ADJUSTING TODAY
Adjusters International
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Providing Loss Consulting Services to the Insured

Coinsurance

WHAT INSUREDS NEED TO KNOW

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The story could have had a happier ending!

Company XYZ, a major supplier to the aerospace industry, had been growing rapidly. Its ownership was hands-on and imaginative. For several years, the company had been purchasing used equipment along with new components for existing machinery. Most hookups and modifications were done by XYZ's own personnel. Company officials believed they had comprehensive insurance coverage and, in fact, their coverages were excellent. But when a substantial loss took place, they were able to recover only 31 percent on their property claim, and only 12 percent on their loss-of-income claim. The problem: horribly understated values, far too low to meet the policy's coinsurance requirements. The result: a disastrous financial loss that could have been avoided with better communications between the insured and the broker when the insurance program was established.

Had the broker known it was the insured's practice to expense and not book all costs for items and equipment under $300, he would have had a far different picture of what those values should have been. But because the costs were not carried in the financial records, and because the insured didn't explain their procedures to the broker, the insurance was woefully inadequate.

A similar problem affected the business interruption coverages. In designing the program, neither the broker nor the insured allowed for the planned expansion of the business, therefore the full potential of the business interruption exposure and its effect on the coinsurance provision were never determined. Coverage the insured presumed to be adequate fell short. Had the policyholder and broker discussed the company's plans for growth, the outcome no doubt would have been different.

An unfortunate sequence of events! But a valuable lesson for insurance professionals who assume that clients understand the coinsurance principle as well as they do. It's essential that the broker make it a priority to extract all pertinent information when the client's insurance program is formulated. Thorough communication, initiated by the broker, is the key to devising and maintaining a program that will best serve the insured when it is called upon to deliver.

THE FIRST CONTACT

The broker is the policyholder's first — and often only — contact with an insurance professional, and he or she can never assume that the client understands the coinsurance concept. Just as important, it's essential that the broker be familiar with the net effect of undervaluation in a claim situation, so that condition can be explained to the client. Definitive communication is important in all coverage areas, but it is especially vital in three:

1. Replacement costs of personal property, including furniture, fixtures, equipment and inventory.
2. Replacement costs of buildings.
3. Business interruption values.

PERSONAL PROPERTY

Because insureds usually rely on historical costs to value inventory or business personal property, the figures they provide are often unsatisfactory for

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insurance purposes. Replacement cost and actual cash value can mean one thing to the insurance buyer, and something else to the broker or adjuster. Insureds who normally purchase used equipment, for example, might assume that they can replace a lost piece with another used item. In fact, replacing the piece could mean not only incurring the cost of a new unit, but paying to have it delivered and installed. Sometimes installation costs can be as high as the price of the machine itself, yet they are often left out when determining insurance values! So, it's essential that all of these factors and interpretations be thought through.

Many insureds rely solely on historical or accounting records, and value inventories differently for different purposes. For instance, inventory value may reflect the figure arrived at for tax purposes and the insured might submit this same inventory or a depreciation schedule for setting insurance values. Unless the risk is a new business, some pieces of equipment might not be listed. That equipment could be very valuable to the business, but for tax reasons it is no longer listed on the schedules supplied to the insurance carrier. If a loss occurs, the insured is likely to suffer a coinsurance penalty because the inventory at risk is of greater value than that insured.

As we saw in the case of company XYZ, this can dramatically undervalue an inventory in which parts and supplies have been expensed rather than capitalized, because much of its equipment will not appear on the asset list. Tools, for example, if expensed to a specific project, must be replaced in the event of a loss, yet their value would not have been included in the insured values.

These valuation problems are all too common. But even more surprising is the fact that in many instances, the insured has absolutely no idea that the submitted valuations are incorrect. With better communication and education, most of these valuation errors can be avoided!

BUILDINGS

Insureds frequently make a mistake here when answering the question, "How much would it cost to replace your building?" They don't realize that what replacement means to them can be very different from what it means to claims personnel settling a loss.

