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Expecting the Unexpected Part of the Unexpected

EDITOR'S NOTE

The text for this article was taken from a presentation given by Ronald A. Cuccaro at "Beyond Entrepreneurship," a national forum of business owners sponsored by Business Week *magazine. The topic of discussion is some of the preparations that can mean the difference between survival and collapse in a company's ability to recover from an insured catastrophe.*

—Sheila E. Salvatore, Editor

Surviving Disasters: Natural or Otherwise

By Ronald A. Cuccaro, SPPA
President & Chief Executive Officer

For a company struck by disaster, whether it be from natural causes like a hurricane, flood, tornado or earthquake; or unnatural causes such as fire, explosion, equipment failure or terrorism, an ingredient crucial to survival is preparedness. Traditionally, that's known as "expecting the unexpected."

However, if it was as simple as that, far fewer companies would be so severely devastated by such losses. Our experience at Adjusters International tells us that there is much more to the process.

In fact, because there are aspects of catastrophic losses that even

Coverage could have been obtained, however, had this type of exposure been anticipated.

▶ Another hurricane story, but with a happier ending. An animal feed processor lost its entire poultry feed market because most of its customers' chickens were destroyed by the hurricane. The birds actually blew away in the storm, leaving little need for the insured's feed products. Fortunately, because they purchased an unusual insurance policy endorsement called the "Customers and Suppliers Endorsement" beforehand, the company was almost fully covered for this indirect loss.

the most seasoned managers would not believe possible, we're convinced that one of the most important keys to survival is expecting the *unexpected part* of a catastrophe.

Although most firms accept the need to pay insurance premiums, they too often rate their coverage on its cost rather than by taking the *claims perspective* of how the policy would actually perform in the event of a loss.

The most important part of establishing a comprehensive disaster recovery program should be adopting the philosophy that you can best protect your firm not just by assuming that you're covered, but by digging deeper into potential problems and exposures and by expecting the *unexpected part* of the unexpected. For a better idea of what the unexpected can entail, here are some examples of actual disaster experiences with which some companies around the world have had to deal.

Some Actual Catastrophes

▶ A hotel fire claimed many lives, resulting in the owners losing ownership of the property because they lacked adequate liability insurance. In this case, the owners lost the involved property because enormous liability claims threatened to pierce the corporate barrier.

▶ A warehouse holding $1.5 million worth of merchandise was broken into in the midst of a hurricane, with hundreds of people literally carrying the stock away. Because the looting was not a direct result of the hurricane, it was not covered under the company's insurance policy.

▶ An electronics company experienced an internal theft of gold, for which it was not covered because their policy specified that such a loss had to be supported by proof that an actual theft occurred. Employee dishonesty policies generally require more than the appearance of a shortage supported only by an accounting calculation. In this case, the company could not identify the person or persons responsible. As a result, the firm suffered a major financial setback.

▶ An earthquake damaged a major food-processing facility, resulting in its inability to process fields of vegetable crops. Forty acres of crops rotted "on the vine" due to the lack of a facility to pack and ship them. The company lost an entire packing season, which translated into lost selling space on supermarket shelves. Unfortunately, the loss to the field crops wasn't covered, and the company had to incur extraordinary expenses regaining its shelf space in the stores.

▶ A U.S. company's European facility producing metric standard products suffered a total loss, and management decided to fill its sales orders with nonmetric machines produced in the United States.

The firm was eventually able to restore normal sales levels, but then discovered that in order to comply with its service and warranty program, it had to stock nonmetric repair/replacement parts at the European location for an extended period of time. The resulting loss for these warranty parts was unanticipated and one for which the company was not covered.

▶ A U.S. firm relied heavily on a foreign supplier for parts critical to its domestic production. A major earthquake destroyed the plant of the supplier.

Because the U.S. company did not have coverage for this type of contingent business interruption loss, they were devastated. The fact that the insured didn't anticipate this type of indirect business interruption loss ended up costing them a great deal.

▶ A condominium association that suffered $250,000 worth of damage to an asbestos roof spent approximately $1 million to dispose of the damaged asbestos—and their loss was only partially covered. The process of removing hazardous materials can sometimes be more costly than installing the materials themselves.

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▶ A hotel casino under construction could not open on time because a hurricane delayed by four months the delivery of steel needed for its construction. The company's insurance policy did not provide coverage for materials not on the premises at the time of loss. Consequently, the late opening—created by the delayed delivery of the steel—caused the owner to sustain an extensive loss in earnings as well as additional interest expenses. These indirect losses were never anticipated.

