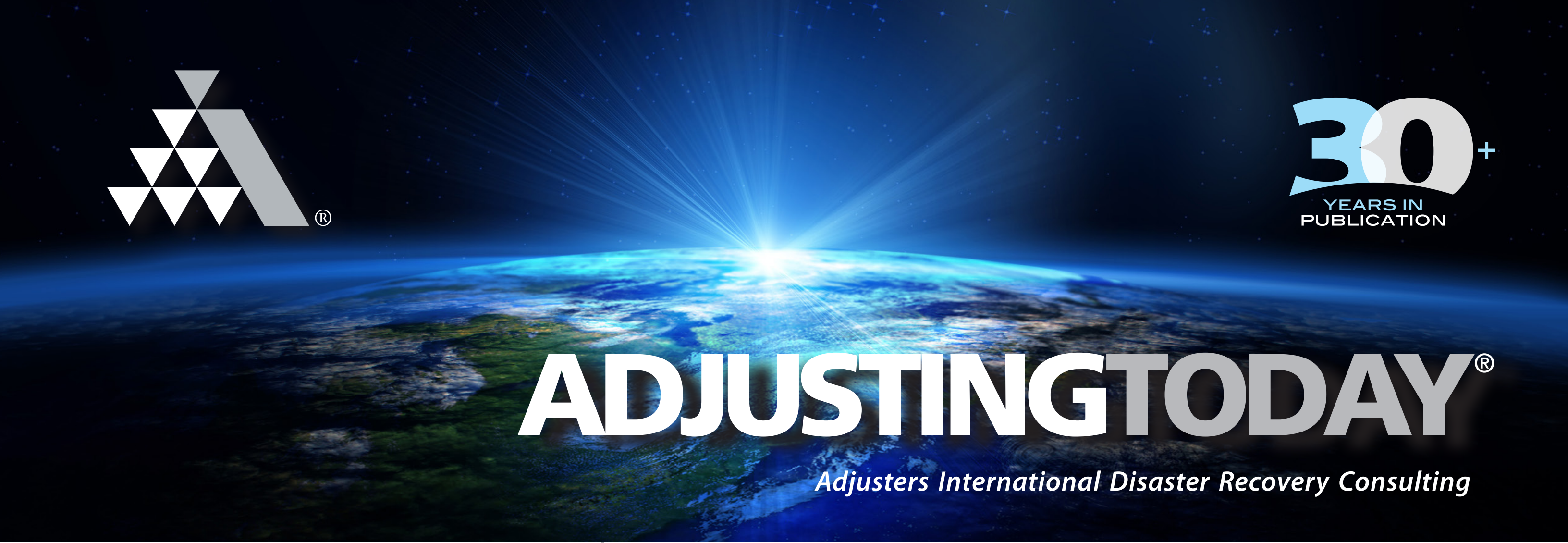


FROM THE EDITOR

Jaw-dropping devastation from Hurricane Ida that wreaked havoc from the Central Gulf Coast to the Mid-Atlantic, triggering a tornado of unheard of proportions in Annapolis and record-setting rainfall rates in New York. A separate, unprecedented outbreak of tornadoes in the central and southern U.S.

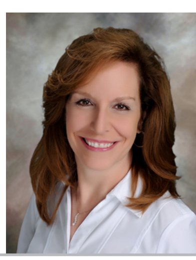
More than 2.5 million acres burned by wildfires in California. A historic cold snap that paralyzed Texas.

Deadly floods in Europe, and earthquakes, volcanoes and cyclones destroying life and property elsewhere around the globe. Let's not forget cyber attacks that crippled operations essential to companies and the well-being of society itself.

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

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

It is essential reading for anyone concerned with protecting their operations or those of a client.



Sheila E. Salvatore
Editor

Avoiding a Double Disaster

Risk Professionals Under Scrutiny to Avoid Underinsurance

By Joseph S. Harrington, CPCU

Call it the second wave: First, there is a natural disaster. Then come widespread reports that property owners were underinsured for damage caused by the event.

In the wake of this increasingly common scenario, insurance professionals who deal directly with the public — agents, brokers, underwriters and claim adjusters — are under increased regulatory and media scrutiny to see that their clients are adequately insured and get the full benefit of their coverage.

