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Chairman's Corner

What Does the Coming Year Have in Store for those Involved in Risk Management?

by Stanley Oetken, CPCU, ARM

Stanley Oetken, CPCU, ARM, is senior vice president in Marsh's Denver office, and is part of the Alternative Risk Financing Unit, assisting clients using large deductible programs, captives, and risk retention groups in loss forecasting and cash flow analysis.

He has been involved in servicing and marketing large corporate and public entity clients; and in the implementation and administration of professional liability programs for attorneys, accountants, and real estate professionals. He has spent extensive time in the formation and administration of self-insurance programs for public entities. During his tenure at Marsh, he has been actively involved with clients in the oil and gas industry, construction project wrap-ups, electric and gas utilities, environmental remediation, and sports teams and venues.

Oetken earned a B.S. in mathematics from Wake Forest University in Winston-Salem, N.C.; and a master of science degree in insurance management from Boston University.

Those individuals in the industry who have been involved in risk management, either as risk managers or on the broker/underwriting/consulting side have enjoyed a stable property/casualty market over the past several years. While the risk managers whom I work with would always like to see lower premium costs, they have been pleased with the market and the fact that they can assure their firm's senior management that there will not be any surprises at renewal.

So what does the future hold for risk management professionals and how should they prepare for it? Based on trade press articles that I have read recently, most of the industry experts (whether self-proclaimed or not) expect the market to remain fairly stable throughout 2008. While there could be differences in particular industries or size of program, in general, we should not see any big changes. Most of these predictions come with the caveat "barring any major catastrophes natural or man made."

Even the prognosticators at my firm, Marsh, confirm this in the firm's most recent market report. They note that in 2007 the property and casualty (P/C) industry will record its third underwriting profit in the last four years and only its third since 1978. Other points of interest include the following:

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Chairman's Corner

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- The soft property market is likely to continue in 2008 barring major catastrophic losses, opportunities for clients to achieve premium savings, enhanced coverage terms, and higher limits. Rate reductions, however, may not match those of the fourth quarter of 2007.
- The casualty market is unlikely to firm in 2008 even if other lines experience adverse financial results.
- Many of the forces driving the workers compensation (WC) marketplace came from outside the insurance industry. In 2007, 41 states enacted new WC legislation and/or reforms. More than 1,000 bills with WC-related issues were introduced throughout the United States; more than 20 percent passed.
- The 2006 net combined ratio for workers compensation was 96.5 percent—the best underwriting result in 30 years and the first underwriting profit since 1995.

Standard & Poor (S&P) has noted that the number of U.S. insurance companies placed under regulatory supervision continues to decline, hitting its lowest point in a decade. S&P reported 10 insolvencies for 2007, down from 11 in 2006, 16 in 2005, and 19 in 2004. Of those, the property/casualty sector was responsible for four in 2007, down from eight in 2006.

The low number can be attributed to a mild hurricane season and high profits for the U.S. property/casualty industry and S&P maintains its stable outlook for 2008. S&P said, however, that it expects net written premiums to "decline modestly" in 2008. As a result, insurer's combined ratios will increase 3 to 4 percent this year.

In its *U.S. Property/Casualty—Review & Preview*, A.M. Best believes "the U.S. property/casualty industry is positioned to sustain its underwriting profitability through calendar year 2008." It goes on to say that it expects a slight premium decline in 2008, due to increased competition, a weakening economy, decreased demand in the Florida marketplace and more capital-market solutions. As results are likely to deteriorate from current levels, insurers will need to demonstrate a sustained commitment to pricing and underwriting discipline to maintain profitability.

Will this soft market be different? The perspective of A.M. Best emphasizes the following points:

- "Pressure on underwriting will increase. At the same time, loss costs trends will remain relatively benign, resulting in only modest deterioration.
- The investment environment has not fostered the rise in cash-flow underwriting that exacerbated previous soft markets.
- The use of technology has changed since the last soft market.
- At this point, reinsurance has not become so inexpensive or its terms so broad that primary insurers are utilizing it more.
- Primary companies have been increasing retentions, keeping more business that has been profitable in recent years.
- At some point, low prices and easy availability may lead to increased use of reinsurance, with primary insurers increasing their focus on the additional top-line growth they can derive from the ability to cede more on the back end, rather than concentrating on the overall profitability of new business. However, primary companies appear, for the most part, to have avoided taking these actions at this point in the cycle.
- A major catastrophic loss might tilt the cycle back toward a hard market, but the market's reaction to the 2005 hurricane season in the United States suggests the impact likely would be specific to the lines and geographic regions impacted by the catastrophe."

So what about the reinsurance market? In the March 2008 issue of *Best's Review*, the article titled "Accustomed Cycles" noted that "the biggest difference between this cycle and the last one is the amount of cash that is currently sloshing about the market." Bryon Ehrhart, president and CEO at Aon Re Services notes, "After Andrew, it took something in the region of 18 months to replenish capital. After 9/11 it took 14 to 15 weeks, and after Katrina it took nine weeks. The cycles are changing in terms of their texture."

What might kick the market back into its hard state again? Julianne Jessup, head of research at broker Benfield, predicted that a major earthquake in California or Japan might have an impact. James Vickers, chairman of Willis Re International said, "A big loss could have a knee-jerk effect, while attritional losses could result in a gentler hardening." Another impact could come from the effect of flooding and the role of government in addressing the risk.

In *Reactions* magazine, the article titled "S&P Top 150 Reinsurers: A good year, but maybe not good enough" wonders if reinsurers made the most of a year when everything fell into place or whether they blew their chance to set themselves up for a soft market. Peter Grant, analyst at S&P, questions whether the results were good enough given the volatility in the business.

Peter Polstein, in an article titled "Insurance Industry Sings the Back Yard Blues," believes the industry could find itself in an unprecedented hard market because of (1) decreasing profits in the last two quarters of 2007; (2) losses in investments such as collateralized debt obligations (CDOs); (3) use of unauthorized reinsurance; and (4) application of Solvency II requirements by domestic rating agencies and regulators. Coupled with a catastrophic loss year, the industry could quickly be underwater financially.

