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EDITOR'S NOTE

Hurricanes in the Atlantic and Gulf of Mexico. Earthquakes and widespread fires in the Western United States. Severe weather and flooding in many parts of the world. Terrorist bombings in London's financial district and the devastating attacks of 9/11 on American soil.

Besides the immense heartache and property damage these events caused, the recent rash of disasters from which few parts of the globe have escaped, has insurance professionals from underwriters to risk managers scrambling to ask—and answer—new questions about how well organizations are protected against such catastrophes. The questions touch issues far more complex and less defined than those associated with traditional insurance planning and administration.

This edition of Adjusting Today *examines some of the most critical of these issues, citing considerations and provisions, the understanding of which could be indispensable to protecting an organization's stability and security.*

At a time when too many of our worst fears seem to be coming true, this article is essential reading for anyone concerned with protecting his or her facility or that of a client.

—Sheila E. Salvatore, Editor

Disasters Raising Questions of Insurance Adequacy

By Paul O. Dudey, CPCU
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In the wake of Hurricane Andrew's rampage across southern Florida and Louisiana in 1992, many thought they would never again see a storm of such devastating proportions. That was before Katrina.

At the time, the bombing of the Alfred P. Murrah Federal Office Building in Oklahoma City in 1995 seemed to be the worst act of terrorism imaginable on American soil. Then came 9/11.

In addition to driving home the sobering reality that disasters like these—natural and manmade —can and do happen, these events once again refocused the attention of insurance professionals everywhere: of insurers, on the relevancy and soundness of their underwriting standards; and of risk managers and brokers, on the adequacy of risk management techniques and insurance protection against such catastrophes.

According to the Federal Emergency Management Agency (FEMA), the United States experienced an average of 32 disasters per year between 1953 and 2007. In 2007, however, 63 disasters were declared, a figure that had been exceeded only three times in 54 years. In addition to hurricanes and terrorism, recent disasters have included wildfires in California, tornados in the South, flooding in Texas and severe winter storms across states ranging from Texas to Maine.

In light of these alarming developments and the fact that no region is immune from the possibility of such disasters, this discussion explores some of the important areas of risk management and insurance that must be addressed in being prepared for them.

Interruption of Operations

For many occupants of buildings damaged by a disaster, even more devastating than the resulting property damage is the loss of earnings due to the blast. Occupants may suffer loss of business income from shutdown of operations or need to expend substantial sums in extra expense to maintain or hasten re-establishment of operations at the same or another location.

Initially, in such a loss, even tenants that have sustained no damage to their own premises are prevented by order of civil authority from reoccupying their premises to resume operations. In the worst case, they may not even be permitted to enter the building to retrieve business property or records that would allow total or partial transfer of operations to another site.

The civil authority provision of most business income or extra expense insurance policies will normally provide up to two consecutive weeks of coverage for such an event. But beyond that time, there is no coverage if there is no property damage to the involved premises.

Insurance Services Office (ISO), the policy drafting organization for many U.S. insurers, has made some important changes in its business income and extra expense coverage forms. Following their approval, the changes were to be implemented in most jurisdictions in November 2008. Among the changes is a restriction with its civil authority coverage.

Since 1984, the condition precedent to obtaining payment for actual loss of business income or extra expense caused by action of civil authority that prohibits access to the described premises has been direct physical loss or damage resulting from a covered cause of loss—other than at the described premises. In the wake of the many hurricanes that struck Florida and other southern states in recent years, attempts were made by businesses to obtain access when denied by civil authority

because of the threat of damage or destruction—even when physical loss or damage took place many miles from the described premises. Close scrutiny of the civil authority coverage provision makes clear that it does not matter where the physical loss or damage takes place, so long as access by civil authority is denied as a result of it.

ISO did not provide a reason for the recent change in its civil authority coverage, but the changes specify that the direct physical loss or damage must take place not more than one mile from the damaged property. It should come as no surprise to learn that some insurers that file their own coverage forms already have such a restriction in their policies. In fact, one policy reviewed recently states that the damage must not take place more than one mile away.