The most important consideration in this regard is determining the building property coverage limit. Not only does that limit establish the amount of insurance available to repair or replace the principal insured structure(s), but it also serves as the basis for sublimits of additional coverages.

If the recent past is any guide, calculating this limit will have to account for the likelihood of escalating cost increases as well as heightened cost volatility. Whether a limit is sufficient may well depend on fleeting circumstances in construction markets.

To say this is no easy task is to understate the obvious, especially when risk professionals have no direct control over the two most important factors in disaster recovery: construction costs and demand surge for construction and related services.

Cost Calculations

The 2020s opened with an "unprecedented surge in construction costs," according to Clarion Partners, a real estate research and investment firm. According to Clarion, costs for various metal components increased from 40 percent to more than 60 percent from March 2020 through September 2021. Over the same period costs for lumber, plywood, sheet metal, milled aluminum and plastic components all increased by a quarter to a third.

WHAT TO WATCH FOR

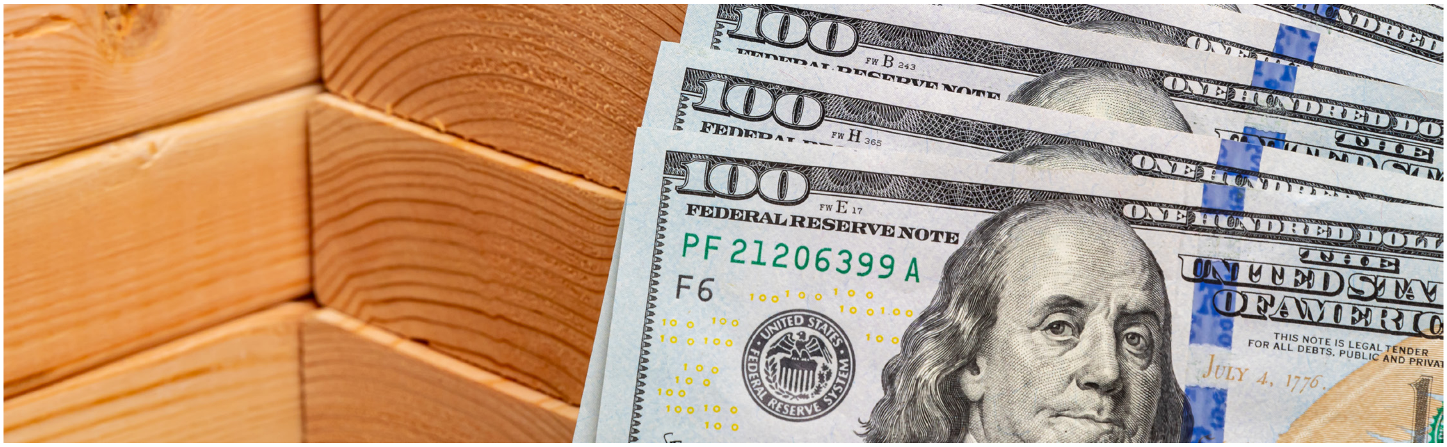
Do reconstruction cost estimates account for cost increases and volatility?

Increased costs for building materials came as construction wages increased at an accelerating rate, reflecting a persistent shortage of skilled construction workers. Clarion reports that construction wages rose 5.8 percent from September 2020 to September 2021, nearly triple the 10-year annual average of 2.2 percent.[1]

Estimating the effect of increased construction costs on insurance claims is complicated by the volatility of material prices due to supply chain disruptions in the wake of the COVID-19 pandemic.

Recent experience with natural disasters has produced a heightened awareness of the impact of "demand surge" on insurance adequacy. Demand surge is generally understood to be *a sudden and temporary increase in costs for construction and related services following a catastrophic event.*[2]

While risk professionals share a general understanding of what demand surge is, there is far less consensus on how the elements of demand surge — labor, materials, equipment and financing — can be identified and measured for their cumulative impact on losses. CoreLogic, a leading property data firm, estimates that demand surge can add 30 percent or more to reconstruction costs, but the added costs can fluctuate greatly from location to location and event to event.[3]



An indication of the growing recognition of demand surge as a post-disaster cost factor came in 2012 with the introduction of a standardized commercial property policy endorsement addressing demand surge by the Insurance Services Office (ISO), an organization that develops standardized policy forms used as the basis of policies issued by most property/casualty insurers.

