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A Risk Manager's Guide To Property Insurance For The Upcoming Hurricane Season

Introduction

INSURANCE POLICIES ARE DRY, TEDIOUS READING AND COVERAGE IS RARELY EXPLAINED IN STRAIGHTFORWARD AND EASY TO FOLLOW TERMS. THE EXCLUSIONS, EXCEPTIONS TO EXCLUSIONS, AND SPECIAL CIRCUMSTANCES MAKE IT DIFFICULT TO DETERMINE WHETHER A CLIENT IS SUFFICIENTLY COVERED UNDER AN INSURANCE POLICY BY SIMPLY READING THE POLICY. USING A MORE ENGAGING AND SYSTEMATIC APPROACH MAY LESSEN THE RISK THAT NEEDED COVERAGE WILL BE OVERLOOKED.

One such approach, outlined in the Principles of Risk Management and Insurance[1], is to answer a series of questions similar to those a newspaper reporter must answer in writing a news story:

- Who is insured?
- What property or activities are covered?
- What perils are insured?
- When (during what time period) is coverage provided?
- What are the limitations, if any, on the amount of coverage?
- What conditions or other policy provisions may affect the coverage otherwise provided?

This paper will address what a risk manager should look for in answering these questions to determine whether a client's business, condominium, or home has sufficient insurance for the upcoming hurricane season.

Who is insured?

This question determines the persons, corporations, or other entity, such as a secured creditor, that is entitled to benefits under an insurance policy. The insured entity can be designated by name, classification, or relationship to entities identified by name.

What property is covered?

Property policies cover two kinds of property: real, which is fixed and immobile, such as land and buildings; and personal, which is all other movable property. Obtaining coverage for all property is often not as simple as it seems.

Regarding real property, is each structure insured? Are exteriors and common areas included? Generally, landscaping, swimming pools, signs, bridges, paved areas, pilings, piers, wharves, docks, building foundations, and underwater pipes are specifically excluded. Sometimes excluded property can be added to a policy, if not, separate coverage must be purchased.

Fixtures must also be considered. What fixtures are covered under the policy? Is machinery or manufacturing equipment covered as a fixture or as personal property? The amount of coverage must contemplate the cost to replace fixtures and machinery quickly, on the open market, and include the costs incurred to transport, install, and restart it. Sales tax must also be considered.

Does the client have valuable art, furniture, or inventory that must be specially insured by a floater policy? Inventory costs should be evaluated as if the client is at peak inventory.

[1] C. Arthur Williams, Jr., George L. Head, Ronald C. Horn, G. William Glendenning, *Principles of Risk Management and Insurance, Volume II*, 63-64 American Institute for Property and Liability Underwriters (2d ed. 1982)

Motor vehicles are typically not covered under a property or business owner's insurance policy; a separate motor vehicle policy should be obtained to cover personal, business, maintenance, and security vehicles and golf carts. Likewise, watercraft and trailers almost always require separate policies.

In addition to a client's property, there are other necessary coverages such as Additional Living Expense Coverage, Loss of Rents Coverage, Business Expense Coverage and Business Interruption Coverage. Though these coverages are often reimbursed after the actual costs have been incurred, many insurance carriers will make partial payments to policyholders to assist them on their way to recovery.

Additional Living Expense coverage pays for temporary housing when a covered event renders the covered primary home uninhabitable. Additional expenses, such as the additional expense in travel to and from work due to the new living location, may also be covered.

Loss of Rents coverage pays for lost income when a covered property is made uninhabitable by a covered event, as a renter has no obligation to make rental payments due to *force majeure*. A lease or a rental agreement is helpful in documenting the amounts to be paid under this provision.

Business Expense Coverage under a commercial policy can reimburse a policyholder for money spent moving a covered business to a different location while the covered property is restored. Similar to the Additional Living Expense Coverage, Business Expense Coverage is intended to offset the extra expense associated with returning to the normal operation of the business. Equipment breakdown coverage is often available under these policies and should be purchased if a client's business is dependant upon certain equipment.

