

How Quickly We Forget

By Robert N. Hughes, CPCU, ARM

How often each day do you hear the phrase "How quickly we forget?" The answer to that eternal question seems to be, "Rather quickly." The horrors of the images from 9/11 that assaulted our senses for so many days seem to have passed beyond memory into a sort of unreal never-never land. So, too, will the images of Katrina, Rita and Wilma pass into obscurity for most of the populace. Not so, however, for those in the affected areas, who must now try and put things back together, including collecting payments due from insurers who may or may not be willing or able to respond as promised. Those involved in the process will range from persons and/or businesses that receive rapid response and payment to those (mostly businesses) that will be litigating their claims years into the future. While some of the difficulty will be inevitable and, from the standpoint of the insured, unavoidable (due primarily to the instability and/or insolvency of their insurers), some problems may be avoided or mitigated by applying a little knowledge and a lot of planning.

First, let's look at the potential problem areas. For individuals, the easiest claims to collect will likely be the automobile physical damage claims. The "all risk" coverage provided under the "comprehensive" coverage in most auto policies is broad and fairly straightforward, with no water-damage exclusions. The difficulties that arise will most likely be typical of automobile claims in general and not specific to

hurricane damage ... questions of value, partial loss vs. total loss, etc.

Claims for damage to homes and personal effects, however, will be a different story, with the most prevalent problems arising from water-damage exclusions that appear in homeowners' policies. While the wild stormy scenes flashing across the video screen might

"Not so, however, for those in the affected areas, who must now try and put things back together, including collecting payments due from insurers who may or may not be willing or able to respond as promised."

lead one to believe that most of the damage from a hurricane is caused by the wind, in fact a great deal of damage is caused by the storm surge and rising waters. That certainly was the case in New Orleans, where large blocks of residences that for the most part escaped wind damage were inundated by the flood waters resulting from the failed levees. Governors of at least two states have responded to the anticipated difficulties by issuing orders that insurers will be restricted in their ability to invoke the ubiquitous flood exclusions in their policies.

Although the legality of such actions will have to be determined by the courts, such action nevertheless signals the difficulties to come.

We predict, therefore, that many if not most homeowners will be faced with the following difficulties in collecting payment for claims arising out of the hurricanes:

- Differentiating water damage from covered damage such as wind, collapse, etc.
- Evaluation, i.e., replacement cost v. actual cash value
- Cost for temporary housing ... when does it begin and end?

These potential problems presume that the insurer is solvent and acting in good faith. The most distressing problems that will arise for some homeowners, however, will come when they discover that their insurer is either broke and unable to pay, or crooked and unwilling to pay. The latter problem might be mitigated somewhat by the employment of a

(Quickly, continued inside)

IN THIS ISSUE:

- ***How Quickly We Forget***
- ***From Near and Far***
- ***Happy Holidays***

(Quickly, continued from cover)

good attorney or by joining a class of others in the same boat. The former, however, is probably unfixable.

Although we anticipate that there will be a significant amount of coverage litigation on the part of homeowners arising out of the hurricanes, we predict that the majority of those claims will be amalgamated into class actions against the larger personal lines insurers ... All State, State Farm, etc.

“The most distressing problems that will arise for some homeowners, however, will come when they discover that their insurer is either broke and unable to pay, or crooked and unwilling to pay.”

Business and industry? Well, we think that will be a completely different story. Small neighborhood businesses with partial damage will probably not have too much difficulty. That is, unless they have significant business interruption. Then things might get sticky. For larger businesses and industrial installations, however, the likelihood of settling large physical damage and business-interruption claims without controversy is practically nil. Of course, there will be the argument over excluded perils, such as flooding and rising waters, mold, contamination, etc. The stickiest problems, however, will come out of the claims for business interruption, with the biggest controversies of all arising from contingent business-interruption claims pressed by business and industries whose business was impaired, not by damage to their own

facility but by damage to the premises of their suppliers, joint-venture partners, customers, etc.

Space limitations prevent my listing every potential coverage problem that might arise in such circumstances (even if that were possible). Therefore, I will cite a limited number of examples and then hopefully make some suggestions that might help prevent or mitigate the problems.

Replacement Cost

Most “all risk” property policies are written on either a “replacement cost” basis or an “actual cash value” basis, with the former in the majority. Actual cash value (ACV) is usually defined as “the cost to repair or replace with property of like kind and quality less reasonable deduction for depreciation.” “Replacement cost” is usually defined as “the cost to repair or replace with property of like kind and quality, with no deduction for depreciation.” For insureds with ACV coverage, the core question is, how much depreciation. Insurers tend to calculate depreciation on a straight-line basis based on the property’s age, with no consideration for utility value. For instance, should a completely serviceable 10-year-old wall with no structural deterioration be subject to depreciation? Insurers will probably say “yes,” but insureds should say “no.”

Unfortunately, all such problems are not averted with the purchase of “replacement cost” coverage. The principal question that arises is, “What is like kind and quality?” Several years ago a client who operated a knitting mill which utilized mechanical knitting machines that were almost 100 years old suffered a loss from a tornado. Unfortunately, it was impossible to replace the machines, as knitting is now done by machines that contain

sophisticated electronic components. The insured insisted that the machines should be rebuilt, while the insurer insisted that new-generation machines should be purchased, which was less costly. Unfortunately, the new-generation machines simply could not be made to produce the product that was being made by the old machines. Hence a lawsuit arose. Ultimately, the court ruled that, in order for the insured to be “indemnified” (that is to say, placed in the same financial position after the loss that existed prior to the loss), the

“For larger businesses and industrial installations, however, the likelihood of settling large physical damage and business-interruption claims without controversy is practically nil.”

old machines would have to be rebuilt so that the integrity of the product could be preserved.