So where does all of this bring us as risk management professionals? Polstein recommends negotiating multi-year contracts where possible and to work out loss-sensitive programs as soon as possible. Given the right set of circumstances, change could happen very quickly.

Above all, we must be vigilant, always looking for signs of change and be prepared to move quickly if we need to. For those in risk management positions, it is wise to maintain a close relationship with someone in your organization who is wired into the firm's future activities, whether it is the CFO or general counsel or someone else. Being forewarned is being forearmed, as the saying goes. In addition, it is advantageous to know your firm's financial capacity to retain risk. Senior management, perhaps the CFO, has some idea of what the firm can handle in terms of catastrophic loss. The wise risk manager, whether internal or consulting, should know what that number is and review it annually. ■

As chairman for the Risk Management Interest Group, I would like to remind all of our members of two needs:

- We are looking for additional members for our committee to join us in leading the interest group. We meet twice a year, at the CPCU Society's Annual Meeting and Seminars and at the Leadership Summit. Please apply online at the Society web site if you are interested.
- If you wrote an article or spoke at an event as a CPCU, please let us know by sending an e-mail to CPCURiskManagement@sbcglobal.net. We would like to hear about the things our members are doing.

Your Risk Management Interest Group Presents Two Seminars at the 2008 Annual Meeting and Seminars

Workable Wrap-Ups for Large Construction Projects

Monday, September 8
10 a.m. – Noon

Controlled insurance programs (OCIPs and CCIPs), also known as "wrap-ups," can be effective in controlling cost of risk and securing broad coverage terms for construction projects. A panel of experts will share the best practices to maximize the possibility that an OCIP or CCIP will be successful. Attendees will learn key issues to consider in determining if a CIP is feasible, some of the problems that owners and contractors encounter and how to overcome those issues. They will also discuss the coverage issues contractors must address in their own programs to assure they coordinate with the CIP insurance coverages.

Moderator
Jack P. Gibson, CPCU, CRIS, ARM

Presenters
Donald S. Malecki, CPCU

William D. Motherway, J.D.

Karen Keniff Schwartzkopf, CPCU, CIC, ARM

Karen Reutter, CPCU, ARM

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Workers Compensation for the 21st Century

Tuesday, September 9
10:15 a.m. – 12:15 p.m.

This seminar will discuss the history, development and future of workers compensation insurance. It will focus on current critical issues, the strengths and shortcomings of assigned risk plans and the management of experience rating modifications. It will also provide an actuary's view of self-insured plans.

Presenters
Robert P. Hartwig, Ph.D., CPCU

James R. Jones, CPCU, AIC, ARM, AIS

Filed for CE credits

Editor's Note

by Jane M. Damon, CPCU, CPIW, CIC

■ **Jane M. Damon, CPCU, CPIW, CIC,** is an assistant vice president and commercial account executive with Wachovia Insurance Services in Dallas, Texas. She earned a bachelor of business administration in management, and master of business administration in strategic leadership from Amberton University.

Damon also has earned the Chartered Property Casualty Underwriter, Certified Insurance Counselor, and Certified Professional Insurance Woman designations. She is past president of the CPCU Society's Dallas Chapter, and currently serves on the CPCU Society's Risk Management Interest Group Committee and edits its quarterly newsletter. Damon has more than 20 years of experience in the insurance industry, and works on large complex accounts in the real estate, construction, and technology fields. She has administered the two largest privately held construction projects (at the time) under a Contractor Controlled Insurance Program (CCIP) through a captive program. Damon joined Wachovia Insurance Services in October 2001.

March was Ethics Awareness Month for the CPCU Society. Ethics should not be a topic of discussion only one month out of the year. We should always keep ethics issues on our minds. In this issue, **David P. Schmidt, Ph.D.,** has written a thoughtful article outlining the difference in compliance and ethics.

Our Risk Management Interest Group chairman, **Stanley Oetken, CPCU, ARM,** has provided us with an article on the coming year in risk management.

It is hurricane season and **Randy J. Maniloff** has written an article on the insurance battle in Louisiana on flood exclusions and **Michael D. Strasavich, J.D.,** discusses business interruption arising from hurricanes and other disasters.

David J. Skolsky, CPCU, writes on the Risk Management Interest Group webinar titled "Emerging Issues in Risk Management" that aired in December. In addition to the article included in this issue, you can listen to the webinar and see the PowerPoint presentation on the Risk Management Interest Group's web site at http://riskmanagement.cpcusociety.org.

Do you ever ask why when carriers make requests? **Earl D. Kersting, CPCU, ARM, ALCM, AIC, AU, AAI, AIS,** has provided an article on how to explain why to your clients and help them understand items and their importance.

George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM, is back with an interesting article on teaching the meaning of value.

Please enjoy another wonderful issue provided by our authors. As always, please feel free to let us know your thoughts on the articles, what you would like to see, what you like and don't like. If you would be interested in providing an article, please contact me at jane.damon@wachovia.com. We welcome all authors and commentaries. ■

http://riskmanagement.cpcusociety.org

The Thrilla in MaNOLA: Court Resolves Heavyweight Insurance Battle in Louisiana

by Randy J. Maniloff

Randy J. Maniloff is a partner in the Business Insurance Practice Group at White and Williams, LLP in Philadelphia, Pa. He concentrates his practice in the representation of insurers in coverage disputes over various types of claims. Maniloff writes frequently on insurance coverage topics for a variety of industry publications, and his views on such issues have been quoted by numerous media, including *The Wall Street Journal, The New York Times, USA Today, Associated Press, Dow Jones Newswires,* and *The National Law Journal.*

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It was an insurance coverage case with all the trappings of a heavyweight title fight: (1) pre-fight publicity (The Associated Press ran a set-up story the day before oral argument.); (2) tickets nearly impossible to obtain (The courtroom was packed with 120 lawyers, paralegals, and law clerks.); (3) one of the most coveted prizes in sports on the line (At issue, insurance coverage for thousands of New Orleans residents whose homes were damaged by Hurricane Katrina); (4) unquestionable muscle in both corners (One of the appellate briefs had 59 lawyers on the service list.); (5) the fighters brought an entourage (There was a lot of amicus involvement.); and (6) the aura of a re-match hung over the ring (The policyholders had scored a stunning upset just seven months earlier and the insurers were hungry for redemption.).