Business Interruption Coverage (Time Element Coverage) provides lost income payments, which can prevent a business affected by a covered event from going out of business or into bankruptcy by during the period of restoration or replacement of the damaged property.

What perils are insured?

To determine whether a peril is covered, it must have both a covered cause and a covered consequence. In a specified perils policy, named occurrences such as fire, lightening, windstorm, vandalism, and theft are specifically covered. All risks policies cover all perils unless specifically excluded. Like perils policies are usually written for marine insurance and cover specified perils and those similar to them. In every case, a covered peril can be subject to exclusion, so all details of the policy must be carefully scrutinized before sufficient coverage can be presumed.

Covered consequences are a bit more complicated. Pursuant to the doctrine of proximate cause, the covered peril must initiate an unbroken chain of events leading to a covered consequence. This can be a direct consequence, such as wind damage to a roof, or indirect loss, such as loss of inventory when a grocer loses power for several days following a windstorm. The doctrine of proximate cause can expand or narrow recovery, depending on the insurer or court that decides the issue.

While it seems straightforward, application can be tricky. Debris removal is a classic example during hurricane season. Clearly, hurricane winds cause trees to fall and structure damage, resulting in debris. However, some insurers consider the cost incurred to remove debris not to be a cost of the storm itself, *but instead a cost of repair*. Likewise, many insurers consider the added costs incurred because of building codes a cost of repair, and not the result of a covered peril. Because costs for debris removal and expensive code-required upgrades are almost certain when a large storm hits, the smart policyholder will specifically add coverage for these potentially very expensive losses or purchase separate Law and Ordinance coverage.

When (during what time period) is coverage provided?

A peril is covered if it commences during the policy period. If a named storm hits land a day after a policy expires and new coverage is not yet in effect, the policyholder may not be covered. During hurricane season, continuous coverage is advisable.

What are the limitations, if any, on the amount of coverage?

In every case, recovery for a loss is limited by the amount value of the policy. To ensure that a policyholder can be made whole after a loss, the policy limits must accurately reflect the value of the property. Today, most properties are underinsured.

This is most often caused by the property owner's or responsible party's lack of understanding of the risk the property is exposed to and inaccurate estimations of the property's insurable value, or the policyholder's desire or need to reduce premiums.

Replacement Value and the Costs of Repair

Perhaps the biggest contributing factor to the unintentional under valuation of property is misunderstanding regarding replacement value and repair value. As noted above, replacement value is limited by the total policy value. In many cases, the cost to repair a structure far exceeds the stated replacement value. For example, an insured may have determined the cost of their building based on the purchase price or current market value. However, after a loss, the structure is to be *repaired* rather than simply replaced, and the cost of repairing the structure can far exceed the estimated replacement costs. Debris removal, specialized work to dry out walls, and new building codes can push the repair costs well over the replacement value limit. Additional factors such as temporarily high prices in the wake of a catastrophe can also significantly increase the repair costs.

To ensure that the replacement value of a property is accurate, it is advisable to consult an expert, such as a contractor, who is knowledgeable about the current costs of construction, including current costs of materials and code requirements. For large properties, the relatively small costs of the estimate and premiums based on accurate value could significantly affect a business' or condominium's ability to recover. In every case, the policyholder should insist on visual inspections and estimates.

In most situations, it is advisable to purchase Replacement Cost coverage, rather than Actual Cash Value coverage. Actual Cash Value is sometimes measured as the cost of replacing damaged or destroyed property with identical or comparable property, less accumulated depreciation and obsolescence. This could mean the difference for a complete recovery after a catastrophe, as the actual cash value usually will not provide sufficient benefits to replace or restore damaged property.