Although the 72-hour waiting period for this coverage remains unchanged, another change makes this waiting period commence after the time that the first action of civil authority prohibits access to the described premises. The period of coverage is also being extended from three consecutive weeks to four consecutive weeks after the date of that action, or when the civil authority coverage for business income ends, whichever is later.

Two endorsements also are being revised, in conjunction with the revisions to the coverage forms. Civil Authority Increased Coverage Period CP 15 32 is being retitled, "Civil Authority Change(s)." The purpose of this endorsement is to change the coverage period from four weeks to the number of

days shown and, probably at the discretion of the underwriter, to extend the one-mile restriction even farther.

The second endorsement, Business Income Changes—Beginning of the Period of Restoration (No Waiting Period) CP 13 56, is being retitled, "Business Income Changes—Beginning of the Period of Restoration." At the underwriter's discretion, this endorsement is used to decrease the waiting period from 72 to 24 hours.

For building occupants who sustain damage to their property or any property on their premises that forces interruption of their operations or requires extra expenses to sustain operations, their business income coverage will apply to pay for lost net profit plus any continuing expense. If extra expense coverage is carried, either separately or as a part of the business income coverage, expenses incurred to maintain or more quickly restore operations are covered, even if they exceed the amount by which the loss of business income is reduced. If extra expense coverage is not included, the recovery of such extra expenses under business income insurance will be limited to the amount by which the business income loss is reduced.

Extended Period of Indemnity

Historically, a business interruption insurance claim ended when the premises was restored and operations could be resumed (and merchandise stocks or production of manufactured goods brought to the same level that existed at the time of loss), unless extended period of indemnity coverage was purchased, extending the coverage beyond date of restoration to allow for the delay before the momentum of the business can be regained.

Under business income coverage, 30 days of extended period of indemnity coverage is included in the basic business income coverage. Even this amount of time may not be enough in a disaster situation, so consideration should be given to increasing the extended period of indemnity coverage beyond the basic 30 days. Up to 12 months coverage can be provided under standard ISO forms.

Scope of Business Income Coverage

A problem that often develops for some commercial tenants involves their inability to occupy their own undamaged premises because of damage to the service areas of the building—elevators, lobby, etc. If the description of premises of the business income or extra expense

coverage is limited to the space occupied exclusively by the tenant, no coverage applies except for the period of civil authority coverage. For coverage beyond that time period to apply, the description of premises would have to be broad enough to include service areas needed for access to the insured's premises.

It should be noted also that in some cases a question of interpretation of the definition of premises will arise. Does it extend to the entire building including public and service areas, or is it limited to the area within the building exclusively occupied by the insured?

Unless the description clearly identifies the intent to cover beyond the insured's own space, the insurer may well contend that the coverage is limited to loss from property damage within that space, and deny coverage for damage to property outside the insured's premises that prevents occupancy of the insured's space.

The insured, on the other hand, can argue that any ambiguity in interpretation of the definition of described premises should be resolved in their favor, allowing coverage. The argument can also be made that the tenant's personnel "occupy" the public area as well as the area of exclusive occupancy. If the description of premises says simply "premises occupied by" rather than "premises occupied exclusively by," a case can be made for the more inclusive coverage.

The insured's lease of the premises may also shed light on this question. If it clearly extends the insured's right of occupancy to include use of public areas, the argument for the broader interpretation of coverage will be enhanced.

In this regard, the description of premises in business income and extra expense forms currently includes service areas needed for access to the insured's premises.

Loss Recovery Time

Remember also that in a major hurricane or earthquake, resources for rebuilding quickly become hard to obtain. So extra time will be needed to restore operations, and the amount of business income coverage should be increased accordingly, possibly with use of a higher coinsurance percentage at a slightly reduced rate, to hold down the cost.

Property Loss

For example, while much of the damage in the Oklahoma City disaster involved federal property—not "insured" in the conventional sense—extensive damage to properties located quite a distance away, including: furniture, records, files, supplies, machinery and equipment, and property belonging to employees, privately insured, also resulted. In many cases, coverage was adequate to cover losses involving partial repairs but, in cases involving more serious damage, problems were encountered due to valuation problems and rebuilding requirements.