The endorsement, titled "Increase in Rebuilding Expenses Following Disaster," provides for additional insurance beyond a policy's limits in situations when the costs of rebuilding a structure damaged by a covered peril during a federally or state-declared disaster increase as a result of the disaster and exceed the policy's applicable limit. Insurers are allowed to adjust policy limits (and corresponding premium) to reflect any improvement or additions that increase the replacement cost of the building by 5 percent or more.

ACV Loss Settlement

Fortunately, property risk professionals do not have to rely solely on construction cost calculations to implement adequate property coverage. Careful attention to policy provisions over which risk counselors and their clients have more control will pay dividends at the time of a loss.

Next in importance to the building property limit is the loss settlement condition, which comes down to a choice between two basic approaches: actual cash value and replacement cost settlement. Actual cash value (ACV) loss settlement has the benefit of costing less in premium than replacement cost valuation.

WHAT TO WATCH FOR

Does the building property limit under ACV loss settlements reflect up-to-date construction cost appraisals?

Public concern over underinsurance generally does not extend to ACV policies, since they are not intended to cover the cost of reconstructing destroyed buildings. That's not to say it's impossible to be underinsured with an ACV policy, however. That's because determining the actual cash value is not the last word in an ACV settlement; the building property limit is.

Actual cash value will be determined at the time of loss, but loss recovery will be subject to a pre-determined limit — which could be less than the ACV. Except in unique arrangements, ACV provisions do not automatically increase a building

> *... property risk professionals do not have to rely solely on construction cost calculations to implement adequate property coverage.*

property limit to reflect changes in insured values. Unless effort has been made to keep a building property limit up to date with current appraisals, an ACV insured could get less than the current value of their property.

Also, when it comes to insuring personal property ("contents"), commercial insureds must decide whether to value stock for its cost of production or selling price, and pay the corresponding premium. Relying on balance sheet entries could lead to underreporting of values and a net loss even after an insurance payout.

Replacement Cost

At the core of the current concern over underinsurance is the fact that property owners aren't always aware that having "replacement cost" insurance does not necessarily mean they are covered for the entire cost of replacing a damaged structure.

WHAT TO WATCH FOR

Does the building property limit truly allow for full coverage of the potential replacement cost?

After a deductible is satisfied, basic replacement cost loss settlement pays for the actual cash value of damaged property plus additional costs to repair or replace it with property of like kind and quality. (Note: Under replacement cost coverage, the ACV amount is paid immediately, but the depreciation that is deducted is not paid to the policyholder until the repair or replacement is completed.) *Functional* replacement cost coverage is a less costly variant that pays to repair or replace damaged property with property that serves the same function, but is not necessarily of the same kind or quality.

In personal lines insurance, replacement cost settlement is built into most homeowners policies; however, it must be selected on commercial property policies.

Many insureds are surprised to learn that *replacement cost settlement is still subject to a building property limit* that may not be enough to cover the actual cost to replace damaged property, especially in demand surge conditions following a catastrophe. To minimize or avoid that shortcoming, two other forms of replacement cost settlement are provided by some insurers:

- *Extended* replacement cost coverage, which pays an amount beyond the building property limit, usually expressed as a percentage of that limit. In some cases, agents are suspected of "low-balling" the building property limit on an

> *Before repairing or replacing damaged property one must remove the debris and perhaps demolish undamaged portions of a structure (and remove that debris as well).*

extended replacement cost policy to produce a more competitive premium, believing that the settlement extension will protect the buyer.

- *Guaranteed* replacement cost coverage, which pays whatever it costs to replace damaged property, regardless of the building property limit. (That limit may still be in place for purposes of rating coverage and serving as a benchmark for other limits.)

Of these options, only guaranteed replacement cost coverage represents a commitment to fully cover the cost of reconstructing a damaged structure (minus a deductible). Guaranteed replacement coverage was once a common feature of homeowners insurance, but it no longer is. Its relatively high premium cost reflects the high level of risk insurers assume.

