Risk Management Quarterly RMQ

Volume 24 Number 1 March 2007

From the Editor

by Jane M. Damon, CPCU, CPIW, CIC

Jane M. Damon, CPCU, CPIW, CIC, is assistant vice president/commercial account executive for Wachovia Insurance Services in Dallas, TX. Damon has more than 20 years of experience in the insurance industry. She works on large, complex accounts in the real estate, construction, and high-tech fields. She has more than nine years' experience with American Contractors Insurance Group on large construction contractors as a special account executive, where she administered the two largest privately held construction projects, at the time, under a Contractor Controlled Insurance Program (CCIP) through a captive program.

Damon is past president of the CPCU Society's Dallas Chapter, was national new designee representative, and currently serves on the national Risk Management Section Committee as editor of the *RMQ*.

It is a new year, and a new set of articles for you to enjoy in the *RMQ*.

This issue includes two articles from regular contributor **Jerome Trupin, CPCU, CLU, ChFC,** one on policy forms and language, the other addressing business interruption and the difference between suspension and interruption on the policy form.

And again, our very own regular contributor, **George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM,** director emeritus, American Institute for CPCU, has provided an article that will surely bring some thought and controversy.

"The Shocking Future Facing Risk Managers" is a great article to get you thinking, written by **Elise M. Farnham, CPCU, ARM, AIM, CPIW, RPA.**

Brian Jilek, CPCU, ChFC, ARM, AIAF, CBCP, has provided an article on how to prepare for emergencies. With the continued interest in captives and alternative markets, **Albert R. "Skip" Counselman, CPCU,** with RCM&D, has provided an article on five keys to captive success.

Risk Management Section Committee member **Martin J. Frappolli, CPCU, AIS,** has provided an overview of the Risk Management Section web site. He provides information on how to navigate the system, and on the information available.

We are off to a great start and a wonderful new year. 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. ■

What's In This Issue

Greetings from the Chairman

by Patricia A. Hannemann, CPCU

Patricia A. Hannemann, CPCU, is chairman of the CPCU Society's Risk Management Section. Her insurance career consists of more than 20 years' experience working in agencies and companies. Currently, she is working with The Insurance Society of Baltimore in promoting and teaching various insurance classes. Hannemann served as the CPCU Society's Maryland Chapter president, and chaired both the Public Relations and Good Works Committees. The Maryland Chapter's CPCU Excellence Award was presented to her for spearheading the Good Works Committee and establishing the chapter's scholarship fund in connection with the SADD organization. Serving on the CPCU Society's Chapter Awards Task Force, she helped create and judge the current Circle of Excellence Recognition Program. Hannemann received her CPCU designation in 1987, and holds bachelor's and master's degrees in music from the Manhattan School of Music, and a master's degree in business from Johns Hopkins University.

The holidays have ended, and we are back to our normal routine. It's that time of the year when it is supposed to be cold. So, what has happened to the weather? It seems Wisconsin is often warmer than Atlanta. These weather changes must really keep the modeling projections for weather-related losses puzzling. My philosophy is "only Mother Nature knows what will happen next."

As you may have noticed, we are attempting to keep our *RMQs* at their regular intervals as well as "loaded" with extra special material that keeps you abreast of what is happening in the insurance industry. Thanks to our wonderful editor, **Jane M. Damon, CPCU, CPIW, CIC,** the *RMQ* just keeps getting better and better. We've changed the format of the *RMQ* so the editor's message is on the front for you to scan and find out what exciting topics are contained within. Let us know if you like this approach better or if you have any suggestions to make your *RMQ* more reader friendly and enjoyable.

Our Risk Management Section web site keeps expanding thanks to **Martin J. Frappolli, CPCU, AIS.** In this *RMQ*, Marty has an article to help you become acquainted with the various segments and items on our site. You can view pictures taken at the various meetings and even read the meeting minutes, if that is of interest to you. Overall it is quite informative. Oh yes, you can even view the latest *RMQ* prior to receiving the printed copy. When you receive Marty's e-mail regarding the *RMQ*, you are able to access it on the Risk Management Section web site once you log in to the site.

As we all know, time passes too quickly; therefore, we are now in the process of planning the exciting seminars for the CPCU Society's Annual Meeting and Seminars in Hawaii in September 2007. Just imagine being in Hawaii, the wonderful climate, all of the exciting sessions, and of course those beautiful beaches. Usually the new designee class doubles when the conferment is in Hawaii, so why not join everyone there? As usual, we will keep you posted on our sessions through articles in the *RMQ*. However, between now and then we have a lot of work to accomplish as well as an exciting mid-year meeting, April 18–21, 2007, in Orlando, FL, for the NLI and section committees. These are two wonderful and exciting places to visit, so mark your calendars to attend the sessions and visit these exciting places. You can register online at **www.cpcusociety.org.** ■

Be Sure to Attend Your Risk Management Section Seminar at the 2007 Annual Meeting and Seminars!

Sustaining Profitability through Enterprise Risk Management

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Register today for the CPCU Society's 2007 Annual Meeting and Seminars at www.cpcusociety.org.

And stay tuned for more information!

Preventing, Preparing for, and Responding to Emergencies

by Brian Jilek, CPCU, ChFC, ARM, AIAF, CBCP

■ **Brian Jilek, CPCU, ChFC, ARM, AIAF, CBCP,** got his risk management start in business continuity. Jilek is an American Red Cross (ARC) Disaster Services Instructor, and co-founder of the Central IL chapter of the non-profit Association of Contingency Planners (ACP). He is also a limited lines producer (state of Illinois)/ Independent Associate for Pre-Paid Legal Services Inc.