Such was the atmosphere surrounding the May 6, 2007, oral argument before the U.S. Court of Appeals for the Fifth Circuit in I*n re Katrina Canal Breaches Consolidated Litigation v Encompass Insurance Company, et al.* Before the court was a review of a November 2006 decision by Judge Stanwood Duval, Jr. of the Eastern District of Louisiana that several insurance companies' flood exclusions that did not distinguish between man-made and naturally occurring floods were ambiguous and, therefore, did not preclude coverage for damage caused by the New Orleans levee breaches associated with Hurricane Katrina. *See In re Katrina Canal Breaches*, 466 F. Supp. 2d 729 (E.D. La. 2006).

On August 2, after promising a quick decision, three Fifth Circuit judges returned unanimous scorecards and reversed Judge Duval, holding that "The flood-control measures, i.e., levees, that man had put in place to prevent the canal's floodwaters from reaching the city failed. The result was an enormous and devastating inundation of water into the city, damaging the plaintiffs' property. This event was a 'flood' within that term's generally prevailing meaning as used in common parlance, and our interpretation of the exclusions ends there." *Katrina Canal Breaches*, 2007 U.S. App. LEXIS 18349, *79–80.

Given the significant length of the opinions from the District Court and Fifth Circuit, there is no short answer to the question: why did the courts disagree? For starters, both courts at least agreed on one thing—that their task in discerning the meaning of the flood exclusion must be guided by Louisiana's established rules of insurance policy interpretation, which follow the maxims of contract interpretation generally. However, agreeing on the ground rules is not the same as agreeing on their application. And that is where the courts parted ways.

It does not take a lot of effort for a court to conclude that an insurance policy provision is ambiguous. Insurance policies are complex documents, governed by a large body of case law, the determination of ambiguity is inherently subjective and the one making the call has years of experience in a profession in which finding more than one meaning in a word is a core skill. For these reasons, the District Court did not struggle to conclude that the flood exclusion was susceptible to two meanings and, therefore, ambiguous. In general, the court hung its hat on the following hooks (albeit in a 30-page discussion): that the word "flood" has numerous dictionary meanings and has been the subject of

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differing case law interpretations. *Katrina Canal Breaches* at 756.

The Fifth Circuit looked at the same arguments and concluded that they did not give rise to an ambiguity. It takes more effort for a court to conclude that an insurance policy provision is not ambiguous, and that's what the Fifth Circuit brought to the task. The court reviewed and rejected the various arguments advanced by the policyholders that the flood exclusion was ambiguous.

For example, the Fifth Circuit concluded as follows: The fact that a term used in an exclusion is not defined in the policy alone does not make it ambiguous. If so, "an insurer would have to define every word in its policy, the defining words would themselves then have to be defined, their defining words would have to be defined, and the process would continue to replicate itself until the result became so cumbersome as to create impenetrable ambiguity." *Id.* at *40-41.

The court also held that: "[T]he fact that an exclusion could have been worded more explicitly does not necessarily make it ambiguous." *Id.* at *43. "Nor does the fact that other policies have more explicitly defined the scope of similar exclusions." *Id.* at *44. And, just as the District Court did, the Fifth Circuit looked at numerous dictionary definitions of the term "flood." The Court of Appeals concluded that the dictionaries it reviewed "make no distinction between floods with natural causes and those with non-natural causes." *Id.* at *61.

But perhaps the biggest difference between the two opinions was the Fifth Circuit's adherence to La. Civ. Code Ann. Art. 2049, directing it to interpret a term with a meaning that renders the term effective. In doing so, the Fifth Circuit made the following sage observation about the District Court's distinction between man-made and naturally occurring floods: "Because levees are man-made, one could point

to man's influence nearly any time a levee fails. If a levee fails despite not being overtopped by the floodwaters, it is because the levee was not adequately designed, constructed, or maintained. If a levee fails due to the floodwaters overtopping it or loosening its footings, it is because the levee was not built high enough or the footings were not established strongly or deeply enough. . . . Any time a flooded watercourse encounters a man-made levee, a non-natural component is injected into the flood, but that does not cause the floodwaters to cease being floodwaters." *Id.* at *69.

In both boxing and litigation, when it's over, those on the losing side never agree with what's on the judges' scorecards. What's more, just as boxers never seem to retire, neither do unsuccessful litigants. The policyholders have sought *en banc* review from the Fifth Circuit. ■

Why?

by Earl D. Kersting, CPCU, ARM, ALCM, AIC, AU, AAI, AIS

Earl D. Kersting, CPCU, ARM, ALCM, AIC, AU, AAI, AIS, is assistant risk manager for The Kroger Co., Delta Division, in Memphis, Tenn., where he oversees all areas of risk faced by more than 100 retail stores in a five-state area. He has held the position since 1986. Kersting is a past president of the CPCU Society's Memphis Chapter, and a past member of the Risk Management Interest Group Committee. Kersting may be contacted at EARLKERSTING1@yahoo.com.

Author's note: If we, in risk management roles, expect compliance and follow-through, we need to educate our clients, customers, and employees regarding why certain questions are asked, why certain regulations, codes, and restrictions exist, and why we, and the carriers and organizations we represent, ask certain things of them.

Those of you with children know that they pass through a stage when they question everything with "Why?" No, not the teenage years when it's, "Why can't I do that?", or, "Why can't I go there?", but I'm referring to the much younger years when it's truly a quest for knowledge and understanding, not the pursuit of disagreeing with everything you say just for the sake of rebellion. (If you're a parent, I needn't say more; if you're not, you've got yours coming some day.) Asking questions such as, "Why is the sky blue?," and, "Why is the stove hot?," is how our young children begin to learn, and how we begin to teach them science, logic, and reasoning. At some point, perhaps after we've heard countless questions, or now have several children, we lose some of our patience for explanations and simply start to reply, "Just because," or the ever popular, "Because I say so."