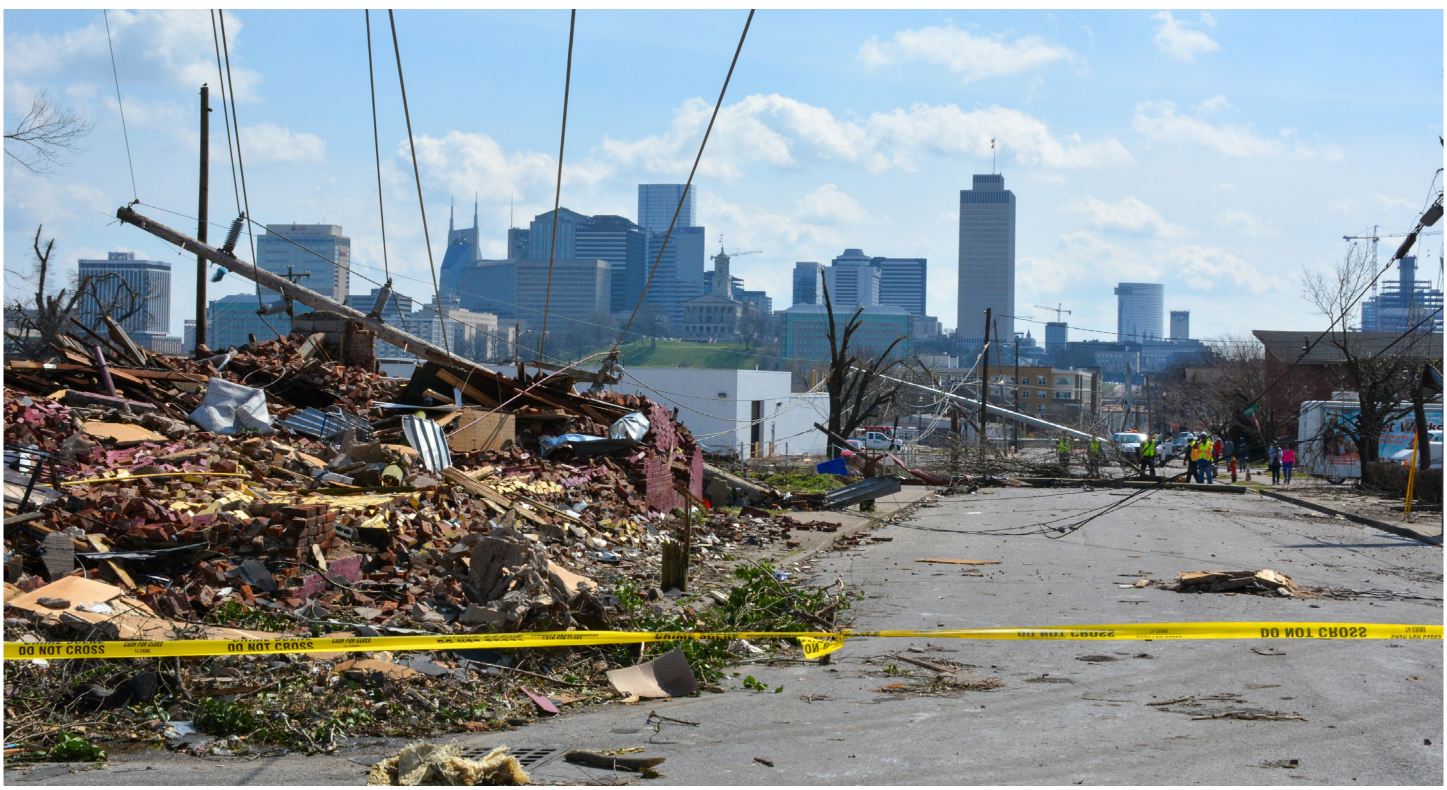
Debris Removal

Neither guaranteed replacement cost settlement nor ample limits, on their own, will ensure that a property owner is fully insured for a loss. Still other factors must be considered.

Before repairing or replacing damaged property one must remove the debris and perhaps demolish undamaged portions of a structure (and remove that debris as well). Coverage for debris removal costs is provided differently in commercial property

WHAT TO WATCH FOR

How much additional coverage does the debris removal provision provide (above 5 percent or 25 percent of the deductible and loss payment)?



and homeowners policies and has been subject to change over time.

Under typical homeowners policies debris removal is covered under the limit for the type of property insured (the dwelling, related private structures or contents). An additional 5 percent of the applicable limit is provided to cover debris removal costs *if* the loss payment and debris removal costs (combined) amount to more than the limit. This requires allocation of debris removal costs to different types of property — quite a challenge if an adjuster is dealing with a pile of rubble or a smoldering ruin.