Earl. D. Kersting's article "Not If, But When Will It Happen? . . . " in the October 2006 *Risk Management Quarterly* got me thinking. As we close out 2006 and enter 2007, we all ought to build in at least one New Year's resolution.

This resolution applies both personally and professionally. The American Red Cross's mission helps frame this resolution for each of us, as the Red Cross is committed to *helping people prevent, prepare for, and respond to emergencies*.

For starters, personally we are responsible for our own prevention, preparedness, and response. The reality of the three scenarios (9/11, Katrina, avian flu/ pandemic preparedness) that Kersting cited in the opening of his article is that the cavalry perhaps didn't arrive either in the timing we would have envisioned, or with the resources we would have thought they'd have brought or both. There may come a time, like in a pandemic outbreak in our era of globalization, where the cavalry from state and national levels may not arrive—the broad-based impact may affect each level to the point they cannot respond.

The Red Cross chapter for which I volunteer prepares with a 72-hour time frame in mind, and I think this is a universal expectation within that organization—each chapter handling its local environment for 72 hours before assistances from other chapters and national can be mobilized and arrive. If we adopt a similar window to help ourselves, we are first and foremost better able to meet any situation for our own households and immediate families. Second, we're no longer the draw and the burden on the possibly over-burdened system we once were.

■ ***To prepare our businesses with prevention, preparedness, and response, we need to be connected.***

To that end, the Red Cross offers family preparedness assistance. Personal planning for families—American Red Cross "disaster planning" guidance (http://www.redcross.org/static/file_cont36_lang0_23.pdf#search=%22red%20cross%20family%20disaster%20plan%22).

So the first part of our resolution is three tasks: (1) to access this document, (2) print it, and (3) do it!

The second part involves our businesses. We cannot prepare our clients, if we are not ourselves prepared, practiced, ready, and available. The value that I've seen in business continuity plans is not necessarily the I's dotted and T's crossed to the nth degree (although critical information like vital contact details ought to be accurate and up to date!). The value is in the process of planning: studying our business, studying our connection points, the inflows, the outflows, supply chain, and risks present to each of those, and cost-effective mitigation to these risks. In a disaster, the best planning may go quickly out the window, like the NFL coaches of renown who have to toss out their opening playbook and call audibles to win the game. If we don't understand our game as it's unfolding, it's difficult at best to call effective audibles.

To prepare our businesses with prevention, preparedness, and response, we need to be connected. Our first level of any event will be our crisis management. Crisis management will through time give way to business continuity and disaster recovery. None of these will happen in a vacuum, and one of the best preparedness activities any professional can do is network.

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Preventing, Preparing for, and Responding to Emergencies

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Network with the government (local, state)—the first responders in the fire department (fire marshal) or the health department (director) who will make critical decisions about your business and access to your buildings in say a fire, or a pandemic outbreak. Understand their concerns, what they will consider, how they will consider it, and let them understand yours. Trade business cards—ensure points of contact are in synch flowing both ways.

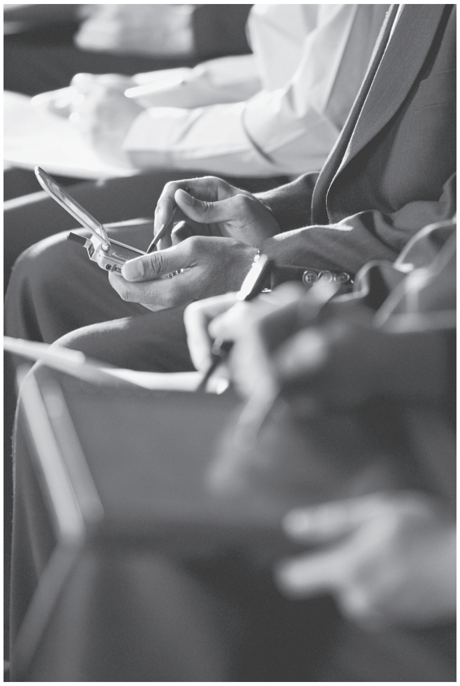
Network with private practices within your industry. Leverage knowledge within your industry—specific challenges each industry faces and how others have mitigated them or are planning to deal with them.

■ ***Network with private practices within your industry . . . network outside of the industry . . . and network and understand your regulators and regulatory climate.***

Network outside of the industry. Keep the pulse of "best practices" regardless of an entity's affiliation because there are issues we will deal with that transcend public versus private, insurance versus banking, etc.

Network and understand your regulators and regulatory climate. Certain industries and regulators expect and demand more in the way of preparedness from specific entities. Understand and exceed these expectations.

Professional non-profit associations such as the ACP can provide these types of networking opportunities.[1]



And always, always be cognizant of the three points of the resource triangle for business continuity. **First,** people. Second and third, facilities and technology. Engage in the planning process, understand what resources in each of these three your business utilizes and how, and consider mitigation to assist with your risks. The nicest facility and the most cutting-edge technology work for nothing without your people. By way of example, companies impacted by Katrina set up tent cities for their employees without housing and provided cash loans for employees in need of money for necessities. These were audibles companies called to meet needs and continue operations.

