioning the legal aspect of liability insurance and torts, the reasonable person principle should also be borne in mind (Bajtelsmit & Thistle, 2008:815-823). When applying the reasonable person principle, the faculties and senses as well as the vicinity and circumstances of the insured should amongst others be taken into consideration to determine whether the insured has acted reasonably by doing what he/she did (Dorfman, 1991:149). The purpose of this paper is not to discuss these legal issues, but to emphasise that legal aspects play a very important role in liability insurance.

The underwriting process consists of three important steps, focusing on obtaining the relevant information about the risk, deciding whether and to which extent the risk will be covered by the insurer, and thirdly setting the suitable insurance premium which the insured will have to pay. The possibility of a moral hazard, which focuses on the insured's behaviour towards loss prevention, should also be taken into account during the underwriting process of liability insurance, as it may play an important role throughout the entire insurance period (Parsons, 2003:448-471).

The *objective* of this research embodies the improvement of financial decision-making by short-term insurers regarding the underwriting process of liability insurance. Both secondary as well as primary data play a role in this research to ensure that the objective is reached. The empirical survey focused on the top 10 short-term insurers which underwrite liability insurance as they are the market leaders of this class of short-term insurance in South Africa. The paper also highlights the *importance* of the underwriting factors in liability insurance, how *often* the stipulations are adjusted by the short-term insurers to take the underwriting factors into account and the *problem areas* which the short-term insurers experience when underwriting liability insurance.

2. Underwriting Factors of Liability Insurance

The general underwriting factors which should be present when short-term insurers underwrite all types of liability insurance are addressed in this section (Diacon & Carter, 1988:50 & 192; Mogel, 2003:11-12; Tobolsky, 2012:38-40). Following that, the underwriting factors applied to the main types of liability insurance receive the due attention. These main types of liability insurance focus on product, public, employer's, professional, personal and householder's liability insurance which are discussed in the following sections.

2.1 The general underwriting factors present in all types of liability insurance

The insured's *name* is one of the important factors which appear on the application forms of insurance. The names of the members of the applicant's household or business are also critical in order to assess the entire risk to which the short-term insurer will be exposed. The applicant may present a low risk level, while the members of his/her household or business may expose the short-term insurer to unacceptable high risks. The *age* of the applicant and the members of his/her household or business is also important, as young as well as old people may bear a higher risk. The physical address of the insured's household or business is important as it provides an indication of the *geographical location* of the premises and the risks associated with the neighbourhood. Unsafe vicinities may have a higher risk level and may therefore have to pay a higher premium if the risk is eventually covered by the short-term insurer.

The *character, reputation and lifestyle* of the applicant, applying for liability insurance, and the members of his/her household or business provide an indication whether they are exposed to more than normal risk due to the level of their dangerous or harmful lifestyles. The *claims history* of the applicant and the members of his/her household or business, is very important as it provides the details concerning the number of claims and the extent of the claims from various insurers in the past.

The implementation of *safety precautions* by the applicant and the members of his/her household or business, which may be of a physical, financial or procedural nature to avoid liability exposures, is an important underwriting factor to consider by the insurer. It is of prime importance to take any *refusals* of coverage by any insurer to the applicant or the members of his/her household or business in the past into account. The focus should be on the reasons why the insurer was reluctant to provide indemnity to the particular exposures. An applicant should also disclose *previous criminal convictions* of him/her or the members of his/her household or business to the short-term insurer even if the conviction occurred long ago.

The *amount* of coverage which the applicant requires, the liability coverage which the applicant and the members of his/her household or business already obtained from *other* short-term insurers, as well as *aggregate* indemnity limit of liability coverage which the applicant and the members of his/her household or business will eventually have, should point at the extent of the liability exposures of the applicant and the members of his/her household or business. The *nature and particulars* of the liability exposures for which the applicant and the members of his/her household or business want coverage are also an important underwriting factor in the underwriting process of liability insurance.

Over and above the general underwriting factors present in all types of liability insurance, there are

also underwriting factors which are linked to particular types of liability insurance. The following sections focus on the underwriting factors which affect product, public, employer's, professional, personal and householder's liability insurance.

2.2 The underwriting factors of product and public liability insurance

The number of branches of the applicant, the number of employees at each branch, the annual turnover of the enterprise, the various types of products manufactured and/or sold, as well as the liability coverage provided to the applicant up to a stipulated indemnity limit, are amongst the most important underwriting factors when underwriting product and public liability insurance.