Coinsurance Provisions

Coinsurance provisions can significantly reduce the amount a policyholder can recover within policy limits. Often an insured will choose to insure their property at less than full replacement value and pay a lesser premium. Under a coinsurance provision, if the property is not insured to one hundred percent of its replacement cost value, any loss can be prorated to the percentage of the amount purchased. For example, if only $100,000 worth of insurance was purchased but the replacement value of a property was $200,000 and there was a $50,000 loss, the insurer may pay only $25,000, because only 50% of the replacement value amount was purchased.

What conditions or other policy provisions may affect the coverage otherwise provided?

Anticoncurrent Causation

Floods are specifically excluded from most property insurance policies, but flood insurance is absolutely essential for all properties in low lying, flood, and hurricane prone regions. Most policies contain an anticoncurrent causation clause which prohibits recovery when a covered peril and a not-covered peril combine to cause a loss. For example, hurricane winds may devastate the structure of a building and then a storm surge floods it. Because the covered peril (wind) combined with the not-covered peril (flood) to cause the loss, the insurer may not cover it. In the litigation following Hurricane Katrina, courts routinely enforced anticoncurrent causation clauses, leaving those without flood insurance devastated, with inadequate means of recovery. Unless it could be shown that specific damage was caused by wind and not flood, policyholders were out of luck.

Flood coverage is available through the National Flood Insurance Program, and can be purchased through FEMA or authorized private carriers. Flood coverage primarily covers a property's foundation. The premiums are relatively inexpensive and recovery is limited (under a homeowner's policy is limited to $250,000 for the dwelling and $100,000 for contents, businesses can purchase more coverage). In many hurricane situations however, this may be the only recovery a client could get. If a client's property requires more coverage, it can be purchased through private carriers as excess flood coverage.

Hazardous Circumstances

Most policies specifically exclude especially hazardous circumstances, which may or may not be within the policyholder's control. A circumstance often within the policyholder's control is vacancy. As a result of the current economy, there has been a dramatic rise in the number of vacant structures. Likewise, after a devastating storm, a structure can be uninhabitable for several months before repairs even start. Most insurance policies automatically suspend coverage when a property is vacant or unoccupied for more than sixty (sometimes thirty) days. In such a case, the insurer may suspend coverage for losses caused by vandalism, malicious mischief, or broken glass. If an insured's property becomes vacant or unoccupied, specialized coverage is available.

For business properties, coverage can be automatically suspended when certain required safeguards, such as burglar alarms, fire sprinklers, or locks are not maintained. If storm damage disables a required safeguard and it cannot be immediately repaired, the agent and insurer should be made aware and special coverage arranged, so that the policyholder can recover if otherwise covered peril, such as fire or theft, occurs.

Conditions of the Policy

An insurance policy is a contract, and the policyholder has obligations to render the contract enforceable in the event of a loss. If the policyholder does not fulfill its obligations, such as making payments, honest accounting, and prompt notice of a loss, the insurer could deny coverage.

Practical Advice for Working with an Insurer

Deductibles in Today's Credit Market:

Many commercial and residential insurers offer a percentage deductible, especially for windstorm coverage. A five percent deductible sounds manageable, but it can result in a multimillion dollar out-of-pocket expense. For a structure valued at fifty million dollars, the deductible would be 2.5 million dollars. In today's credit market, it may be difficult to obtain funds to cover the deductible, especially in the wake of a major hurricane. Deductible buy down coverage helps mitigate this problem. Recently, an insurance carrier offered to cover a $375,000 deductible for premiums of $17, 941. While the cost of deductible buy down insurance is not insignificant, it might be a wise gamble until the credit markets recover.

Real-Life Examples Dealing with an Insurer in the Event of a Major Storm.

Condominium 1

The property manager called Merlin Law Group *before* Hurricane Ivan hit. She received approval to retain a contractor before the storm devastated Destin. Financing was arranged, and construction started immediately on emergency repairs while the adjusters were contacted and kept informed of the plans for repair. The flood adjusters were arranged to be the same for the wind claim, so duplication was avoided.