So here's to 2007, and all of us, personally and professionally, working on our prevention, preparedness, and response to future disasters. Certainly not an "if" for any of us, it is a matter of when—and I propose we as risk managers lead by example. ■

Endnote

1. ACP main site (for risk managers looking for a network or chapter) is http://www.acp-international.com/

The Shocking Future Facing Risk Managers

by Elise M. Farnham, CPCU, ARM, AIM, CPIW, RPA

Elise M. Farnham, CPCU, ARM, AIM, CPIW, RPA, is president of Illumine Consulting, a firm serving the risk management and insurance communities. She began her career in 1973 with Crawford & Company, and became its first female claims branch manager. She is a member of the CPCU Society, and has served on the Board of Governors and various committees and task forces. She is a member of the American Institutes' Associate in Risk Management Advisory Board. Farnham is past president of the National Association of Insurance Women, and currently serves on the Board of the Insurance Professionals of Atlanta. She has been named Insurance Woman of Atlanta, and National Claims Professional of the Year. Her articles have been published in *Business Insurance*, *Claims* magazine, *Claims Quarterly,* and other publications.

The challenges facing businesses and organizations today continue to increase in complexity, cost, and impact. Future risk managers will face challenges we haven't even considered today. More will be expected of them, and their importance to their organizations will be greater than ever. With growing demands being placed on them, they will seek out knowledge and assistance. I fear they will be shocked by the shortage of available help.

As a member of the Risk and Insurance Management Society's professional development faculty since 1995, I have met many new risk managers. It is exciting to see their enthusiasm, their eagerness to learn, and their professionalism as they begin to grasp the scope of the challenges facing their organizations. It is particularly gratifying to see their employers encouraging them to expand their knowledge in order to capture the best ideas for dealing with the exposures they face. The young professionals seek out information aggressively by attending educational programs and earning designations such as the Associate in Risk Management and the RIMS Fellow.

Far too many risk managers still enter the field with no knowledge of insurance or the process of risk management.

I meet more and more new risk managers who are entering the field with backgrounds in accounting or risk management, which puts them far ahead of the point where many of my peers stood at the same point in our careers. When I first entered the industry, it was unheard of to find anyone with a degree in risk management. But not all of today's new risk managers have a finance and risk management background, education, and training. Far too many risk managers still enter the field with no knowledge of insurance or the process of risk management. Many do so because an unforeseen job opening occurs and they are shifted from another part of their organization to assume risk management duties.

How does this happen? My best guess is that it happens as companies grow and are pressed to pay more attention to loss exposures due to rising costs. Owners and senior executives know they need someone paying attention to these issues, but are not risk managers themselves, and may be uncertain as to the skills required. Or, they may simply be hard pressed to find the time to search for someone with the appropriate skills, preferring instead to focus on their core business. They make a determination that it is better to promote someone from within who is familiar with the organization to take over these duties in hopes of learning risk management processes and techniques later, rather than find a risk manager professional with knowledge of their organization's unique loss exposures.

When the new risk manager steps into the position, insurance professionals—brokers, agents, underwriters, adjusters, consultants—spend a lot of time informally training and educating the person about loss exposures, insurance products, policy language, policy management, and a myriad of other issues.

So, "big deal," you might say! Maybe no "big deal" for us, the ones who entered the industry 20 to 30 years ago when it was hard to find anyone with a degree in risk management or insurance and when formal in-house education programs and on-the-job training from coworkers and other insurance professionals was the business model for training entrants to the field. This is, however, a "big deal" for future entrants to the field of risk management. If there are fewer experienced professionals in the industry, who will provide the on-the-job training that new entrants need? Who will serve as mentors?

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The Shocking Future Facing Risk Managers

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The Board of Directors for the Registered Professional Adjusters Society, of which I am a member, is undertaking deliberation on the future of the insurance adjuster. What will the job look like? How many adjusters will there be? And, will knowledge certification be necessary and desirable? The average age for claims adjusters is presently over 40, and the Bureau of Labor Statistics predicts that the need for new claim handlers will increase by 19 percent over the next 10 years. I personally doubt that all of those positions will be filled. If they are not filled, who will serve to educate new risk managers about claims issues? In fact, who will be available to handle the claims at all? How will risk managers deal with the losses they face if there are too few claims professionals available to adjust and resolve the losses?

The future of other insurance professionals is no less uncertain. For all intents and purposes, personal lines underwriting is a thing of the past, and companies are vigorously searching for methods of underwriting that will commoditize commercial lines as well. Underwriters have always been the best source of information regarding loss exposures faced by organizations. A new risk manager could count on the underwriter to outline specific risks and exposures faced by the business when providing an overview of the insurance program. Without experienced underwriters, how will a risk manager know that most if not all exposures have been addressed?

■ ***How do we gain the necessary knowledge to do the job when there are fewer and fewer professionals available to help?***

This is what makes the future shocking for risk managers. How to gain the necessary knowledge to do the job when there are fewer and fewer professionals available to help.

Unfortunately, I don't have a good answer to this dilemma, but there are some possibilities. For instance, industry organizations will be challenged to offer more and more educational events and activities to maximize learning opportunities. Insurance companies may expand services to businesses by offering insurance education along with safety and loss control services. And, let's not underestimate the power of the Internet to put information at the fingertips of the new risk manager.

In the future and after the "shock" of a promotion, the new risk manager will seek out information and knowledge. Insurance companies and consultants who can provide information as well as insurance protection will have a competitive advantage. ■

Plain Vanilla or Tutti-Frutti?

by Jerome Trupin, CPCU, CLU, ChFC

Jerome Trupin, CPCU, CLU, ChFC, has worked as a consultant for mid-sized commercial and governmental entities since 1975 and as an expert witness in a variety of insurance coverage disputes. He has written extensively on insurance topics including numerous insurance textbooks for the American Institute for CPCU and the Insurance Institute of America, such as *Commercial Property Risk Management and Insurance* and *Commercial Liability Risk Management and Insurance,* the texts for CPCU 551 and 552 (formerly CPCU 3 and 4). He is currently working on the revision of *Commercial Insurance,* the text for INS 23 and CPCU 557. He has spoken on insurance topics across the country. Trupin headed a local insurance agency until 1989, and is a graduate of Syracuse University School of Management, with a major in accounting, and Columbia University Graduate School of Business where he majored in insurance.