Now think about your professional family: those with whom you interact not as a parent, but as a risk management professional. Have we lost our patience for explanations and simply reply, in a manner of speaking: "Just because," or: "Because I say so?" People in general seek to do a good job. In order to do a good job, they're typically interested in learning about their company, their duties, and why certain functions are performed or even necessary. They are in search of knowledge and understanding. If we spend a few moments with them, and explain the science, logic, and reasoning behind what we ask of them, they'll learn. If we tell them, because policy or regulation says so, they'll not see nor understand the logic of the reason to comply.

Consider the following: a locked fire exit. If we tell a client or customer an exit cannot be locked because it's against fire safety code, he or she may unlock it in front of us, and relock it as soon as we leave. If we tell the same client or customer that an exit cannot be locked because in the event of a fire, employees will be trapped in a fire and die, as did 25 employees at the Imperial Foods facility in Hamlet, N.C., and that the facility was fined $808,000 and that the owner, Emmett Roe, 65, was sentenced to 19 years 11 months in jail, suddenly the logic and reasoning—the "why"—take on significant meaning. Along with an explanation that includes logic and reasoning comes understanding and acceptance. That client or customer now sees the relationship between his or her rule, and their role in saving lives, or if less altruistic, may at least see the relationship to financial penalties, or imprisonment. For whatever reason the client is more likely to comply because the reason given them is no longer: "Because policy says so." The reason now has science and logic backing it.

Once those clients or customers have had the "why" answered, it often leads to shared understanding. Let's consider again that same locked fire exit. Once the client understands why the door can't be locked, it may lead to further discussion, such as: "If I can't lock the door, what can I do to deter theft?" Knowing the reason the client thought it necessary to lock the door, we as risk management professionals can now offer alternative solutions, such as time-delay-release alarmed doors, doors with approved break-away seals, or other acceptable options that satisfy the client's needs without jeopardizing occupant safety. However, without having first arrived at the "why," we would never have reached the stage of "instead, how about."

Oftentimes we don't get to work face-to-face with the client, but may be dealing via written correspondence or even through an audit form. It is perhaps even more important in those scenarios that we communicate to the client why certain issues are being questioned and audited, or else in the absence of understanding, the propensity to misstate the truth may be greater if the reason for the inquiry is not explained in detail. If a client simply has to initial an audit form regarding machine safeguarding, it's easy to make

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Why?

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his or her mark without giving it a second thought; however, if we share with that same client that Inca Presswood Pallets of Dover, Ohio, is being fined $157,000 after the death of an employee who was crushed while servicing a hydraulic press that had been disabled but not locked-out, that same client may think again about the potential for similar such incidents in their facility.

How about the teenager who died in early October after falling into a vat of sulfuric acid at the Coastal Circuits factory in Redwood City, Calif.? With that explanation, it may cause a client to reevaluate his or her HazCom and chemical safety processes instead of seeing an audit question regarding HazCom and checking it off because "I've got a program; it's in that binder on the shelf."

I could fill this article with countless stories and examples regarding why certain guidelines and recommendations exist, but that's not the intent of this piece. My message is simple: If we expect compliance and follow-through, we need to educate our clients, customers, and employees regarding why certain questions are asked, why certain regulations, codes, and restrictions exist, and why we, and the carriers and organizations we represent, ask certain things of them.

Explanation yields understanding; understanding yields acceptance; acceptance yields compliance; and compliance yields reduced frequency, reduced severity, and acceptable levels of risk. Explanation produces an acceptable risk, but as with any equation, when one element in the process is missing, the result can't be obtained. Reinforce the process, and the outcome can be repeated. ■

Ethics Above the Bottom Line

by David P. Schmidt, Ph.D.

■ **David P. Schmidt, Ph.D.,** is associate professor of business ethics and chairman of the Management Department in the Dolan School of Business at Fairfield University. Schmidt is also a member of the editorial advisory board of the Interdisciplinary Journal of Business Ethics. His most recent publication is *Wake-Up Calls: Classic Cases in Business Ethics,* 2nd edition. His Ph.D. in social ethics was completed at the University of Chicago.

Editor's note: This article first appeared in the March 2007 Chubb Compliance & Ethics Update and is reprinted here with permission.

Businesses across America are closely reviewing and enhancing their ethics programs, in large measure, because of the disturbing wave of recent corporate scandals. And yet, some companies may overlook questions of morality in their quest to stomp out corporate corruption. As one executive proudly told me, "We have a highly ethical company—nobody here has been arrested in the last year!" While we can appreciate the pride he takes from this achievement, something about his statement leaves us scratching our heads. It seems he has missed the importance of ethics.

It is vital for business to have rules of conduct, to enforce these rules and to punish wrongdoers. But this is not the whole story. To understand what's missing, we simply need to remember that there is a "bottom line" in ethics. Just as business has a monetary bottom line (to maximize profit), so too ethics has a bottom line—the duty to do no harm. Some version of this ethical imperative is found in nearly every society; it is the basis of our most rigorous standards of professional conduct, such as the medical professional's Hippocratic oath. The basic insight is this: we must ensure that we don't hurt others, especially without good reason.

While it is tempting to be content with not falling below the bottom line—e.g., nobody's been arrested—there is more to ethics than simply avoiding harm or staying out of trouble. We need to ask, "what's on the other end of the spectrum?" The question reveals the good we can accomplish by regularly promoting ethical behavior in the workplace. By moving beyond bottom-line ethics, businesses can act in a manner that inspires mutual confidence and increases the capacity of people to do their very best.

Compliance is about "playing by the rules of the game." Building upon this foundation, ethics is about "playing the game well." We see this distinction in sports. All sports activities are governed by rules. Some sports use referees or umpires who ensure that the rules are followed. To stay in the game, one must play by the rules, the bottom line. But simply playing by the rules does not guarantee one will win. To triumph, it is necessary to play better than the competition. Compliance with the rules is necessary and important, but it is not the whole story. In sports, success depends upon things like physical prowess, superior teamwork and strategy. In business, excellence in ethics depends upon things like loyalty, courage, trust, honesty and integrity.