For any buildings damaged in a catastrophe to the extent that they must be demolished, the loss would be the total actual cash (depreciated) value of the building plus the cost of demolition and removal of the debris. If rebuilt, replacement cost insurance (a built-in feature of most homeowners and business owners policies but an optional feature with other commercial property policies) would be needed to pay the total cost to rebuild at present prices, plus any demolition and debris removal costs.

Moreover, if building, zoning or environmental ordinances or codes required demolition of undamaged portions of the building or enhancements to bring it to current code requirements, ordinance or law coverage (an infrequently purchased but highly desirable endorsement for property insurance policies) would be needed to pay these additional costs. Examples could include a building code requirement that the restored building be sprinkler equipped or be handicap accessible, when the original building did not contain these features. (See *Adjusting Today*, Ordinance or Law edition.)

Valuations

A common problem in all of these disasters has been inadequacy of the insurance to cover costs fully. In the California wildfires, rebuilding costs of the dwellings destroyed in the fire proved in case after case to require much more than the amount of insurance available. In the absence of an up-to-date insurance appraisal, "guesstimates" of property value tend to underestimate the present-day rebuilding costs and the value of personal property, particularly if building or zoning ordinances apply and require demolition of undamaged portions of the building or extensive upgrade in construction on rebuilding, or both.

The common practice of purchasing insurance to meet mortgage loan or coinsurance requirements, rather than the full actual loss potential, works well in most partial loss situations, but in disasters of the magnitude considered here, the insurance has been proven time and again to be substantially below the amount needed to cover the loss fully. Values and replacement costs must be reviewed regularly. In addition, business interruption exposures need to be fully projected and insured accordingly.

Be wary, also, of reliance on real estate appraisals or "book value" figures as a basis for setting the amounts of insurance. Their basis for valuation may be at odds with the factors used in an insurance appraisal, particularly in the areas of depreciation and inflation. In many cases "book" depreciation will be accelerated for tax purposes and will not have been adjusted upward for inflation, giving an artificially low number as compared with "insurable value." Also, quantities of the contents may have been written off as expenses without ever having gotten onto the books as assets, again giving an unrealistically low picture of actual insurable value.

Blanket Insurance

For insureds with both buildings and personal property, or with multiple premises, either at the same or separate locations, or a combination of any of these, purchase of "blanket" insurance over all of the property is recommended if the insurer has not issued a margin clause (discussed later). While the rate will be slightly higher (usually between 5 and 10 percent more) with blanket insurance than with "specific" insurance on each separate item of property, the flexibility of the blanket insurance will more than offset the higher rate.

With blanket insurance at a single location, the full amount of coverage is available to cover any property insured. Whereas with scheduled coverage, the insurance on one item might be exhausted while there is still unused coverage on another item, the entire amount of blanket coverage is available without regard to the distribution of the loss among the items included in the blanket item of coverage.

With two or more locations covered on a blanket basis, the

entire blanket amount overall becomes available to apply to the loss at any one location. If the insurance is based on 90 percent of total property value (as required for blanket insurance with a 90 percent coinsurance or agreed value clause), the insured can recover 100 percent of a loss, (up to the limit of blanket insurance carried), including cost of debris removal, even though the loss substantially exceeds the amount (90 percent of property value at that location) used as the basis to determine the amount of blanket insurance to provide.

If appropriate ordinance or law coverage is also included, the cost of demolition and site clearance, loss of the value of the undamaged portion that must be demolished and increased cost of reconstruction according to current code are also covered.

From the perspective of reinsurance companies, the ability of insureds to purchase blanket agreed amount insurance and obtain the full amount of coverage at any one location—even when the property values are inadequate—is undoubtedly the reason insurers are adding margin clauses to their policies.

Briefly, when a margin clause is added to a commercial property policy, it eliminates the agreed amount provision. The net effect is to provide no more coverage than a certain percentage—ranging from 10 to 20 percent—of the damaged or destroyed property as shown on the statement of values.

If, for example, the blanket limit is $1 million and the building destroyed by fire is shown on

the statement of values to have a replacement cost limit of $500,000, the most the insurer has to pay, with a 10 percent margin clause, is $550,000—with the difference between actual cash value and replacement cost paid when reconstruction is completed.