It was commonplace to refer to ISO forms as "plain vanilla" or "industry-standard" with the implication that individual company forms are superior. This may once have been true, but ISO forms have come a long way. It's still true that some individual company forms do provide broader wording, but many times it is ISO's treatment that is preferable.

To illustrate this, let's look at four ISO provisions:

- definition of "suspension" in the business income policy
- waiver of subrogation
- dishonest acts exclusion
- insects, birds, rodents, or other animals exclusion

Definition of Suspension

We have always felt that a partial interruption of operations caused damage by an insured peril at the insured's premises triggered business income coverage; however, the courts feel otherwise. In an example of "tough cases make bad law" the judge in a case involving deficient computer equipment that was alleged to have caused a business income loss fastened on the word "suspension" and said that since operations were not "suspended," only slowed down, there was no coverage. This line of reasoning has been adopted in numerous cases.

In tacit agreement that this was not the intent of the policy, ISO has added a definition of suspension to its business income form. It is:

> "Suspension" means:
>
> a. The slowdown or cessation of your business activities; or
>
> b. That a part or all of the described premises is rendered untenantable, if coverage for Business Income including "Rental Value" or "Rental Value" applies.

If an independent form still uses suspension and doesn't define it, there is a problem.

This topic is discussed in more detail in another article shown on page 13.

Waiver of Subrogation

Of course ISO can't use the word "subrogation" any longer; simple language requirements dictate that it be called "transfer of your rights of recovery against others to us," which is much clearer, right? Be that as it may, ISO's subrogation provision is much better than the one found in most independent forms:

> . . . But you may waive your rights against another party in writing:
>
> 1. Prior to a loss to your Covered Property or Covered Income.
>
> 2. After a loss to your Covered Property or Covered Income only if, at time of loss, that party is one of the following:
>
>   a. Someone insured by this insurance;
>
>   b. A business firm:
>
>   (1) Owned or controlled by you; or
>
>   (2) That owns or controls you; or
>
>   c. Your tenant.
>
> This will not restrict your insurance.

Few independent forms have the wording shown in paragraph two, and some are silent on the issue entirely.

Dishonest or Illegal Acts Exclusion

Almost all property forms, including ISO's, contain an exclusion of losses due to dishonest or illegal acts of employees as well as others, but the others aren't pertinent to this discussion.

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ISO's exclusion contains an exception—one sure way of mystifying the reader is to put an exception into an exclusion. The ISO exception reads:

> This exclusion does not apply to acts of destruction by your employees (including leased employees); but theft by employees (including leased employees) is not covered.

. . . one sure way of mystifying the reader is to put an exception into an exclusion.

Not every form contains this exception. In one case, an irate employee torched his employer's factory. The insurer's form did not contain this exception to the exclusion, and the court agreed with the insurer that there was no coverage.

Insects, Birds, Rodents, or Other Animals Exclusion

A deer crashes through a plate glass window and bleeds all over the expensive merchandise displayed in an upscale store. The insured has special form so the loss is covered, right? Yes, if it is a current version of the ISO special form; maybe not if it is an independent or old version of ISO.

The current version of ISO's insects, etc. exclusion reads:

> We will not pay for loss or damage caused by or resulting from . . .
>
> Nesting or infestation, or discharge or release of waste products or secretions, by insects, birds, rodents, or other animals.

But some versions of this exclusion read:

> We will not pay for loss or damage caused by or resulting from . . .
>
> Insects, birds, rodents, or other animals.

Under the latter version, no coverage.

Deconstructing the "Evil Empire"

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 AICPCU in Malvern, PA.

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

In the ever-lengthening wake of 2005's Hurricane Katrina, several major homeowners insurers—including those who claim to be "like a good neighbor" and "on your side," as well as those who assure that "you're in good hands"—are now publicly labeled, much like the tobacco industry, as perpetrators of "the evil empire."

How did this happen? How can it be fixed?

What Happened?

It began when homeowners insurers with large exposures in Louisiana and along the rest of the Gulf Coast forgot that they were not merely insuring dwelling structures—they were insuring peoples' lifetime dreams. Instead of honoring the trust they had worked so hard to build in policyholder's hearts and minds, these insurers—seemingly striving to protect first their underwriting profits and only second their insureds' futures—sought refuge in some technical policy language that few homeowners ever understood. These insurers maintained, to thousands of distraught homeowners and in the federal courts, that Katrina's damage had resulted from storm surge and flood, not from wind. Therefore, virtually all homeowners insurers argued, they were not legally obligated to honor any water or flood claims. According to recent news reports, these insurers encouraged their engineers and adjusters to conclude wherever possible that the damages from Katrina were caused by water, not by wind and therefore the claims were denied. (See ABC News online "The Blotter" report of August 28, 2006, by Brian Ross and Joseph Rhee.)