True business leaders do not settle merely for meeting the ethical bottom line. Instead, they push relentlessly beyond this bottom line to pursue excellence in all aspects of their work. Not content simply to stay out of trouble, the preeminent will set new standards and best practices that will redefine what counts as success. ■

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Business Interruption Insurance Issues Arising from Hurricanes and Other Disasters

by Michael D. Strasavich, J.D.

■ **Michael D. Strasavich, J.D.,** is a partner with Burr & Forman LLP in Mobile, Ala. A native of Dallas, Texas, he is a graduate of Spring Hill College and the University of Alabama law school from which he earned magna cum laude honors in 1995. Since that time, he has maintained an active practice in the areas of insurance law, commercial litigation, and employee benefits law. He maintains active membership in national and state defense organizations and has spoken on several occasions to bar and industry groups on hurricane-related insurance issues.

The devastation of the Gulf Coast by Hurricane Katrina in August 2005 dwarfs any previous natural disaster in American history. Eight of the top 10 most costly American catastrophes in terms of insured losses have been hurricanes, with six of the top 10 occurring in just 14 months between August 2004 and October 2005. This growth in insured losses parallels recent growth in waterfront areas, with the largest population growth in Florida, Texas, and Virginia.

The Essentials

Among the myriad of claims arising from such disasters are business interruption claims. When first analyzing a business interruption claim, it is of paramount importance to read and understand the particular coverages within the policy. There are an infinite variety of available coverages and coverage forms, many of which are tailor-made for a particular company or business. Just a few of the prevalent coverages are:

- **Civil Authority:** Covers loss of business income and extra expense sustained from governmental denial of access to your property due to physical damage to third-party property.
- **Business Income:** Replaces income to the business that would have been earned had no loss occurred.
- **Extra Expense:** Pays necessary additional expenses incurred during the Period of Restoration that would not have been incurred absent physical loss or damage to the property. This often includes additional expenses to continue operating at the original location or at a temporary replacement location.
- **Contingent Business Interruption:** Covers loss of income incurred in the insured's business due to a property loss at the location of a key supplier or customer.
- **Leader Property:** Covers losses of business income stemming from damage to a third-party property that attracts business or customers to the insured's location.

Interruption by Order of Civil Authority

One common misconception of civil authority provisions is its perceived application to any action of government that causes a loss of income. This broad view is generally incorrect. Coverage under a typical civil authority provision requires physical damage to a nearby property, coupled with an action of a civil authority which prevents access to the insured's undamaged business location. The key inquiry is: Has a civil authority order "prohibited access" by requiring the business to close or suspend operations? See *Southern Hospitality, Inc. v Zurich American Insurance Co.*, 393 F.3d 1137 (10th Cir. 2004) (FAA's order on 9/11 grounding air traffic had not prohibited access to the insured's hotels, which remained open at all times).

Further, the prevention of access must be total, not partial, or a mere hindrance. See *St. Paul Mercury Insurance Co. v Magnolia Lady*, No. CIV. A. 297CV153BB, 1999 WL 33537191 (N.D. Miss. Nov. 4, 1999) (no coverage for casino-hotel whose business decreased 80 percent but which remained open during closure and repair of bridge); *Abner, Herrman & Brock, Inc. v Great Northern Insurance Co.*, 308 F. Supp. 331 (S.D.N.Y. 2004) (no coverage for Manhattan business where access was maintained though admittedly made more difficult after 9/11).

It should be noted that one court has resolved a civil authority provision and the "property damage" requirement quite differently. *Assurance Company of America v BBB Service Company, Inc.*, 593 S.E.2d 7 (Ga. Ct. App. 2003) (property damage requirement met by hurricane that did not make U.S. landfall as it caused property damage in Caribbean). Eliminating this issue, many policies will outline in a civil authority provision a requirement that the property damage that causes the civil authority order to issue must occur within a certain geographic radius from the insured's business location.

The Loss Must Be Caused by Physical Damage to the Described Location from a Covered Peril

Coverage for a business interruption claim will ordinarily be found where there is physical damage to the insured's business location caused by a peril covered under the subject policy. Each of these criteria is important in analyzing a business interruption claim.

First, the loss of business income must be caused by physical damage to the described location. Not all conditions interrupting business qualify as physical damage. See *Keetch v Mutual of Enumclaw Insurance Co.*, 831 P.2d 784 (Wash. Ct. App. 1992) (volcanic ash that fell on

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hotel after Mount St. Helens eruption, burying hotel in six inches of ash not physical damage where hotel remained open); *National Children's Expositions Corp. v Anchor Insurance Co.*, 279 F.2d 428 (2nd Cir. 1960) (snowstorm that caused reduced attendance at exposition did not trigger coverage where building was undamaged).

After this initial hurdle is cleared, it is important to establish that the property damage at issue was caused by a covered peril. See *Valley Forge Insurance Co. v Hicks, Thomas & Lilienstern, L.L.P.*, 174 S.W.3d 254 (Tex. Ct. App. 2004) (law firms business interruption policy containing flood exclusion afforded no coverage for closure of building due to flooding from Tropical Storm Allison). Traditional exclusions that are applicable to other coverages within the policy may also apply to the business interruption coverage.

One should also examine whether the physical damage is the cause of the claimed business loss, or whether other factors are involved. Business losses caused by factors other than physical damage to property, such as poor weather, will typically not be covered under a business interruption policy. See *Harry's Cadillac-Pontiac-GMC Truck Co., Inc. v Motors Insurance Corp.*, 486 S.E.2d 249 (N.C. Ct. App. 1997) (1993 snowstorm, not roof damage, caused business loss to a car dealership which was inaccessible for a week).

The Described Location and the Period of Restoration

The insured's business location(s) will usually be referred to as the described location (or described premises). The way the described location reads in the policy can be crucial in determining not only whether coverage is afforded for any loss, but also the period of time for which benefits are payable (referred to as the Period of Restoration). For example, is the described location listed as a particular suite or floor of a 10-story office building, or is it listed as the street address for the entire building?

Assuming there is (a) physical damage to the described location caused by a covered peril, and (b) a causal relationship between the physical damage and the lost business income, the question then becomes: How long is the period of time for which business losses are covered under the policy? This time period is customarily referred to as the Period of Restoration.