Under commercial property policies debris removal coverage is provided *separately* from the applicable property limit and the amount of coverage is linked to the policy deductible rather than the limit of insurance. Up through the late 1900s debris removal coverage typically amounted to 25 percent of the loss payment and deductible combined; a commercial insured received an additional quarter of the cost of the loss to remove the debris.

The amount of insurance available for debris removal has generally increased with the release of new commercial property forms by ISO. In 2002 ISO modified its debris removal provision to add another $10,000 in coverage (in addition to the 25 percent of payment and deductible) in situations where (1) the loss payment and deductible exceeded the applicable limit, *or* (2) the cost of debris removal alone exceeded 25 percent of the loss payment. In 2012 ISO increased the additional amount from $10,000 to $25,000 and extended debris removal coverage to cover costs of removing property of others cast onto an insured location.

These changes help address the impact of post-disaster demand surge on debris removal costs and they demonstrate the importance of reviewing policy form issue dates and specific policy provisions.

Ordinance/Law Coverage

The growing frequency and severity of natural disasters has prompted many jurisdictions to implement or update building codes to mitigate disaster losses. The more such codes there are, and the more they are updated, the greater the chance that a property owner will have to upgrade a structure after a loss to meet new standards. This often entails demolishing and replacing undamaged portions of a building. As with debris removal, this additional cost is covered differently under homeowners and commercial property policies.

WHAT TO WATCH FOR

Is an insured structure at risk of requiring increased cost for reconstruction to meet building codes? Is the "ordinance/law" limit sufficient for likely losses?

Under the most common homeowners policies insureds are entitled to use up to 10 percent of the dwelling property limit for additional costs needed to bring damaged or undamaged property into compliance with building codes or ordinances. This "ordinance or law" coverage is provided in addition to the dwelling limit but remains dependent on that limit. An otherwise adequate dwelling limit could still leave a homeowner underinsured for additional costs to comply with building codes.

In commercial property, basic policies typically exclude coverage for increased costs due to enforcement of building regulations; if desired, the coverage must be purchased by endorsement. Commercial ordinance/law coverage endorsements include complex provisions addressing damaged and undamaged portions of an insured structure, and whether the cause of loss was a covered peril.

For our purposes here it is important to note that standard commercial ordinance/law coverage endorsements *allow insureds to extend the building property limit* to cover the loss of an undamaged part of a structure that must be destroyed to comply with building regulations. (This presumes the demolition requirement is triggered by damage to part of the structure by a covered peril.)

In addition, standard commercial ordinance/law coverage endorsements allow insureds to establish their own limits for the actual demolition and increased cost of construction necessitated by compliance with building regulations. Thus, adequate coverage for ordinance/law exposure depends upon:

- The overall building property limit; and
- The endorsement limits for demolition and increased cost of construction.

Blankets, Schedules and Coinsurance

For a commercial account with properties at multiple locations, whether coverage is adequate at the time of loss may depend on whether those properties are insured on a blanket or scheduled basis. Under blanket coverage a single limit applies to any insured damage at any insured location; under scheduled coverage a separate limit is determined for each location.

WHAT TO WATCH FOR

Are scheduled limits adequate to cover each scheduled property? Is a blanket limit sufficient to avoid a severe coinsurance penalty after a loss?

If a blanket limit is at least roughly equivalent to the sum of proposed scheduled limits, blanket coverage provides a greater hedge against being underinsured for a loss since the entire amount of insurance for all locations is available to respond to a loss at any one of them. That's why, other things being equal, blanket coverage will cost more in premium than scheduled coverage.

Now, suppose a property owner owns three buildings, each of which would cost $250,000 to rebuild (thus amounting to $750,000 of total building property at risk). If the owner thinks it is unlikely there would be a loss to all three of them at the same time, why couldn't the owner purchase $250,000 in building coverage, and apply it on a blanket basis so it would apply to a loss at any of the three locations?

That's where coinsurance comes in.

Risk professionals understand that the more property you have at risk, the more likely you will suffer a loss. If you have five properties of equal value, you are more likely to sustain a loss to one of them than if you had just one property of that value.

Agents and brokers must explain that coinsurance requires insurance for the aggregate value. For their part, claim adjusters must explain how coinsurance provisions limit loss payments to reflect how a limit of insurance relates to the values at risk.