Could these insurers not have foreseen that their purposefully biased conduct was contrary to traditionally objective loss adjusting procedures, thus inciting lawsuits and public condemnation? Indeed, it was largely on this very basis that a federal jury in Gulfport, Mississippi awarded $2.5 million in punitive damages against one insurer for denying Norman and Genevieve Broussard's homeowners claim for Katrina damages—a punitive award more than 10 times their original $225,000 claim. (See MSNBC News online Associated Press report of January 11, 2007.) After this verdict, the Broussards' attorney likened these insurers to rulers of "the evil empire."

Adding to this tide of lawsuits, Senator Trent Lott of Mississippi and his brother-in-law attorney Richard Scruggs are suing their homeowners insurer. Together they contend that their homes were destroyed by Katrina's wind, not flooded by storm surge. The political ramifications of this and similar suits may be as damaging to the insurance industry as those that have been brought against the tobacco industry for its breach of the public trust.

How to Fix It

Most insureds, particularly homeowner policyholders, truly believe that their insurer will come to their aid when disaster strikes. However, most insurers—immersed in the statistics and contract language of their daily work—can too easily lose sight of the immense long-range value that this public trust brings to the insurance industry. Therefore, one essential element in preventing another industry maelstrom like Katrina brought is for insurers to recognize that policyholders' trust is one of the industry's most valued assets. Insurers must practice their own risk management to protect this asset. Moreover, insurers must establish special procedures so that they begin to operate more effectively in the face of even such national disasters as September 11 and Katrina.

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Risk Management of Insureds' Trust

One essential part of maintaining policyholders' trust is to have honest and clear communications regarding policy coverage. Most Katrina victims did not realize in advance that insurers would classify water damage during a hurricane as flood damage and, therefore, not covered. Insurers should have made this point clear before the storm hit—indeed before any hurricane was imminent. Explaining this key point only after Katrina hit was simply too late for the industry—the loss of public trust had already occurred. To prevent future confusion and even more lawsuits, insurers need to explain to every new homeowner insured that water damage from hurricanes will not be covered. As a longtime supporter of the insurance industry, I would like to think that insurers would have foreseen these public trust issues before they turned into lawsuits. Risk management also applies to safeguarding insurers' assets—especially the faith policyholders have in their insurers.

Even though it is too late in the case of Katrina, we still need to remember that another disaster surely will come—perhaps not as a hurricane but as an earthquake or a massive terrorist attack. Homeowners insurers, but not most homeowners policyholders, know that earthquake and war are not covered perils. Rather than have the industry once again turn its back on policyholders who still have faith that their insurer will come to their aid, should homeowner insurers now make a special effort to explain to insureds what perils are not covered? Or do we once again want to go through another Katrina policyholder public relations debacle?

Special Procedures for Major Disasters

Unexpected—even unprecedented—disasters are bound to strike some day. How can insurers maintain both their financial strength and policyholders' trust after a disaster strikes? Even the most clearly written insurance contracts cannot protect insurers against as yet unknown exposures. Furthermore, Katrina shows that insurers' present underwriting and claims practices can no longer alone protect all homeowners against the loss of their American dream.

To cope more effectively with true national disasters without endangering their financial strength, insurers need to better prepare themselves for extraordinarily widespread claims and resulting lawsuits. First, where physical evidence of the causes of specific losses is not present—such as when Katrina ravaged southern Mississippi, leaving only concrete slab foundations but no clear evidence as to whether it was wind or it was water that swept away insureds' homes—a one-time coverage-restoring exception to insurance policy exclusions under some very special conditions could be instituted. This exception would allow homeowners to redeem their full claim within the limits of their insurance contract, give them coverage portability to move to a less flood-prone location, while also giving insurers the right not to honor repeated similar claims from the same insureds if they fail to take proper precautions against future repetitive claims. This exception is meant to reinforce, certainly not to weaken, standard well-conceived flood insurance contract language, underwriting standards, and claims procedures.

Second, insurance companies need to inform homeowners in flood- or hurricane-prone areas about the limits of their own private insurance, and the limits of buying government flood insurance. We in the industry know that flood insurance does not fully restore or replace flood-damaged property. Homeowners need to know this too; we need to teach them.

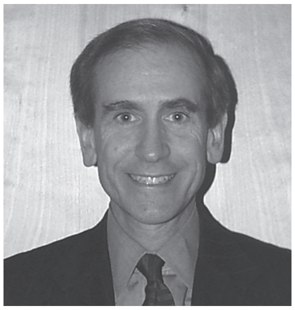
Third, the authority to declare that a particular catastrophic loss, such as Katrina or September 11, is a national disaster should rest in the hands of Congress, not with any insurer or group of insurers. Congress alone has the power to give insurers tax breaks and perhaps other financial incentives for providing one-time-only exceptions to insurance policy exclusions. In an area where Congress has declared a national disaster, it should be presumed that insurers will settle losses under the more liberal exceptions rather than the more restrictive exclusions to provide meaningful real-time relief to affected insureds. In contrast, when Congress has not declared a national disaster, insurers presumably will apply the more liberal exception coverage only when they judge that its use is appropriate. This will prevent great numbers of enraged insurers from suing for, and likely winning, punitive damages.

Some serious questions remain. Such as how the insurance industry can work most effectively with FEMA and other public entities in both the short and long run without allowing the government to dictate how they conduct their free enterprise endeavors. Such questions reach beyond traditional insurance and risk management concerns into some new realms of politics and public governance.