The property manager fee was paid, in part, by the insurance company because she functioned as the "construction manager." Sandbagging costs before the storm were paid for as a mitigation expense. Housekeepers' salary for cleaning the rooms was reimbursed, as were overtime staff costs related to the hurricane.

Merlin Law Group immediately hired engineers to document the damages and provide a method of repair supported by the contractor. The insurance company's engineer was met by counsel and the contractor for an inspection, and the engineer approved all the proposed repair construction.

Condominium 2

The property manager was on site for less than a month when Frances, the first of two Hurricanes, hit this West Palm Beach Condominium. Residents remained inside units and some had to be rescued after windows and doors were blown open during the middle of the storm.

Debris was discarded into a dumpster without photographs and before the adjuster had a chance to see it. There was a shortage of air blowers, so the emergency crew hired after the storm and did not have air blowers to dry out the building.

An out of state public adjusting firm was hired to determine the damage. No construction firm was hired to do the repairs. The property manger walked with the adjuster and indicated that the damage might not exceed the deductible. All carpeting was thrown out under the assumption that the insurance company would pay for it, damaged, or not.

The property manager hired a company to tear out "damaged" drywall without consulting the insurance company for approval for the work. The owners had to move out during this process. They never moved back in because the insurer did not pay, contending that the removal was largely unnecessary.

The condominium association hired a friendly local attorney who had never represented a policyholder on such a large loss. Months went by. The attorney never consulted with the public insurance adjuster.

Litigation ensued, but the local attorney never took a deposition after filing the lawsuit. The Association was on the brink of bankruptcy before eventually hiring experienced insurance counsel.

Condominium 3

This was the tallest Florida condominium north of Ft. Lauderdale. Hurricanes Frances and Jeanne ripped the outside walls. The structure sustained a significant amount of water damage, and the building was condemned from occupancy.

The insurer approved the repair process. Unfortunately, the insurer never indicated to the condominium association or its public insurance adjuster that when the policy limit was reached, it would not extend two policy limits even though two different hurricanes caused the damage. Construction came to a standstill as litigation started.

Merlin Law Group was retained on a contingency fee basis. The problem was two fold. First, the building was severely underinsured. Second, a Florida appellate opinion seemingly supported the insurer's legal position. The condominium association needed to win, win big, and win in a hurry, or face the possibility of bankruptcy.

Merlin Law Group approached the litigation aggressively, requesting the court to expedite the matter to trial within a year. Insurance law experts and professors were retained to distinguish the condominium's policy form from the one unfavorably treated by prior Florida courts. Finally, insurance counsel hired a lobbyist and publicist to pressure the insurer's management to reconsider its position. The result was an approximate $40 million settlement seven months after suit was filed.

Conclusion

A risk manager can use property insurance to limit a client's loss in two ways. First, ensuring a client obtains all necessary coverage and covering all property at a realistic cost to replace it. As discussed above, obtaining the amount of coverage to truly make a client whole after a catastrophic loss will likely require several insurance policies, a visual inspection, and the expertise of an engineer or contractor. Second, as explained by the situation with condominium 1, a client's loss can be limited by working with the insurer in the event of a catastrophe. An insurer may approve mitigation costs *before* a storm if the opportunity is presented. Mitigation efforts could make a tremendous difference in the amount of damage a client sustains and in the recovery time and process. Likewise, having experienced counsel and public adjusters *after* a catastrophe can expedite a full recovery with the insurer and even preclude further loss for your client. One of the inherent, but less obvious costs of a catastrophe, is the emotional toll of seeing one's home or life's work devastated. Consumer advocates experienced in this area can expedite full or partial payments, recommend trusted resources, and curtail negligent or bad faith actions by an insurer which would impede a client's emotional recovery. As with the physical aspects for surviving a hurricane, the key to financial survival is preparation.