▶ Another hotel lost the majority of its tourist business due to publicity surrounding a recent hurricane.

Because the hotel itself was not damaged, their income loss was not covered. Rarely is coverage found for indirect losses like this. But this case drives home the point that when you assume your business is covered for all losses, you could be in for an unpleasant surprise.

▶ A company restored its manufacturing facility within three months of a major fire loss, but it took six months for the firm to return to its preloss sales volume. The business interruption loss sustained during the fourth, fifth and sixth months following the reopening was not covered.

This is not an unusual situation in that policies normally provide coverage only for a reasonable restoration period. However, companies can protect themselves by adding *extended period of indemnity* coverage to their policy.

Heard enough? Unfortunately, most of these are not "happy ending" stories. But they are valuable in demonstrating some of the unexpected things that can and do happen to companies as a result of catastrophes.

Now, in a more positive vein, let's look at some of the things you can do to help minimize your company's exposure. We'll begin by examining the first process you should undertake—preloss planning. Following that, we'll review several important, general postloss considerations, including a number which relate specifically to the insurance claim process.

Preloss Planning

First of all, select a competent broker or risk consultant—one who understands your business vulnerabilities, who's in touch with your growth, and with whom you can communicate. Make an effort to help him/her understand your business, so you can work together to identify possible exposures and solutions.

Understand the valuation clauses of your insurance policy—and don't rely solely on historical records for valuations. Also make sure that you understand the terminology used in the policy.

Actual cash value, for example, isn't the cost to rebuild or replace the property: It's that cost less *depreciation* (or it may be the *market value*, depending on the jurisdiction you're in).

You can purchase *replacement cost coverage*, which would pay you the replacement cost of the property. However, almost all policies will compensate you for the full replacement cost only *after* you rebuild or replace.

On the same subject, in many cases you can replace the destroyed property with property of a different type and/or at a different location.

Remember, the policy will specify its limits on replacement. Know up front what your policy says because it could have a major impact on your operations later on.

Understand *selling price clauses*. Under some policies, if you lose your stock, you can collect most of the full selling price. Other policies reimburse you only for your costs, so you'll need business interruption insurance to recover any losses in excess of your cost.

How will production continue in the event of a loss to your facility? Would your labor costs for employees be covered in such a situation? Often, these costs are not covered, resulting in the loss of a valuable workforce.

Other Points to Consider

In addition to knowing the true value of your property and business interruption exposures—from a *claims perspective*—allow for inflation and your company's growth. If your policy was taken out two years ago, it was probably based on your earnings at that time. Today you may need more protection.

Be aware of any coinsurance requirements of the insurance policy which require you to carry a prescribed level of coverage or face a penalty at the time of a loss. Also, be careful of inventories that fluctuate widely from period to period, alternately peaking and diminishing.

A partial loss to stock can result in damaged products—carrying your label—being sold on the open

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market by a salvage company on behalf of the insurance company. You can normally obtain a "brands and labels" clause which will give you protection in this area.

Pollution risks need to be identified; does your company have any?

Who is responsible for insuring leased items? What about tenant improvements and betterments? In valuing your equipment, have you "expensed" many equipment expenditures? Does installation labor show on your records?

How will a LIFO (Last In First Out) versus a FIFO (First In First Out) method of accounting affect your inventory valuation?

Thinking beyond the insured premises, how would a catastrophic loss to a critical supplier or customer, or to another of your locations affect your business?

What will happen if current building codes require substantial improvements over the building that was lost? Those additional costs are not covered unless special protection is provided.

Understand the limits of your coverage; don't assume that you have coverage. When you start thinking from a *claims perspective*, you get the opportunity to develop "what if" scenarios, and to consider alternatives if a loss should strike. Look beyond the standard coverages to provide for your company's special needs.

Consider the services of a professional loss consultant and valuation expert to assist you and your broker when conducting a preloss review.

Evaluating Your Policy Preloss

- Select a broker who understands your business.
- Make sure that you understand the terminology used in the policy.
- Understand the valuation clauses of your insurance policy—and don't rely solely on historical records for valuations.
- Do you need *business interruption* coverage?
- Every two years revisit your policy to adjust for inflation and your company's growth.
- Be aware of inventories that fluctuate widely from period to period.
- Consider factors associated with pollution and its cleanup.
- Be aware of coinsurance requirements that lead to a penalty at the time of a loss.
- Does your business need *brands and labels* coverage to protect against your company's damaged goods being sold on the open market?
- Who is responsible for coverage of leased items?
- What is the impact beyond the insured premises—on suppliers, customers, or other business locations?
- Do you need *ordinance or law* coverage?
- Consider the services of a professional loss consultant to represent you.