I recognize that these proposals raise many significant issues for property/liability insurers, probably more issues than I realize. However, the currently vilified state of our industry demands innovative yet measured actions to restore policyholder faith and to safeguard the continued financial strength of insurers. Most especially on this occasion, your comments are certainly welcome. Please e-mail me at head@cpcuiia.org. ■

Five Keys to Captive Success

by Albert R. Counselman, CPCU



Albert R. "Skip" Counselman, CPCU, is president and CEO of Riggs, Counselman, Michaels & Downes, an Assurex Global Partner based in Baltimore, MD. He is vice president and director of Professional Agencies Reinsurance Ltd., an agents' E&O captive facility developed through the cooperative efforts of Assurex Global, The Council of Insurance Agents & Brokers, and Fireman's Fund.

He can be reached at acounsel@rcmd.com.

The mid-1980s were not easy times for many agents and brokers. Markets were changing—or disappearing. Agents and brokers spent much time trying to find adequate coverage at relatively reasonable prices. But they weren't always successful.

Most property and casualty insurance clients faced dramatic premium increases. Some counted themselves fortunate to get any coverage at all. The industry saw a higher-than-normal number of carrier insolvencies. And more businesses found their way into alternative markets, with many setting up captive insurers.

It was during this time that some independent agents and brokers came together to devise a way to take better control of our own destiny and insulate ourselves from market volatility. Together, we formed an agents' errors and omissions coverage captive to serve our own needs. Since then, many of us—our agency included—have helped clients form their own captives. Our agency, for instance, manages several captives focusing on professional liability for hospitals.

Through these activities, we've identified several elements that help contribute to creating a successful captive and managing it profitably over time.

1. **Long-Term Focus**
   Perhaps the most significant success factor is to bring together a group that has a long-term reason for wanting to do this. For our agents' E&O captive, it was to gain control of our destiny over the long run and to let us benefit from our collective efforts to better manage our operations. Captives that sprout up simply to avoid impending premium jumps or to address cyclical market tightening generally don't succeed.

   When we formed this captive, we thought far into the future. For instance, we knew exactly what our coverage form needed to be over time. We wanted to ensure a high level of consistent, predictable protection. When you exist at the mercy of market conditions and the in-and-out nature of some carriers, you run the risk of inadequate coverage—often when you need protection the most. As a group, we understood the risks we presented, and were comfortable that we could jointly protect against losses we might encounter and could manage our risks in such a way to minimize those potential losses.

2. **Effective Risk Management**
   The second key success factor involves having a risk management program that responds to exposures you're looking to insure. When we created our agents' E&O captive, we believed we had an effective way to control our exposure to loss. As it turned out, we were right. We've done a good job in keeping losses to a minimum. That's because we agreed up front to spend a lot of time concentrating on potential losses, which can represent anywhere from 60 percent to 70 percent (or more) of the premium dollars.

   A risk management program can be driven internally—insureds working with each other using staff loss prevention and risk management professionals. Or it can be driven by outside consultants.

   Whether you're talking about road contractors or hospitals or agents and brokers, every organization has in-house expertise. And you want to use it. You need to bring members together to share best practices. It's in everyone's mutual best interest to understand trends and effective ways to address them.

   Don't neglect the use of outside resources in your quest for good risk management. As a group, a captive offers a benefit of scale that makes

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tapping the best consultants easier and more cost-effective. Within our agents' E&O captive, we use consultants to go into our insureds' offices and conduct reviews or audits. What they learn they are able to share with all.

■ ***Perhaps the best thing to do when starting a captive is to charge more premium than you actually need.***

3. Adequate Capitalization

Too many captives run afoul by under-funding the start-up. Losses will occur. And when they do, they affect cash flow and reserves. That has an impact on your reinsurance program. Inadequate capitalization combined with ineffective risk management may lead a reinsurer to exit the program or increase premiums so much that the captive's insureds may be unwilling to pay.

Now losses won't always follow the predictable pattern actuaries expect. Things will vary from the projection. Over 20 years, we've seen a couple of years that didn't go according to plan within our agents' E&O captive. But we were very fortunate. We started with enough capital to begin with, and had very favorable loss experience in the first few years. So we very quickly accumulated additional capital.

Perhaps the best thing to do when starting a captive is to charge more premium than you actually need. If your insureds understand the program and are committed to it long-term, extra premium won't upset them. They recognize that you're simply preparing for adverse deviation when it does happen. And, of course, if losses don't materialize, excess capital can go back to the insureds as a dividend or return of premium.

4. Insured Involvement

Another key to captive success involved keeping your insureds, who are part of the captive, involved in the process. This will help keep them committed to the program and reinforce the captive's long-term focus.

We've found several strategies useful in this regard. First, we publish quarterly reports of captive activity and performance. Now, our agents' E&O captive leverages a registered security as part of our funding, so SEC rules require us to publish reports and audited statements. But even in the absence of such requirements, regular communication and sharing is a good idea.

At our E&O captive, and in the other captives with which our agency works, we regularly tell insureds what's happening. If we achieve good loss experience, we share that. If it's poor, we do the same. It's important to be forthright not only with your results, but also with your plans. Making sure insureds are up to speed on the future helps guarantee buy-in and commitment.

We also hold an annual meeting, where designated quality managers from each of our agencies and brokerages come together. They review results and work together to form and strengthen strategies to bolster performance. We also bring our board of directors together each year for an in-person meeting. And beyond that, we have three regional meetings each year for insureds where we detail our accomplishments and lay out our plans for the future. This is a relatively new addition, and the extra layer of meetings has been very well received.

5. Strong Partners

Finally, it's important for captives to find and use the best possible partners. This includes reinsurers, who must be viewed as long-term players who'll go through the ups and downs of adverse loss experience with you. Also, employ good actuaries who understand the program and can give good advice. Tap good lawyers who understand the insureds' business and alternative risk mechanisms, and who will keep the captive and its insureds up to speed on law changes, because laws will change.