Resumption of Business

In the case of businesses that have suffered a complete cessation of operations, most business-interruption policies provide coverage until the premises are rebuilt or otherwise made ready to resume normal activities. Some policies have an “Extended Period of Liability” coverage that continues coverage until the business is restored to its preloss level. Most policies require that the insured resume partial activities as soon as practicable

(Quickly, continued opposite)

(Quickly, continued from opposite)

in order to mitigate the damages. As always, one should read the policy, as there are many permutations of coverage.

It is probably not difficult to discern the potential areas for disagreement in this area. The "Extended Period of Liability" endorsement substantially reduces the potential for disagreement. Without it, insurers will argue that, as soon as the insured premises are repaired and ready to accept business or begin operations, coverage ceases. A good example of the consequences of such a position is seen in the French Quarter restaurants in New Orleans, which, although their own premises were soon cleaned up and ready to serve, were unable to do so because their employees had no homes and could not return to the city.

Ingress or Egress

What if your business is undamaged but your customers cannot get to you? Generally, the policy must be specifically endorsed to provide ingress/egress coverage. Even then, however, things might not be simple, as demonstrated by the claims following 9/11. Hotels in cities other than New York found that, due to the closing of the air space, conventions were cancelled, reservations were cancelled, and business dropped to almost nothing. Many policies were written in such a way that ingress/egress coverage was provided only in circumstances where the public was "prevented" from entering the premises. Insurers took the position (successfully in most cases) that, although the public could not fly to the locations, they could have sought other means of transportation and were therefore not "prevented" from entering the premises.

FROM NEAR AND FAR



New Jersey – According to the Insurance Services Office Property Claim Services unit, the third quarter of 2005 was the worst ever for catastrophe losses. It estimates that \$40.8 billion will be paid out in insured property losses in 14 states. The third-quarter losses for 2004 were \$23.7 billion, while in 2003 they were \$3.7 billion.



Gulf Coast – Hurricane Katrina alone was responsible for more than \$34 billion in insured losses. Hurricane Rita added \$4.7 billion to the quarter's tally, and Hurricane Dennis chipped in with \$1.1 billion.



Washington, D.C. – In 1968 Congress enacted the National Flood Insurance Act, creating the National Flood Insurance Program. The NFIP makes federally backed insurance available in communities that participate in and enforce floodplain-management programs. About 20,000 villages, towns and cities take part in the NFIP. Limits for NFIP flood insurance peak at \$250,000 for a single-family dwelling, with an additional \$100,000 maximum for personal property coverage.




New York – According to statistics published by the Insurance Information Institute, the three largest insurance losses ever recorded are Hurricane Katrina, which struck the U.S. in August 2005 and caused \$34.4 billion in insured losses; Hurricane Andrew, which caused \$21.5 billion in insured losses in the U.S and the Bahamas in August 1992; and the terrorist attacks on New York and Washington, D.C., on September 11, 2001, which caused \$20 billion in property losses. These figures are adjusted to 2004 dollar values.

Contingent Business Interruption

Many of these problems can be averted through careful policy drafting and pre-event agreements. Unfortunately, for this hurricane season at least, it is too late for that. So what can one do to minimize claims controversy and maximize recoveries? First, protect the property and preserve the evidence. Next, DOCUMENT – DOCUMENT – DOCUMENT. Take photos ... hundreds of them. Meet with your agent or broker and make detailed plans for the recovery of your claim. If they are unwilling to do so or you are unsatisfied with his or her response, hire a consultant and/or an attorney. If your insurer is not responding, move quickly, and strongly

consider a preemptory declaratory judgment action. Venue is important, and the courts are likely going to be crammed with coverage claims arising out of these disasters.

Of course, it is always better to have your policy properly constructed before the loss. It's a bit late for that with Katrina and crowd, but it is still very important for the insured to understand the policies they have, anticipate the problems, and structure their claim to eliminate or reduce those problems as much as possible. 

Robert N. Hughes is founder, chairman of the board, and chief executive officer of Robert Hughes Associates, Inc.

ROBERT HUGHES ASSOCIATES INC.

508 TWILIGHT TRAIL, SUITE 200
RICHARDSON, TEXAS 75080
(972) 980-0088 FAX (972) 233-1548

PRSRT STD
U.S. POSTAGE
PAID
RICHARDSON, TX
PERMIT NO. 1380

ADDRESS SERVICE REQUESTED



THE RHA REVIEW

Publisher Robert N. Hughes
Editor John R. Oakley
Assistant Editor Alice H. Oakley

The RHA Review is published quarterly by Robert Hughes Associates, Inc. — an independent international litigation support, actuarial, risk management and insurance consulting company based near Dallas, Texas, with offices in Houston, Texas, and London, England. The purpose of this publication is to offer insurance-related information and critical comment pertinent to the clients, friends and fellow professionals of Robert Hughes Associates, Inc. This publication is available free to interested parties. The information contained in this publication is intended to be general in nature; readers should obtain professional counsel before taking any action on the basis of this material.

For more information, contact
John R. Oakley, Editor
508 Twilight Trail, Suite 200
Richardson, TX 75080
Tel. (972) 980-0088.

Copyright © Robert Hughes Associates, Inc.,
2005. All rights reserved.