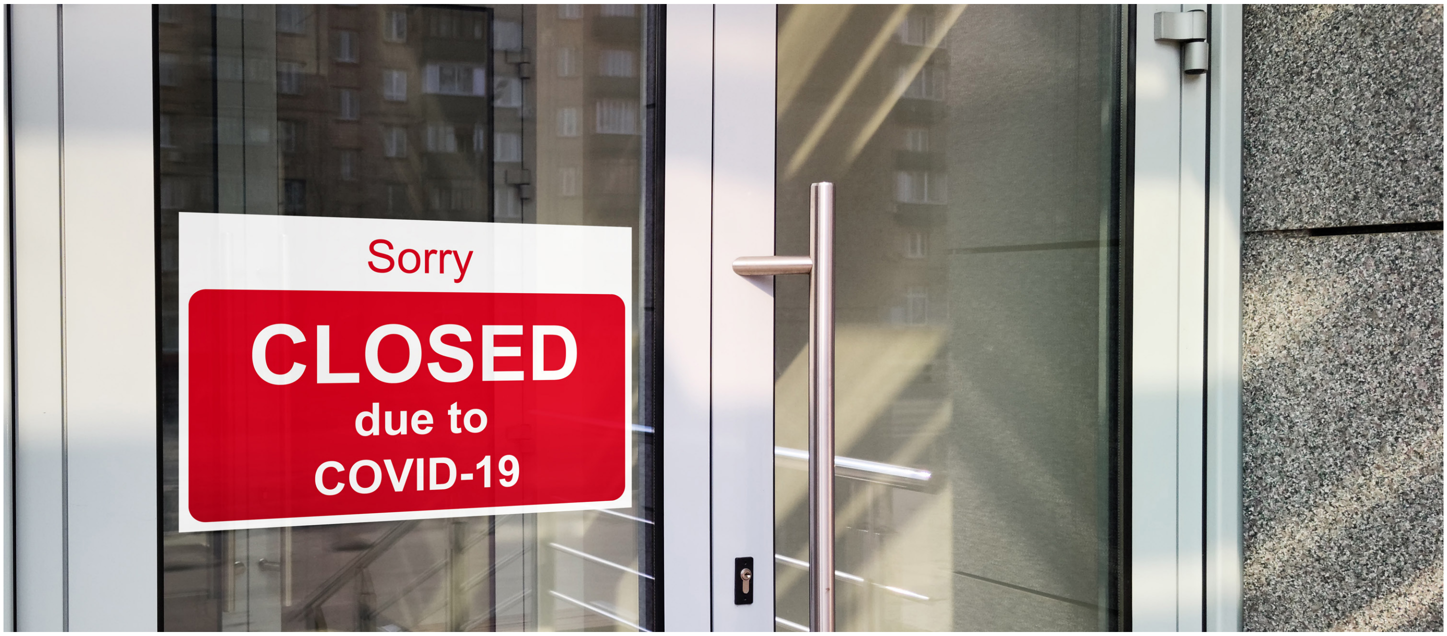
Business Interruption Premises

It took some time for awareness of property underinsurance to reach its current level. In 2020 virtually every business became abruptly aware of the limitations of business interruption coverage.

With their locations closed and operations suspended due to the COVID-19 pandemic, commercial insureds learned they would not collect on their

WHAT TO WATCH FOR

Are all building features essential to using the insured premises included in the definition of premises?



coverage for income loss and extra expenses, as the presence of a virus generally did not qualify as the physical loss or damage needed to trigger coverage.

Even the presence of physical damage at a commercial location will not guarantee business interruption coverage. First, *a qualifying loss must be due to damage by a covered peril* under a commercial property policy's cause of loss form. Then, the *damaged property has to be included in the description of the insured premises*.

Regarding the latter, commercial tenants can find themselves without business interruption coverage in situations where their own premises are undamaged, but they cannot access those premises because of damage to service areas such as lobbies and elevators. For purposes of business interruption coverage, it is important to know whether the insured premises are limited to space occupied exclusively by the insured, or whether it extends to service areas or even an entire building or complex.

Civil Authority

In response to COVID-19 "lockdowns" some policyholders went to court seeking coverage under "civil authority" provisions of business interruption policies.