The Period of Restoration can be an actual period or a hypothetical period. Some policies define the Period of Restoration in terms of both an actual period and a hypothetical period. The Actual Period of Restoration is the period of time it takes the insured to actually repair or replace the damaged described location or to secure an alternate location of similar quality. The hypothetical Period of Restoration, applicable when the insured does not repair or rebuild, is the period of time ending "when the property at the described premises should be repaired, rebuilt, or replaced with reasonable speed and similar quality."

Calculation of the Period of Restoration can vary significantly depending upon the description of the insureds business location contained in the policy, as insurers of tenants in the World Trade Center learned in a series of cases following 9/11. The dispute central to many of these cases was the length of the Period of Restoration, with insureds typically contending that the Period of Restoration was the amount of time to rebuild the entire World Trade Center, and insurers contending the Period of Restoration was the amount of time it took the insured to secure an alternate, suitable business location.

The answer hinged largely on the description of the business premises in the policy and on the nature of the insured's operations at the business location. Generally, the more intertwined the insured's operations were with the damaged property, the broader courts tended to read the business interruption coverage. See *Zurich American Insurance Co. v ABM Industries, Inc.*, 397 F.3d 158 (2nd Cir. 2005) (engineer and janitorial contractor at WTC complex with space on every floor held to have used entire complex); *International Office Centers Corp. v Providence Washington Ins. Co.*, No. 3-04-CV-990 (JCH), 2005 WL 2258531 (D. Conn. Sept. 16, 2005) (Period of Restoration ends when WTC is rebuilt for exclusive provider of temporary WTC office space whose policy defined location as "One World Trade Center"); *Duane Reade, Inc. v St. Paul Fire and Marine Insurance Company*, 411 F.3d 384 (2nd Cir. 2005) (Period of Restoration for drugstore at WTC limited to time it takes to build reasonably equivalent store in reasonably equivalent location); *Lava Trading, Inc. v Hartford Fire Insurance Co.*, 365 F. Supp. 434 (S.D.N.Y. 2005) (Period of Restoration in policy that defined premises as Suite 8369 of World Trade Center ends when offices should have been replaced with other space of reasonable speed and similar quality).

Computation of Loss of Business Income

Even when coverage is found, a business interruption policy does not replace business income. More properly stated, such policies replace the profits of a business. If a business has lost money for an extensive period of time before the loss, it may be unable to recover under a business interruption policy.

Aside from the necessary causal relationship between the physical damage to the insured's business location and the business loss, courts will consider the pre-interruption performance of a business in determining the profits or income that a

business would have had (if any) during the Period of Restoration.

In *Dictiomatic, Inc. v United States Fidelity & Guaranty Company,* 958 F. Supp. 594 (S.D. Fla. 1997), a business claimed a loss of business income after Hurricane Andrew. The court determined that the insured failed to prove that but for the suspension of operations, it sustained an actual loss of business income that was caused solely by the hurricane and not by other factors. The insured could recover only to the extent that it actually lost sales or business during the periods when the business premises and business property were not functioning, and could not put the insured in a better position than it would have occupied without the interruption.

In *American Medical Imaging Corp. v St. Paul Fire and Marine Insurance Co.,* 949 F.2d 690 (3rd Cir. 1991), an ultrasound testing provider had a location sustain smoke and water damage from an adjacent fire, and immediately rented space in a temporary location. The temporary location had fewer telephone lines. To demonstrate a loss of income during its relocation, the insured showed business projections for the year in question and the accuracy of such projections in the past.

In business interruption claims after a hurricane, some insureds contend that they would have reaped a business windfall in the post-storm environment but for the physical damage sustained by their business. This has been dubbed by some The Island Theory as it theorizes profits of a business that is open while its competitors are all closed. Should post-storm business conditions be considered in computing lost business income under the policy? More specifically, in post-Katrina New Orleans, is a loss of business income the result of physical damage, or the result of a decreased population?

A couple of courts have considered these issues. In *Prudential LMI Commercial Insurance Co. v Colleton Enterprises, Inc.,* 976 F.2d 727 (4th Cir. 1992), a hotel damaged by Hurricane Hugo claimed that had it not been damaged, it would have seen a significant increase in business from claims people, repair workers, etc. The hotel, however, had lost $350,000 in the 32 months before the storm. The Court held that the insured should be placed in the position it would have occupied had no hurricane (not damage) occurred, and to do otherwise would be to confer a windfall on the insured. See also *American Automobile Insurance Co. v Fishermen's Paradise Boats, Inc.,* No. 93-2349CIVGRAHAM, 1994 WL 1720238 (S.D. Fla. Oct. 3, 1994) (dramatically increased demand for boats after Hurricane Andrew did not justify upward increase in business income for business interruption claim).

Conclusion

As with claims handling in other areas of insurance, it is of paramount importance to read and understand the provisions contained in a business interruption insurance policy. The details of the policy can influence tremendously the described location, the Period of Restoration, and the computation of business income. As increased hurricane activity is projected over the next decade or longer and as insurers continue to wade through business claims resulting from the storms of 2004 and 2005, proper and uniform handling of business interruption issues will benefit insurers and insureds alike. ■

Teaching Insureds the Meanings of "Value"

by George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM

■ **George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM,** is director emeritus at the American Institute for CPCU in Malvern, Pa.

Author's note: Lisabeth A. Groller contributed significantly to the substance of this article.

Dylan Howell had just landed his dream job as a new junior partner at the law firm of Smith, Smith, and Silverstein. The position came with a six-figure salary and a non-negotiable invitation to relocate his life to Los Angeles. Problem was Mrs. Howell always considered her Charles Town Queen Anne house as "the home of her dreams" and she also had made it clear that the five Howell children would never leave the state of West Virginia as long as they were minors. Knowing whose dream was more important, Dylan Howell divorced his wife, left his young children and moved into a $500,000 split level six blocks away from the Pacific Ocean.