Postloss Considerations

The following recommendations, which apply to the postloss situation, can help you mitigate the loss, protect your property from further damage, and expedite the claim process. They can also help ensure an adequate recovery. Remember—each loss is different and many require additional action.

To begin with, notify your broker of the loss.

You are obligated to protect the property from further damage and to mitigate your losses.

Establish a loss management team, with a leader designated to be the spokesperson for your company. Make sure all of those involved in the claim process understand and are prepared to follow your claims management plan.

Have all of your communications flow through the designated claim manager. Let your claim manager interact for you.

Carefully control access to the premises.

Be sure to document activities on a log and maintain accurate records. Keep a separate "loss account" for loss-related expenses.

After assessing the potential scope of damage, set up a postloss business plan to protect your market. (It's surprising how fast your competitors will try to secure a better position!)

Notify your customers, banks and suppliers of the loss, and prepare a public relations program to protect your market position. You'll need to let everyone know you're still around!

Integrate your claims program with other business operations, including all temporary repair activities. Remember that property damage, business interruption and the business recovery plan are all tied together.

Too many managers expect the insurance company to tell them what to do to save their business. Make decisions that are best for the survival of your business. This point cannot be emphasized enough. You must make the prudent business decisions necessary for your recovery.

The insurance company is responsible for producing the financial solutions provided under your policy; it is not responsible for running your company for you. While the insurance settlement is very important, it could be many months down the road.

Explore *extra expense* coverage with your broker. It can provide reimbursement for many business recovery expenses not normally allowed under standard business interruption coverage. Extra expense coverage can provide a program to help save a business by allowing it to make critical expenditures outside the usual areas of indemnity.

Be careful when using existing raw material inventories to make up production. Its full effect may not be felt until after the claim's indemnity period.

Be sure to track the increased cost of operations during a postloss recovery period. It will eventually affect the "bottom line."

Know the players. Understand what staff adjusters, independent adjusters and their forensic accountants are. They will be working for your insurance company—and you can be sure they will understand their roles.

Know what your broker's role will be throughout the claim process.

Understand your own duties and requirements under the policy contract. For example, it's your responsibility to file and support your claim. You should present your own claim—the insurance company's experts should not do it for you. Take a proactive approach, not a reactive one.

Hire your own experts to prepare your claim, and do not rely solely on historical records. Consider employing a property loss consultant to work on your behalf. Management should concentrate on saving the business, not the details of preparing claims. Leave that to the experts.

Realize that your claim must be verified. It will be audited by the insurance company's adjusters

Postloss Considerations

- Notify your broker of the loss.
- Understand your duties and requirements under the policy contract.
- Protect the property from further damage and mitigate your losses.
- Assess the scope of damage.
- Establish a loss management team with a designated leader.
- Activate a postloss business plan to protect your market.
- Prepare a public relations program to protect your market position.
- Document your activities on a log and maintain accurate records.
- Make decisions that are best for the survival of your business.
- Hire your own experts to prepare your claim, and do not rely solely on historical records.
- Realize that your claim must be verified.

and/or accountants—so prepare accordingly.

Be comprehensive and detail-oriented. Don't expect your insurance company to immediately write a check for your claim just because you believe that's what you're entitled to receive.

Work with the insurance company's representatives to agree in as many areas as possible early in the process. Try not to polarize. That will only lead to two widely separated ideas of what the loss amounts to, making subsequent negotiations more difficult.

Try to agree on the general scope of the loss early on. Find as much common ground as possible.

Request advance payments from the insurance company to ease your firms' financial burden. Your carrier doesn't have to perform this service, but most insurance companies will. It helps the recovery process when you are not operating from a position of financial weakness.

Once again, make sure that you understand the policy's terminology and the claim process *before* you submit a claim.

Like all successful business people, you've worked hard to achieve and maintain the prosperity your company enjoys. You can hope that your firm never suffers a disaster that would interrupt or threaten that prosperity.

And you can try not to think of the risk of loss that is an inevitable part of doing business. But you can be sure that if such a loss does come, there will be a lot more to it than you might expect.

By no means have we been able to identify in a single article all the ways in which a company might be affected by a disaster, nor have we attempted to present every possible solution. But we hope the preceding has stimulated your thinking about what could actually happen to your company during and after a disaster, and that by considering these possibilities now or the next time your insurance program comes up for renewal, you will be better prepared to deal with the *unexpected part* of the unexpected.

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