When valuing a building for its replacement cost, pay close attention to the details of the structure and the materials used in its construction. If the original values were determined through a simple square footage calculation, or a cursory examination of construction materials, significant discrepancies can result when the insurance company's representatives establish values after a loss. Such discrepancies can translate into a coinsurance penalty.

BUSINESS INTERRUPTION VALUES

A very important element in establishing proper valuation for business interruption coverage is the company's growth factor—in terms of sales or sales value of production. Most insureds tend to think of only projected profit and not of the full impact of additional sales, production, or the accompanying payroll, cost of raw materials, etc.

The completion of the business interruption worksheet provides the perfect opportunity for the broker and client to review not only the company's past performance, but also its future potential. "What if" scenarios can be developed to provide valuation data that can forecast potential recoveries in the event of a loss.

Terminologies used in the policy carry different meanings than used by the accounting profession. It is necessary, therefore, to unravel these differences prior to making a determination of sums to be insured.

Further, it is important to determine the time period that will be used for establishing value at the time of loss. Historically, valuation was based on the 12-month period following the date of loss; however, more recent policy forms require the valuation to be based on the 12-month period following the policy's inception date or most recent anniversary date.

COINSURANCE FROM A CLAIMS PERSPECTIVE

When values are determined, coinsurance and its requirements should be viewed from a claims perspective to support better communication. Ask questions like: What would happen in the event of a loss? If the insured lost a plant or a section of a plant, how would the company adjusters approach valuation of the property to determine recovery? What would the *actual* replacement cost of the structure, and equipment and all of the inventory be? What would the actual cash value of that same property be, and how would that compare with the stated values? Has this information been reported correctly? And have we estimated what the true business interruption value would be, considering growth, and what it would be in the eyes of an adjuster?

The time to eliminate a potential coinsurance penalty is *before* the loss occurs. That means both the broker and client must communicate effectively up front, and understand the language that's being spoken. There's no better way to ensure that reported values will be in line with the values used at the time of any subsequent adjustments. When a broker has cultivated that understanding, he or she has acted in the very best interests of the client.

The Extended Period of Indemnity Endorsement

A GOOD INVESTMENT IN COMPLETE RECOVERY

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Loss consultants from Adjusters International are sometimes asked to review, from a claims perspective, the property and business interruption coverages of companies concerned that their policy might not be adequate to cover a serious loss. In the course of such a review, the immediate priorities are usually to determine the values at risk; to ensure that the limits of liability are adequate; and to make sure that any existing coinsurance requirements are met. However, it's just as essential to remember less obvious but equally important areas of coverage whose existence, or lack thereof, can make significant differences in the insured's ultimate claim recovery.

One of the most important and helpful endorsements to a business interruption policy is the Extended Period of Indemnity Endorsement. If the business interruption coverage is being written under more recently issued forms, an automatic 30-day extended period of indemnity is built into the coverage. But absent one of these forms, this endorsement must be added to the policy to extend the indemnity period.

As its name suggests, the benefit of this coverage is that it extends the covered loss period beyond the time required to restore the property. In both mercantile and manufacturing businesses, the level of sales or production during the time following the restoration period is often not as high as the level would have been had no loss taken place. Additional time may be needed to restore revenues to preloss levels.

Making the situation more critical is the fact that because the business is up and running, the full costs of operation are being absorbed without corresponding income. The effect of the revenue shortfall, therefore, goes right to the bottom line. With the proper coverage, however, the insured can be indemnified for the shortfall that occurs during the extended period.

This endorsement also opens up another avenue of indemnification for the insured—for expenses that otherwise would not be covered by the basic business interruption policy. The Extended Period of Indemnity Endorsement can enable the policyholder to recoup significant preopening expenses, incurred during the extended period, to restore revenues to their preloss levels. They might include extraordinary advertising and public relations activities, or be related to locating and hiring new personnel.