Being a divorce lawyer, Dylan took just two weeks to sort out all the alimony, health insurance, and child-support arrangements. The properties and their insurance however, posed more of a problem. After all, Dylan did want to be fair. The Charles Town Queen Anne would be signed over to his ex-wife free and clear after the last 10 years of the mortgage were paid off. Dylan agreed to pay 50 percent of the mortgage and 100 percent of all the insurance in return, his ex-wife would not have any financial gain from or access to his new house or to his future salary after all five children graduate from college or reach 25 years of age.

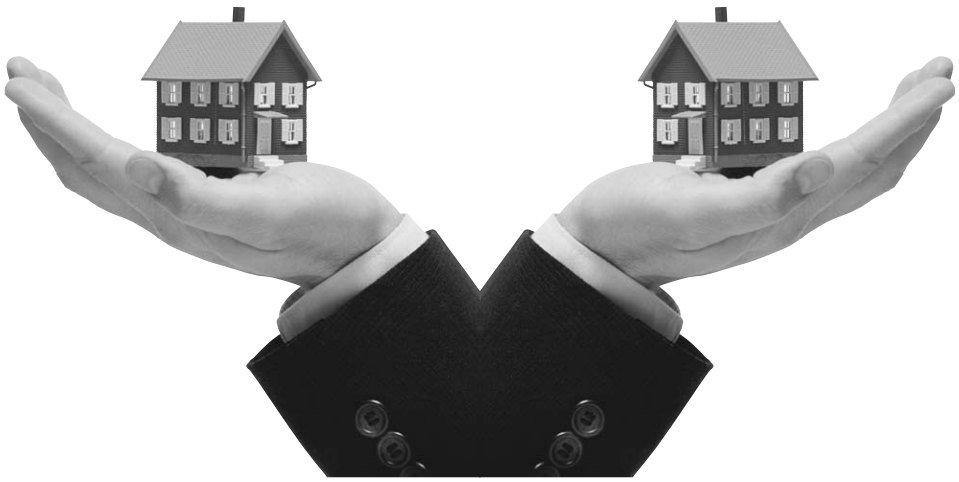
Market Value versus Insurable Value

Before signing his divorce papers, Dylan noticed the vast differences in the housing markets and the insurance premiums between his new split-level and his "ex's" Queen Anne. He has decided to ask an insurance expert two basic questions that will help him clarify the relationship between the house he owns, the house he used to own, and what, if anything, did the changing market values have to do with the amount of insurance he should carry on each house.

"First, my new California house would cost me only half as much if it were back home in Charles Town. Still, I know I paid way too much for my new place, but I deserve this location. So what do you base the insurance value on—the price I paid for the house or its actual value? What is its 'actual value' anyway?

"Second, my 'ex' doesn't know it yet, but there's a garbage-to-steam plant going in the next town over. That Queen Anne is never going to be worth what we paid for it. Can I get the place re-assessed after the plant goes in and buy less insurance? Come to think of it, what if my new neighborhood gets socked with a bunch of foreclosures or something, how do I know my insurance is adequate?

Dylan's two questions highlight many insureds' misunderstanding of important differences between the insurable values and the market values of homes and, in many cases, of commercial buildings as well. For property insurance purposes, the value of a building is defined as its actual cash value (historic cost minus accumulated straight-line depreciation) or its replacement cost (the current cost of replacing a building with materials



of like kind and quality as the original building, with due allowance for present-day construction techniques). Too many insureds equate market value with "what my property is really worth," and therefore the price at which I should be able to insure it. Because traditional insurable values do not move significantly with major changes in the market value of homes and other real property, homeowners like Dylan face a real dilemma when they try to buy insurance sufficient to cover the true value of their property as they see it.

If Market Values Fall

These dilemmas become particularly acute when market values change significantly and quickly. For example, if the Charles Town Queen Anne drops in market value when the trash-to-steam plant comes in, Dylan believes that he will not need to insure it for as much as he does now, because in his mind, the real value of the house went down. Therefore, as he has asked above, he expects that he can insure it for less, but this will create an "underinsurance to value" problem for the insurance company. For the insurer, its premium income will be inadequate to cover the property exposure if the amount of insurance were based on its declining market value. Moreover, if the market value does continue to drop and Dylan feels he is forced to buy more insurance on the Queen Anne than the house is worth, he may have an incentive to find a "creative" way to have the house destroyed by an insured peril. Ethical insurers should not use the insurance mechanism to tempt their insureds to take such desperate, and illegal, measures.

If Market Values Rise

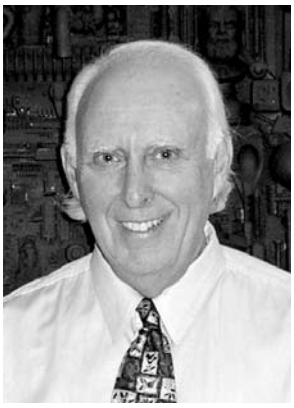
In contrast, suppose the trash-to-steam plant is replaced with a brand-new Arts Center, making Charles Town a much more attractive community in which real estate values climb. Then Dylan will expect that his ex-wife's Queen Anne will need more insurance to protect against loss of what Dylan sees as its true value. However, Dylan will again be confused why he cannot buy more insurance for the house. For the insurer, allowing Dylan to buy coverage beyond the house's insurable value possibly could expose the insurer to criminal liability for fraud for having sold Dylan more insurance than he can collect for even a total loss. More likely, however, Dylan's present insurer risks being replaced by a competitor who is willing to sell Dylan the amount of insurance Dylan thinks he needs.

Our Unchanging Obligation

Particularly in these times when the traditional insurance values of homes and other real property are not tracking well with the market values that insureds consider to be the true worth of their properties, and because so many policyholders are like Dylan in not understanding how insurers value real property, those who market insurance have a special duty to explain how insurance calculates the values in determining the amounts of insurance and of insured losses. We owe this duty not only to our insureds, but to our industry's future as well. ■

Risk Management Interest Group Webinar "Emerging Issues in Risk Management"

by David J. Skolsky, CPCU



David J. Skolsky, CPCU, is the owner of Insurance Analysts & Consultants, based in Avondale Estates, Ga. He relocated to the Atlanta area seven years ago from New City, N.Y., where he worked for more than 20 years for a national insurance brokerage organization. For the past 18 years he has been an independent property/casualty consultant. A graduate of Alfred University, he received his CPCU designation in 1975. Skolsky has taught various CPCU courses and was an active board member of the CPCU Society's Westchester Chapter. He is now a board member of the Atlanta Chapter. Skolsky's consulting practice is comprised of a diverse client base ranging from public school districts, small municipalities, real estate clients, manufacturers, contractors, and textile wholesalers.