So-called civil authority coverage pays for lost income and extra expenses incurred when a commercial insured is forced to suspend operations because public authorities have issued an order closing off access to an insured location. Very few, if any, of the pandemic-related claims were successful, however, as the coverage typically responds only if an order arises from physical loss or damage caused by a peril insured against under the claimant's own property policy.

WHAT TO WATCH FOR

Does the "order of civil authority" provision in business interruption coverage have a geographic restriction for the damage triggering the coverage?

> ***With their locations closed and operations suspended due to the COVID-19 pandemic, commercial insureds learned they would not collect on their coverage for income loss and extra expenses, as the presence of a virus generally did not qualify as the physical loss or damage needed to trigger coverage.***

Civil authority provisions were developed with physical catastrophes in mind. A business can be shut down indefinitely even if it suffers little or no damage itself if there is damage elsewhere during an event that causes police, firefighters or other authorities to close off access.

Agents, brokers and their clients need to be alert to some recent changes in the application of the civil authority provision of business interruption coverage.

Prior to 2008 ISO's standard business civil authority provision provided coverage regardless of where the damage occurred that led to the civil order. In the absence of a geographic limit there were huge and widespread business income losses from the September 11, 2001 attacks on the World Trade Center, which paralyzed parts of lower Manhattan for weeks, affecting many businesses in the area and beyond.

In 2008 ISO modified its civil authority income and extra expense coverage to apply only if the damage prompting the order occurred up to one mile from the premises described in the policy declarations. Endorsements are available to amend that condition, as well as the time element deductible for civil authority coverage.

Nothing should be assumed or overlooked regarding business interruption coverage, a disaster exposure that is at least as common as direct physical damage.

Cyber Exposure

Business interruption insurance typically applies only to circumstances where there has been physical damage by an insured peril at some location.

Regarding an interruption of commerce carried out online through "cyber" means, business interruption coverage would typically respond only in cases where computer hardware was physically damaged by a covered peril and there was a delay in repairing or replacing caused by a covered peril.