When the *number of branches* and/or the *number of employees* of an enterprise increase, it may point to an increase in the product and public liabilities. The extent of the annual *turnover* may indicate two aspects, viz. a positive correlation between the extent of the turnover and the associated risk concerning product and public liabilities, as well as the ability of the enterprise to afford the insurance premium and to settle any excess in the event of a claim.

As the types of *products* manufactured and/or sold by the applicant may differ regarding their level of liability risks and the possibility of defective products, the short-term insurer should obtain detailed information concerning the nature thereof (Mehr *et al.*, 1985:86-87). The level of the premium should be adjusted according to the level of risk related to the various types of products on the premises of the applicant. The legal aspect of product liabilities should play an important role in this type of liability insurance as tort doctrines may negatively impact on the underwriting risk (Barker, 1991:63-79).

Due to the high risk of product and public liabilities which may have a long-tailed nature, short-term insurers prefer to limit the possible claims amount up to a stipulated *indemnity limit*. The short-term insurer thus estimates the possible extent of the maximum claims amount in advance and can set the premium level of the applicant accordingly. It should also be borne in mind that the application of *public policies and decisions* by authorities may stimulate or counteract the effective functioning of the insurance market concerning public liability insurance (Brockett *et al.*, 1990:211-226). An effective insurance market should be attractive to both the buyer and seller of public liability insurance.

2.3 The underwriting factors of employer's liability insurance

Employer's liability insurance covers the risks of an accident or injury to the employees when they are in

the employer's service (Payne, 1999:21). Employment practices and labour laws have an important impact on the application of employer's liability insurance (Mangan, 1997:12-13). The following underwriting factors should play a vital role in employer's liability insurance as the factors are indicating the level and extent of associated risk, namely the number of employees, their average annual wage level and the nature of the manufacturing and/or sales operations of the enterprise. The amount of premium charged by the short-term insurer should increase when the impact of these underwriting factors increases, especially when an escalation of dangerous activities occur.

2.4 The underwriting factors of professional liability insurance

Professional people are accustomed to disclose information to relevant parties (Kothari *et al.*, 1988:307-339). When a short-term insurer underwrites professional liability insurance, the professional person should also disclose information to the insurer to enable the underwriter to assess the level and extent of the associated risk. Special attention should amongst others be paid to the professional knowledge and experience of the staff, whether they are registered at a professional association, the level of fees which they are able to charge, their claims history, as well as their internal controls and procedures to lower their professional risk (Chovancak, 2013:1-3).

2.5 The underwriting factors of personal liability insurance

Although personal liability insurance usually covers the insured and the members of his/her household when they are not at their residence, short-term insurers may sometimes offer personal *umbrella* liability insurance which may provide a more extensive coverage (Chesebrough, 1995:98-106; The Insurance Institute of South Africa, n.d.:9/8). Bodily injury and disease to the third party and damage to the property of the third party may be caused by the private activities of the insured and the members of his/her household. These private activities may, for example, be caused by the use of sport equipment, roller blades and bicycles or by domestic animals (Mehr *et al.* 1985:92-93). It is logic that the larger the number of insureds covered by a specific insurance policy and the higher the risk level of their activities are, the higher the premium will be.

2.6 The underwriting factors of householder's liability insurance

Householder's liability insurance covers liability to third parties for bodily injury, disease and damage to their property caused by events on or in connection

with the premises of the insured (The Insurance Institute of South Africa, n.d.:9/8). Householder's liability insurance should not be confused with house-owner's property coverage which covers the property of the insured as such. The short-term insurer should take the information regarding the activities on or in connection with the property of the insured into account when underwriting householder's liabilities.

3 Research Methodology

The objective of this research was already defined as the improvement of financial decision-making by short-term insurers when they are underwriting liability insurance. To reach this objective, secondary as well as primary data were necessary. The secondary data of the literature study was already discussed in this paper. The primary data was obtained by means of an empirical survey which focused on the top 10 short-term insurers which are the market leaders of liability insurance in South

Africa. These short-term insurers represented more than 85% of the annual gross written premiums for liability insurance in 2010 (Santam Ltd, 2011:6 & 23).

The data of the literature study was used to compile a questionnaire. Copies of an invitation letter and the questionnaire were mailed to the executive managers of the top 10 short-term insurers who were involved in underwriting liability insurance. After following up, 10 completed questionnaires were available.