The Risk Management Interest Group presented its first webinar on Thursday, December 6, 2007, at 12 Noon. The webinar, titled "Emerging Issues in Risk Management," lasted for one hour and covered three topics:

1. Climate Change—Insurance Implications
2. Nanotechnology
3. Genetically Modified Organisms

The webinar was presented by **Jeff DeTurris, CPCU.** DeTurris is assistant vice president—personal lines at ISO where he is responsible for all aspects of the production and development of personal lines rules, forms, and product pricing. He is also ISO's point person on emerging issues and coordinates ISO's emerging issues panel. DeTurris was outstanding in his role as presenter.

Arthur L. Flitner, CPCU, AICPCU/IIA did an excellent job as webinar moderator. Flitner is senior director of knowledge resources at the Institutes with responsibility for the planning and development of the Institutes' insurance coverage courses. He is the principal author or coauthor of eight insurance and risk management text books.

DeTurris spoke for approximately 15 minutes on each of the three subjects leaving time in between each topic for a brief question and answer period. The webinar was presented at no charge to CPCU Society Interest Group members.

By way of introduction, DeTurris provided insight to the reasons why and how ISO studies and monitors emerging issues. In order to "stay ahead of the game," ISO continuously monitors emerging issues since they all have in varying degrees insurance implications. To keep current on emerging issues, ISO formed an emerging issues panel comprised of approximately 40 insurance company members. On a bi-monthly basis, the panel discusses emerging issues in a group teleconference. Some of the current "hot topics" being monitored are:

- The Aging Public Infrastructure
- Avian Flu and Its Pandemic Potential
- Chemicals
- Climate Change
- The Green Movement
- Secondhand Smoke
- The Internet and Personal Injury
- Small Cars and Intelligent Roads/Highways

The first of the three topics discussed in the webinar was climate change. Climate change has many different insurance implications—the first discussed was property damage. Hurricanes and the widespread damage caused by Katrina were used as a prime example.

DeTurris brought up the question about potential claims against third parties for their alleged liability contributing to climate change. Does the standard GL policy cover such an allegation? Is the GL insurance carrier obliged to defend in such actions?

The issue concerning greenhouse gases was discussed with the EPA having the authority to regulate in this area. Today, many insurers insure intensive carbon producing industries. Are the directors and officers of these companies at risk if their companies are producing greenhouse gases?

DeTurris spoke about green buildings and the growing support for the LEED (Leadership in Energy and Environmental Design) Rating system. The green building movement may eventually produce premium credits for builders constructing environmental friendly buildings. Two important factors in the green movement are the increased costs of construction and the ordinance or law insurance coverage implications.

After a five minute break during which several webinar participant's questions were answered, DeTurris continued with the second subject of his talk, nanotechnology.

Very briefly, nanotechnology is engineering at the "atomic level." The standard measure is a nanometer. The size of a nanometer is a human hair split 80,000 times! At such an infinitesimal size, materials take on new characteristics that affect the physical, chemical, and biological properties and makeup of the original material. As a result of nanotechnology, a new language is developing. All fields of study are impacted by nanotechnology:

- Medicine/Surgery
- Cosmetics/Skin Creams
- Household Appliances
- Automobiles, Aircraft, Ships
- Computer Chips/Electronics
- Sporting Equipment

Some of the problems associated with nanotechnology are:

- Lack of information, what is the effect on the human body? With particles so small, they can enter the human body through the skin, in drinking water, in food additives. These microscopic particles can be inhaled and potentially cause respiratory problems.
- Significant workplace concerns for the workers dealing with nanotechnology. It is estimated that two million workers are exposed daily to nanotechnology materials.
- An important environmental concern dealing with nanotechnology is the extremely high mobility of nano particles which can cause contamination of soil and water.
- Nanotechnology must be established into our current regulatory system.

The third topic of the webinar was Genetically Modified Organisms (GMO). A GMO consists of any life form where the DNA has been modified for a specific purpose. DNA can be modified for numerous reasons—two important areas of research involve medicines and the resistance to disease. Scientists have been successful in modifying the genetic makeup of plants, corn, cotton, etc., so that they become insect resistant. The United States is the world leader in genetically modified crops.

Some of the benefits in genetically modified crops are—less fertilizers and pesticides are required, the environment is improved, and costs are reduced in bringing crops to the market. Plants can be made to be resistant to cold temperatures and be draught tolerant.

Some of the concerns dealing with GMOs are: human allergies, toxicity to insects that do good work, cross pollination-super-weeds are produced, at the present time labeling is not mandatory, and the ethical issue—we are dealing with nature. At present, regulation of industries dealing with GMOs has been very slow although there has been no discernible effects noticed on humans. Currently there are three U.S. agencies involved with GMOs—the Environmental Protection Agency, United States Department of Agriculture, and the Food and Drug Administration.

The webinar concluded at 1 p.m.

We would like to extend special thanks to the following for their outstanding efforts in creating a successful webinar: Jeff DeTurris, CPCU; Arthur L. Flitner, CPCU; John Kelly, CPCU, ARM; Steven M. Wooton, Sr.; Nancy S. Cahill, CPCU; Martin J. Frappolli, CPCU; and Jerome Trupin, CPCU, CLU, ChFC. Also the members of the Risk Management Interest Group webinar subcommittee Stanley E. Oetken, CPCU; Patricia A. Hannemann, CPCU; Bill Carr, CPCU; and David J. Skolsky, CPCU. ■

For anyone interested in listening to a recording of and viewing the PowerPoint slide presentation of the webinar, it is available at no charge by accessing the CPCU Society's web site. Click on the Risk Management Interest Group's web page and then click on the Webinar Archive.

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