Within our agents' E&O captive, we've used consulting partners who work with our insureds to identify what is and is not working within their own operations. The consultant captures and shares what is going well—good risk management strategies, for instance—and shares them as best practices with other partners. When problems are identified—for example, something people might be doing to create exposure to loss but which may not have occurred to them—the consultants apply their own expertise or elicit ideas from other members. ■

What a Difference a Word Makes[1]

by Jerome Trupin, CPCU, CLU, ChFC

In business interruption coverage, is "suspension" different from "interruption?"

The 1986 ISO simplified-language forms[2] changed the title of "business interruption" forms to "business income," changed the method of calculating coverage and loss from a top-down to a bottom-up calculation, and changed the wording in the insurance agreements.

It is the change in the insuring agreement wording that we want to look at. Prior to 1986, the business interruption form insuring agreement read, in part:

> This policy insures against loss resulting directly from necessary ***interruption*** (emphasis added) of business caused by damage to or destruction of real or personal property . . .

This was replaced in the simplified-language version with:

> We will pay for the actual loss of Business Income you sustain due to the necessary ***suspension*** (emphasis added) of your "operations" during the "period of restoration." The suspension must be caused by direct physical loss of or damage to property at the premises described in the Declarations . . .

In short, "interruption" was removed from the form and replaced with "suspension." Most probably this was done for consistency ("interruption" was eliminated from the title of the form) and to lower the Flesch[3] score; syllables add points—interruption has four syllables but suspension has only three. Most insurance practitioners saw no change in coverage then and most don't see any change now; when ISO promulgated the new forms, it said that there was no change in coverage.

However, lawyers look at it differently. When defending problematic claims, lawyers raise every argument to support their position. One of the arguments that they make is that "suspension" means total cessation of business—if the business can operate partially, they argue that no business income coverage is triggered.

One of the first cases to accept this line of reasoning was *Hyplains Beef v Home Indemnity*.[4] This case involved a malfunctioning computer system in a meat-packing plant that allegedly resulted in a serious reduction in output. The decision is a perfect example of the maxim that hard cases make bad law. Rather than deal with the complex issue of whether electronic data is tangible property (the forms hadn't yet been changed to settle that issue) the court apparently focused on the word "suspension." It equated "suspension" with complete cessation and, because work had not stopped completely, ruled that there was no business income coverage.

■ ***Most insurance practitioners saw no change in coverage then and most don't see any change now . . . .***

In the ensuing years, this defense has been raised successfully in numerous cases. An example of the scope of this doctrine is *Forestview The Beautiful, Inc. v All Nation Ins. Co.* Forestview owned and operated a resort with 20 cabins and a lodge on Leech Lake in Minnesota. On July 4, 1999, a severe storm damaged the resort rendering four cabins unrentable for the rest of the summer. Forestview was able to rent the other cabins, and it continued to operate the resort despite the storm damage. The court held that "closing four cabins while the other 16 cabins remained open was not a suspension even of Forestview's cabin-rental operation.

At best, it was a partial suspension of the cabin-rental operation. . . . We conclude that the plain and ordinary meaning of 'suspension' in Forestview's business-income endorsement does not include a partial suspension of business operations."[5] In Solomonic fashion, the court did order the insurance company to pay Forestview's extra expense loss.

ISO recognized that this line of decisions did not reflect coverage intent—if coverage is limited to total cessation, many large firms, and even some smaller ones, would almost never have a covered business interruption loss—and modified its forms to clarify that partial suspension was covered. The ISO circular accompanying the change said, in part:

> Like the business interruption coverage forms that preceded it, the business income and extra expense coverage form is designed to provide coverage for income loss that results from direct property damage from a covered cause—regardless of whether the suspension of the insured's operations is partial or

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> total. In recent years, however, some insurers have interpreted the phrase "necessary suspension of your operations" to mean only a complete cessation of all of the insured's operations and have refused to pay for otherwise covered business income loss because the insured's operations did not completely cease during the period of restoration. Unfortunately, some courts have accepted this argument. To prevent such misinterpretations, a definition of the term "suspension" was added to the definitions section of the 2000 edition of the form. This definition . . . clearly establishes that a suspension means either the slowdown or the cessation of the insured's business activities. . . .[6]

■ ***While ISO forms are now clear, we have to be alert to this problem because of the widespread use of individual company forms.***

The revised ISO forms in current use define "suspension" as follows:

> "Suspension" means: a. The ***slowdown*** (emphasis added) or cessation of your business activities; or b. That ***a part or all*** (emphasis added) of the described premises is rendered untenantable, if coverage for Business Income including "Rental Value" or "Rental Value" applies.

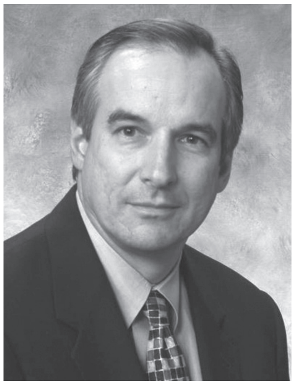
While ISO forms are now clear, we have to be alert to this problem because of the widespread use of individual company forms. Many of them do not contain the new definition. If your client has a policy that covers business income loss due to a suspension of operations and it does not define "suspension," you have a timebomb waiting to explode when there's a business income claim-dispute with the insurer. Get the wording modified or change insurance companies. ■