Some of the questions of the questionnaire used a five point Likert interval scale. It was explicitly stated on the questionnaire that the five point Likert interval scale forms a continuum which enabled the weighting of the answers (Albright *et al.*, 2002:224-229 & 245). The answers of the respondents, which appear in Section 4, were weighted by assigning the following weights:

Table 1. The weights assigned to the answers of the respondents

Answers of the respondents:		Weights assigned:
Extremely important	Always	5
Highly important	Very often	4
Moderately important	Sometimes	3
Little important	Seldom	2
Not important	Never	1

4 Empirical Results

The results of the empirical survey are depicted and discussed in this section. The following aspects will be addressed, viz.:

- The importance of the underwriting factors when short-term insurers are underwriting liability insurance,
- How often the stipulations of insurance policies need to be adjusted to take the underwriting factors into account, as well as
- The problem areas in the underwriting process of liability insurance and possible solutions to solve them.

4.1 The importance of underwriting factors in liability insurance

The empirical results concerning the importance of the underwriting factors in liability insurance appear in Table 2.

The preceding answers of the respondents based on the five point Likert interval scale were weighted by applying the weights discussed in Section 3 of this paper. The total weighted scores calculated are depicted in Table 3, where the scores appear in a declining order of importance.

It is interesting to note that the nature and scope of the risk linked to the applicant and the members of his/her household or business, as well as the indemnity limit of liability insurance which the applicant needs from the respondent's company, are the underwriting factors which received the highest total weighted scores calculated. According to Table 2 these two underwriting factors received an almost unanimous vote of "extremely important" from the respondents, as only one respondent indicated a slightly lower vote of "highly important" for each underwriting factor.

Table 2. The importance of the underwriting factors when underwriting liability insurance, as perceived by the respondents

Underwriting factors	Extremely important	Highly important	Moderately important	Little important	Not important
Name and address of the applicant and the members of his/her household or business applying for liability insurance	5	2	2	1	
Age of the applicant and the members of his/her household or business applying for liability insurance		1	6		3
The <i>lifestyle</i> of the applicant and the members of his/her household or business applying for liability insurance	1	1	6	1	1
The <i>character and reputation</i> of the applicant and the members of his/her household or business applying for liability insurance	3	4	1		2
The <i>nature and scope of the risk</i> that the applicant and the members of his/her household or business wish to obtain protection for	9	1			
Particulars of previous <i>convictions</i> of the applicant and the members of his/her household or business applying for liability insurance	7		1		2
Particulars of previous <i>refusals</i> of cover to the applicant and the members of his/her household or business applying for liability insurance	8	2			
Particulars regarding the <i>claims history</i> of the applicant and the members of his/her household or business applying for liability insurance	8	2			
Particulars regarding the <i>geographical location</i> of the applicant and the members of his/her household or business	1	5	2	2	
Particulars of whether or not the applicant has implemented any safety precautions to lower the liability risks	7	1	2		
Particulars regarding liability insurance coverage already obtained by the applicant and the members of his/her household or business from other insurance companies	1	3	5	1	
The indemnity limit of liability insurance which the applicant needs from the respondent's company	9	1			
The aggregate indemnity limit of liability insurance which the applicant and the members of his/her household or business will eventually have at their disposal from the various insurers	8		2		

Table 3. The weighted responses on the importance of the underwriting factors as perceived by the respondents, in a declining order of importance

Total weighted score calculated	Declining order of importance	Underwriting factors
49	1	The <i>nature and scope of the risk</i> that the applicant and the members of his/her household or business wish to obtain protection for
49	1	The <i>indemnity limit</i> of liability insurance which the applicant needs from the <i>respondent's</i> company
48	3	Particulars of previous <i>refusals</i> of cover to the applicant and the members of his/her household or business applying for liability insurance
48	3	Particulars regarding the <i>claims history</i> of the applicant and the members of his/her household or business applying for liability insurance
46	5	The <i>aggregate indemnity limit</i> of liability insurance which the applicant and the members of his/her household or business will eventually have at their disposal from the <i>various</i> insurers
45	6	Particulars of whether or not the applicant has implemented any <i>safety precautions</i> to lower the liability risks
41	7	<i>Name and address</i> of the applicant and the members of his/her household or business applying for liability insurance
40	8	Particulars of previous <i>convictions</i> of the applicant and the members of his/her household or business applying for liability insurance
36	9	The <i>character and reputation</i> of the applicant and the members of his/her household or business applying for liability insurance
35	10	Particulars regarding the <i>geographical location</i> of the applicant and the members of his/her household or business
34	11	Particulars regarding <i>liability insurance coverage</i> already obtained by the applicant and the members of his/her household or business from <i>other</i> insurance companies
30	12	The <i>lifestyle</i> of the applicant and the members of his/her household or business applying for liability insurance
25	13	<i>Age</i> of the applicant and the members of his/her household or business applying for liability insurance