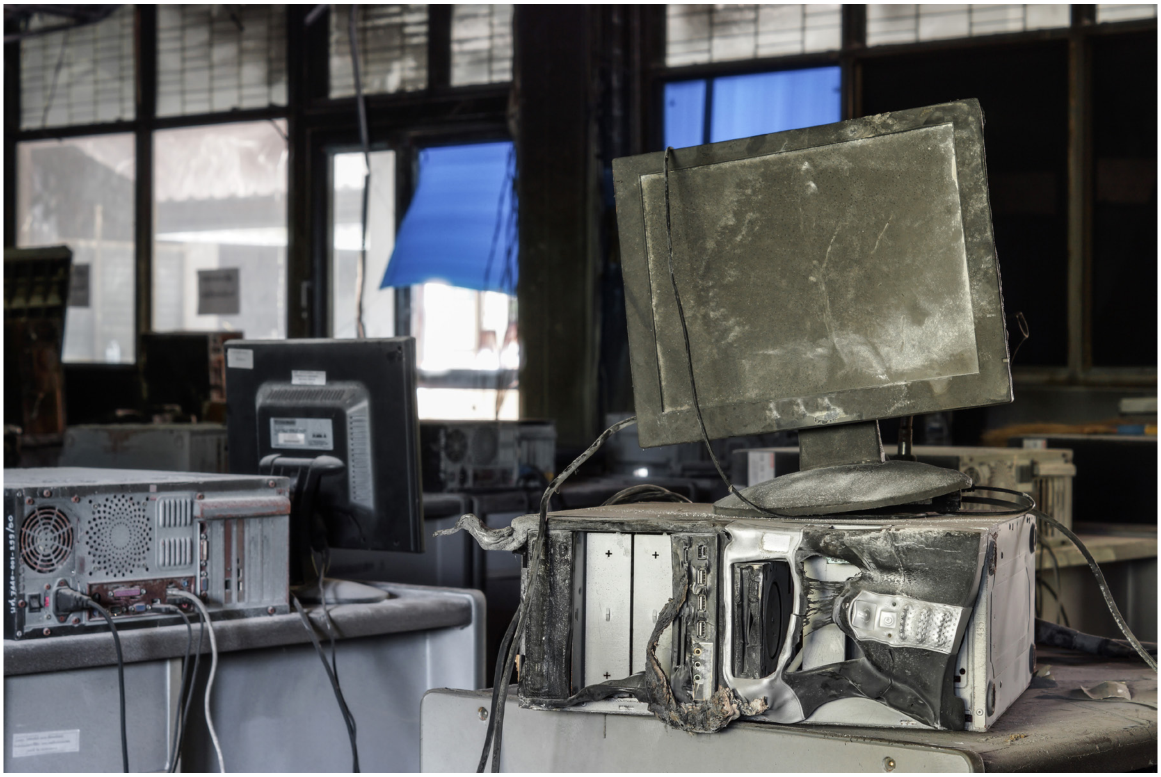
WHAT TO WATCH FOR

Is a separate cyber policy in place to cover income loss by "cyber perils?" Does it exclude coverage for losses arising from physical damage?

In any event, there would likely be no coverage under a standard business interruption policy for a suspension of operations or delay in resuming them caused by a typical "cyber" peril — such as hacking or the imposition of paralyzing "ransomware."

As a practical matter, insurers are seeking to separate coverage for cyber perils — typically willful acts of malicious individuals — from the coverage provided in commercial property policies and their business interruption coverage parts.

It's not uncommon in this high-tech world for an enterprise to hold very little in physical assets but to have enormous asset values in intangible data and intellectual property. Effective coverage of those exposures requires a separate cyber insurance policy with its own provisions for business interruption. The problem here is that some cyber policies, while starting to restrict coverage for certain cyber perils, also exclude coverage for losses caused by physical damage, the presumption being that such losses are the purview of the property policy.



The complex interaction of business interruption coverage under commercial property cyber and equipment breakdown coverage is covered in issue #3048 of *Adjusting Today* titled "Business Interruption Coverage Times Three."

Liability Considerations

In the immediate aftermath of a disaster there is typically a sense that members of the affected communities will rally to show solidarity and support for each other. The time comes, however, when people who are severely injured or suffered severe property damage will seek compensation from those they believe bear some responsibility.

In the case of occupational injury there will be no avoiding the liability. In the wake of a disaster more people will be doing more work, much of it unfamiliar work outside of ordinary routines, and some of it hazardous. There is potential for increased frequency and severity of employee injury — and any workers compensation program for an employer in a disaster-prone area should reflect that.

As for general liability exposure, keep in mind that public sentiment does not pay the bills for people who have suffered losses that are not fully insured on their own, such as complications arising from bodily injury or economic loss due to physical damage at a key time for an enterprise.

WHAT TO WATCH FOR

Does the workers compensation program for a business in a disaster-prone area account for the work hazards associated with disaster recovery?

None of us is perfect, and for that reason virtually every enterprise carries general liability insurance (except, perhaps, home-based sole proprietorships). We can all be negligent at times and repeated disasters increase the chances that our negligence could result in a loss to someone during a time of general distress.

Insure accordingly.

> *…public sentiment does not pay the bills for people who have suffered losses that are not fully insured on their own…*

[1] Tim Wang and Julia Lamont, "Surging Construction Costs: Implications for Commercial Real Estate, Fall 2021, p. 1; accessed at https://www.franklintempleton.com/articles/clarion-partners/surging-construction-costs-implications-for-commercial-real-estate.

[2] Anna H. Olsen and Keith A. Porter, "What We Know about Demand Surge: Brief Summary," *Natural Hazards Review,* American Society of Civil Engineers, May 2011; accessed at https://ascelibrary.org/doi/abs/10.1061/%28ASCE%29NH.1527-6996.0000028.

[3] CoreLogic, "2019 Insurance Coverage Adequacy Report: The Effects of Underinsurance to the Property Ecosystem," accessed at https://www.corelogic.com/wp-content/uploads/sites/4/downloadable-docs/2019-insurance-coverage-adequacy-report-0419-06-screen.pdf.

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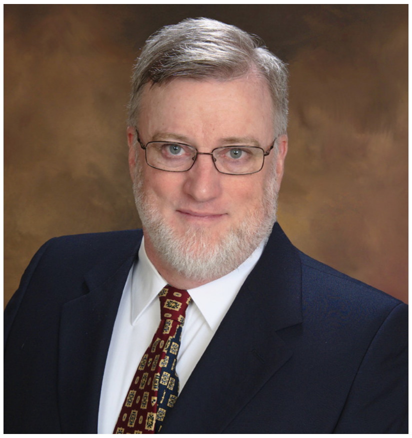

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