Endnotes

1. The late Joe Mangan, CPCU, a prolific writer on insurance topics, wrote an article with the same title for a different topic. It's an example of subliminal plagiarism or great-minds-think-alike. Your choice.
2. "Simplified-language insurance policies" was a contender for the "Oxymoron of the Year" award.
3. The Flesch score was created by Rudolph Flesch, the author of *Why Johnny Can't Read*. It rates the complexity of a document on a scale from 1 to 100; the higher the score the more complex the material. The score can be converted to grade-level reading ability. Microsoft Word can automatically review a document and calculate the Flesch score. Einstein's theory of relativity scored grade 12+; prior to simplification many insurance policies had a higher score.
4. *Home Indemnity Co. v Hyplains Beef,* L.C., 893 F Supp 987 (D Kan 1995).
5. *Forestview The Beautiful, Inc. v All Nation Ins. Co.,* 704 N.W.2d 773 (Minn. App.)
6. Richard P. Lewis and Jean M. Farrell, "Disaster and Business Interruption Coverages in the Aftermath of Katrina" http://www.andersonkill.com/pdfs/katrina_busint.pdf (accessed 12/2/06).

New Features and Photos Added to Risk Management Section Web Site

by Martin J. Frappolli, CPCU, AIS



■ **Martin J. Frappolli, CPCU, AIS,** is director of curriculum at The American Institutes in Malvern, PA. He joined the Institutes in 2002 and served first as the primary program director for the AIS (Associate in Insurance Services) and the AIT (Associate in Information Technology) programs. Presently, he is the program director for the INS (General Insurance) program, CPCU 553, and CPCU 557.

Prior to joining the Institutes, Frappolli spent 19 years with NJM Insurance Group, in the IT and data management functions. Earlier in his career, he had data management roles at Scottish & York International Insurance Group in Princeton, NJ, and General Accident Group in Philadelphia. He is a 1978 graduate of Rutgers College, New Brunswick, NJ. He earned his CPCU in 2000 and received the Distinguished Graduate Award, which is presented to the graduate of the CPCU program with the highest grade average on the required examinations.

He is immediate past president of the CPCU Society's Philadelphia Chapter, and currently serves as webmaster for both the Philadelphia Chapter and for the Risk Management Section. He is editor of the Philadelphia Chapter's Chaptergram and the *IDMA Quarterly,* and also serves on the Education Committee and the Professionalism Committee of IDMA (Insurance Data Management Association).

The CPCU Society provides each interest section with its own dedicated web site for the sharing of information with its members. During 2006, your Risk Management Section Committee took advantage of this great communications tool to populate the web site with news, photos, shared files from presentations, and contact information for section committee members.

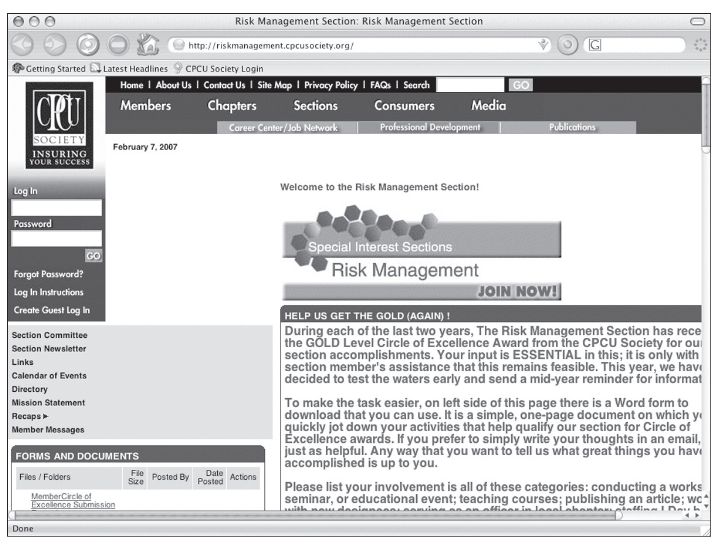
If you are not already a regular visitor, surf by our site at http://riskmanagement.cpcusociety.org/. The main navigation panel is the pale blue section in the upper left-hand side of the home page. There, you can always find links to the Section Committee (members and their contact details) our *RMQ* section newsletter, and recaps of our semi-annual meetings.

On our Section Committee page, we now feature biographical information (with photos) of our newest Risk Management Section Committee members. Reading the details (go online to look at the publications of member Jerry Trupin, for instance), you will see the great professional network you can develop by joining us as active members of the Risk Management Section. Remember, while we have experts, we have novices, too. I joined the Risk Management Section, volunteering as webmaster, specifically because I wanted to learn more about risk management. Every CPCU is welcome to participate. The Section Committee page also lists the name, company, and contact information for committee members.

The Section Newsletter link takes you a page on which you can find our latest *RMQ* newsletter, in PDF format, as well as many past issues. Each one is quite full of timely and timeless articles of interest to insurance and risk management professionals.

The Recaps link contains photos and meeting recaps from our most recent sessions; right now, you can find the recap from our meeting in Nashville in September 2006, and our meeting in Phoenix in April 2006. It's the nextbest thing to being there. Back on our home page, you can find a free download of the PowerPoint slides used by Jerry Trupin in his seminar session, developed by the Risk Management Section, at the CPCU Society Annual Meeting and Seminars in Nashville, September 2006.

If you have written an article or made a presentation that you think would be of interest to the Risk Management Section members when posted to our site, let us know! ■



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Risk Management Quarterly
is published by and for the members of the Risk Management Section of the CPCU Society.
http://riskmanagement.cpcusociety.org

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Risk Management Quarterly RMQ

Volume 24 Number 1 March 2007

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