Two other underwriting factors occupied the third place in the declining order of importance, namely:

- The particulars of previous *refusals* of cover to the applicant and the members of his/her household or business applying for liability insurance, and
- The particulars regarding the *claims history* of the applicant and the members of his/her household or business wishing to obtain liability insurance coverage.

While one of the preceding underwriting factors addresses the indemnity limit of liability insurance which the applicant needs from the *respondent's*

company, the underwriting factor which has the fifth highest total weighted score calculated, is the *aggregate indemnity limit* of liability insurance which the applicant and the members of his/her household or business will eventually have at their disposal from the *various* insurers. This underwriting factor provides an indication of the total liability risk exposure of the applicant and the members of his/her household or business.

It is interesting to note that the character and reputation, geographical location, lifestyle and age of the applicant and the members of his/her household or business were not perceived by the respondents as very important underwriting factors, although the

respondents take them into account during the underwriting process of liability insurance.

4.2 How often the stipulations of insurance policies are adjusted to take the underwriting factors into account

The stipulations of insurance policies have to be adjusted from time to time to incorporate changes in the underwriting factors. The following table shows how often the stipulations of insurance policies need to be adjusted according to the respondents to account for changes in the underwriting factors of liability insurance.

Table 4. How often the following stipulations of the liability insurance policies need to be adjusted to take the underwriting factors into account, as perceived by the respondents

Stipulations	Always	Very often	Sometimes	Seldom	Never
Adjust the level of the <i>premium</i>	1	4	4	1	
Adjust the <i>excess</i> (deductible) to be paid when a claim is made		5	3	2	
Adjust the requirement that the household or business be fitted with the necessary <i>safety precautions</i>		3	5	2	
Adjustment due to the <i>nature and scope of the risk</i> that the applicant wishes to obtain protection for	5	4	1		
Adjustment due to the particulars regarding <i>liability insurance coverage</i> obtained from <i>other</i> insurance companies	2	1	4	2	1

The preceding empirical results based on the five point Likert interval scale were weighted (as discussed in Section 3 of this paper). The total

weighted scores calculated appear in the following table in a declining order of frequency.

Table 5. The weighted responses on how often the following stipulations have been adjusted in the liability insurance policies to take the underwriting factors into account, in a declining order of frequency

Total weighted score calculated	Declining order of frequency	Stipulations
44	1	Adjustment due to the <i>nature and scope of the risk</i> that the applicant wishes to obtain protection for
35	2	Adjust the level of the <i>premium</i>
33	3	Adjust the <i>excess</i> (deductible) to be paid when a claim is made
31	4	Adjust the requirement that the household or business be fitted with the necessary <i>safety precautions</i>
31	4	Adjustment due to the particulars regarding <i>liability insurance coverage</i> obtained from <i>other</i> insurance companies

The nature and scope of the risk linked to the applicant and the members of his/her household or business was indicated in Table 3 (of Section 4.1 of this paper) as one of the two underwriting factors which received the highest total weighted scores calculated for the *importance* of the underwriting factors of liability insurance. It consequently does not come as a surprise that the adjustment of the policy stipulations due to the *nature and scope of the risk* that the applicant wishes to obtain protection for,

received the highest total weighted score calculated in a declining order of *frequency* according to Table 5. It therefore appears that the high level of *importance* of the nature and scope of the risk concerned may lead to the high *frequency* of adjusting the stipulations of liability insurance policies due to the same aspect.

The stipulations of a liability insurance policy which have the second and third highest weighted scores calculated according to Table 5, focus

respectively on the adjustment of the level of the *premium* to be paid by the insured, and the level of the *excess* (deductible) to be paid when a claim is made. These two stipulation adjustments usually come into force within a short period after informing the insured about the change of the policy stipulations.

4.3 Problem areas in the underwriting process of liability insurance and possible solutions to solve them

The respondents were requested to indicate three problem areas which they experience when underwriting liability insurance. Their responses appear in the following table.