These expenses are not ordinarily reimbursed under basic BI coverage because they do not qualify as normal operating expenses, nor would they be considered "expediting" expenses because they do not reduce the loss within the traditional loss period. On the other hand, these expenses do reduce the carrier's liability when the post-restoration period is covered by the Extended Period of Indemnity Endorsement.

Consider the following illustration: The REM corporation manufactures widgets to order. A fire causes extensive damage to the manufacturing facility, resulting in a shutdown and period of restoration of six months. When REM reopens, company officials find that their level of business is only 50 percent of what it would have been had the loss not occurred. The second month after reopening, the firm is realizing only 75 percent of anticipated volume. Ultimately, it takes four months after reopening to return to preloss levels.

One month before reopening, and for a considerable period thereafter, the company incurs significant additional expense contacting the trade to advise that it will be back in business shortly. Advertisements are placed in trade journals and representatives are sent around the world to assure customers that the company will be able to fill their orders.

Without the Extended Period of Indemnification Endorsement, the REM corporation would have been indemni-

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fied only for the first six-month period, through the period of repair. With the endorsement, the firm would also be paid for the covered loss occurring during the four-month period following reopening. What's more, the endorsement would provide coverage for the costs incurred to publicize the reopening to customers.

Just how long the period of indemnity should be extended depends on the nature of the individual risk. A period of 90 to 120 days is the recommended minimum, but the characteristics of each individual risk must be weighed carefully. For example, a bowling alley that suffers a fire in July and doesn't reopen until October is likely to lose all of its league business, and therefore substantial revenues, through the next season.

Another attractive feature of the endorsement is that its cost is usually minimal because it doesn't necessarily increase the business interruption limits. This makes the coverage an even better value.

Simply put, the Extended Period of Indemnification Endorsement provides an insured with an otherwise uncollectible reimbursement; that cannot only help a business return to prosperity, but could be decisive to the company's very survival.

LEARNING THE LANGUAGE

Adjusting worldwide requires an understanding of worldwide terminology. Here are a few common terms used in policy interpretation.

United States	United Kingdom
Actual Cash Value	Indemnity
Replacement Cost	Reinstatement
Business Interruption	Consequential Loss
Lost Sales	Shortfall in Turnover
General and Admin. Expenses	Standing Charges
Expenses to Reduce Loss	Increased Cost of Working
Freight	Carriage
Coinsurance	Average Clause
Expediting Expense	Expense to Reduce Loss

Adjusting Today Meeting a Need!

Ronald A. Cuccaro, SPPA
President and Chief Executive Officer, Adjusters International

When Adjusters International introduced *Adjusting Today* in the fall of 1989, we promised that it would be a tool designed to help you stay current in a rapidly changing profession. Your enthusiastic reactions continue to indicate that the newsletter is fulfilling that pledge. I'm pleased to welcome you to this issue of *Adjusting Today*, which features two more timely and thought-provoking articles.

The first, by Bob Lucurell, FPPA, addresses the crucial subject of coinsurance. Examples of the unfortunate consequences that can result when insureds misunderstand the coinsurance principle are all too numerous. Bob explains how they can be avoided through better communication, and offers some specific recommendations on steps the broker can take in leading that process.

Our second article targets the Extended Period of Indemnity Endorsement, extremely valuable but often overlooked coverage that can mean the very survival of a company following a major loss.

Bill Rake, SPPA, points out that the time it takes a business to fully recover from a loss can extend significantly beyond the period required to restore the property itself, and provides insight as to why this endorsement deserves attention in formulating a sound business interruption insurance program.

And since the language of the adjusting field differs around the world, we have again included a table of corresponding terms used in the United States and United Kingdom.

We hope you will enjoy and be stimulated by these discussions and this information. As always, we welcome your questions, comments and suggestions as to how *Adjusting Today* can help all of us better serve our industry.

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