Adequacy of Construction

A common finding after a catastrophic loss is that buildings supposedly built to generally accepted construction standards are deficient in many subtle ways not obvious to the potential buyer. In a competitive construction market, corner-cutting, which can be the difference between the contractor's profit and loss, becomes obvious only after a major disaster.

Following Hurricane Andrew, numerous instances of deficient construction came to light: buildings inadequately anchored to the foundation, roofs not sufficiently tied down, use of inferior wall panels that were highly subject to damage under hurricane conditions, to mention but a few. Comparable deficiencies also frequently come to light in the aftermath of a major earthquake. In major fires, failure to firestop between adjacent portions of buildings can allow rapid spread of fire, engulfing the entire building. Use of inferior materials can contribute to more rapid fire spread or greater structural damage than standard materials.

Moreover, many older buildings —built to the standard at the time of construction—have not been upgraded to meet modern standards. This produces a twofold problem: (1) under loss conditions, greater damage may result than if the building met current standards; and (2) following loss, upgrade to meet current standards may be required, perhaps even requiring demolition of undamaged portions of the building.

This is especially true of earthquake exposures where technology has advanced rapidly and building codes, although commonly allowing "grandfathering" of existing buildings, have become increasingly restrictive, even to the point of requiring demolition of a damaged building.

While it is not always possible to recognize building deficiencies before they are dramatically revealed by a loss, many defects are recognizable and should be

corrected when discovered. The services of a competent structural engineer or building contractor will often prove invaluable in identifying such defects. Consultation with municipal officials regarding possible building code deficiencies and the measures that would require correction following a loss may also be helpful.

Protecting Records

Another important question is: How well are records protected, given possible exposure to a catastrophic loss of the kind under consideration here?

While insurance is available to cover accounts receivable records and other "valuable papers," in the interest of business continuity and "hassle avoidance," it is sound, basic risk management to also have adequate file backup or duplication at a separate location, as well as fire- and burglar-resistant storage receptacles for key records.

A further concern, apart from catastrophe losses, is security for your technology infrastructure. Analysis of these exposures and setting up adequate controls may well call for the service of outside consultants.

Liability Exposures

In a major loss, persons or organizations suffering property damage or bodily injury will possibly look for a negligent or allegedly negligent party to sue to recover damages. Even when the damage is the result of an act by an outsider, such things as failure to maintain adequate security, faulty design of electrical service or lack of standby or backup electrical facilities, failure to respond properly to alleged bomb threats, and the like may give rise to suit for damages against others apart from the perpetrators.

In addition, major losses, especially in high-rise buildings, can result from causes other than terrorists, and give rise to allegations of negligence against the building owner or any tenant.

Such suits can involve substantial amounts, so building owners and occupants of such buildings are well advised to maintain high limits of liability insurance, probably including one or more layers of excess or umbrella liability insurance.

Workers Compensation

In addition to the tragic death or injury of workers involved in a terrorist attack, with the loss of employment skills and the need for replacement and training of new personnel to restore operations to their former level, the impact on future operating and workers compensation costs can be severe.

For smaller employers who have little or no experience modification in their workers compensation coverage, the effect on future workers compensation costs will be minimal.

But for larger employers, workers compensation costs are based in large measure on the employer's own loss experience. Whether using a basic experience rating plan, some type of retrospective rating program, or a totally or partially self-insured program, the cost of these workers compensation claims can be reflected in higher workers

compensation costs at some point down the road.

Also, in planning before such a loss occurs, the possibility of such an occurrence should be considered in deciding what sort of workers compensation program to adopt. In this regard, it is a good idea to seek the advice of experts in this complex area of risk and financial management.

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With all of the other challenges a business owner or manager must deal with today to keep their operation successful, it would be comforting to think that a disaster—natural or otherwise—isn't one of them. But reality, especially of late, suggests otherwise. If there is good news, however, it is that a thoughtful and thorough approach to risk management and insurance planning can help prepare an organization to survive such an occurrence.

That calls for understanding the nature of losses the firm could sustain and their implications, as well as the latest insurance mechanisms available to protect against them.

For owners and managers, it should be among the highest of priorities. For brokers and other insurance professionals, there is no more important service they can provide to their clients.

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