Table 6. Problem areas in the underwriting process of liability insurance, as perceived by the respondents

Problem areas	Number of respondents who mentioned the problem area
Change in the nature and scope of the risk	9
Uncertainty about the frequency and severity of possible claims	9
Breach of contract (including breach of utmost good faith) by the insured	6
Contribution resulting when the insured has liability insurance from other insurers	4
Insured not having an insurable interest in the risk insured against	1
Change in legislation (e.g. consumer protection act)	1

Nine of the 10 respondents indicated the next two problem areas, namely a change in the nature and scope of the risk, as well as uncertainty about the frequency and severity of possible claims. Respectively six and four respondents were of the opinion that a breach of contract (including a breach of utmost good faith) and the application of the basic principle of contribution when the insured has liability insurance obtained from other short-term insurers may also represent problem areas in the underwriting process. Possible solutions to address these problem areas are discussed in the following paragraphs.

Short-term insurers usually insert a specification in the policy contract at inception which enables them to change the stipulations thereof with a 30 days' notice send to the insureds. It is therefore possible for short-term insurers to address any *change in the nature and scope of the risk* in the short term. Furthermore, the insured has the obligation based on the basic principle of utmost good faith to immediately disclose any change in the nature and scope of the risk to the insurer. Failing to do so may result in no coverage to the insured. The education of insurance brokers as well as the insureds on the application of the basic principle of utmost good faith should provide a long-term solution to address changes in the nature and scope the risk. Another practical measure which short-term insurers often apply, is to require that every insured completes an annual questionnaire in order to identify any change in the nature and scope of the risk.

The uncertainty about the *frequency and severity of possible claims* also represent a problem area to short-term insurers. The *frequency* of possible

claims can be addressed by implementing an excess to be paid when the insured lodged a claim, while the premium can also be increased with each claim to discourage a high frequency of claims. As the *severity* of claims is usually not in the control of the insured, a short-term insurer should utilise reinsurance coverage to financially assist him when the extent of a claim is beyond the insurer's reasonable limits. While the education of insurance brokers and insureds pertaining to the basic principles of short-term insurance is important for a long-term solution, insureds should be encourage to notify the short-term insurers immediately when a third party threatens with litigation which may lead to a liability claim.

Short-term insurers can try to avoid a *breach of contract* (including a breach of utmost good faith) by the applicants by requiring as much information as possible from them. The education of insurance brokers and insureds on the application of the basic principles of short-term insurance should once again provide a long-term solution to this problem area. When short-term insurers have adequate information at their disposal, the application of the basic principle of *contribution* should not create a major problem area.

5 Conclusions

The *objective* of this research was already formulated as the improvement of financial decision-making by short-term insurers regarding the underwriting process of liability insurance. This paper is based on a literature study, as well as an empirical survey which involved the leaders of the short-term

insurance market in South Africa, which is classified as a developing country with an emerging market economy. This study leads to the following important conclusions which should also be valuable to short-term insurers in other developing countries:

(1) The *nature and scope of the risk* linked to the applicant and the members of his/her household or business, the *indemnity limit* of liability insurance which the applicant needs from the insurance company, the particulars of previous *refusals* of cover to the applicant and the members of his/her household or business applying for liability insurance, and the particulars regarding the *claims history* of the applicant and the members of his/her household or business wishing to obtain liability insurance coverage, are the underwriting factors which received the highest total weighted scores calculated from the respondents. They are therefore regarded as the underwriting factors which should receive special attention when short-term insurers are underwriting liability insurance.

(2) The adjustment of the policy stipulations due to the *nature and scope of the risk* that the applicant wishes to obtain protection for, the stipulations which focus on the adjustment of the level of the *premium* to be paid by the insured and the level of the *excess* (deductible) to be paid when a claim is made, are the stipulations most often adjusted in liability insurance policies. These stipulation adjustments usually come into force within a short period after informing the insured about the change of the policy stipulations.

(3) The largest number of respondents indicated the following four problem areas in the underwriting process of liability insurance, namely a change in the *nature and scope of the risk*, uncertainty about the *frequency and severity of possible claims*, a *breach of contract* (including a breach of utmost good faith), and the application of the basic principle of *contribution* when the insured has liability insurance obtained from other short-term insurers. Possible solutions to address these problem areas were discussed, but the long-term solution focused mainly on the education of insurance brokers and insureds pertaining to the application of the basic principles of short-term insurance.

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