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fsi@fsiinsurance.com • www.forrestsherer.com



COMMERCIAL INSURANCE CENTER

24 North 6th St. • P.O. Box 900

Terre Haute, IN 47808

Telephone: (812) 232-0441

Toll Free: (877) 232-0441

Fax: (812) 232-0926

PERSONAL INSURANCE CENTER

1219 Ohio St. • P.O. Box 900

Terre Haute, IN 47808

Telephone: (812) 232-0441

Fax: (812) 232-0926

THE INSURANCE NEWSLETTER

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Insuring Against Employee Dishonesty

Most insurance buyers typically spend a fair amount of time reviewing their fire insurance policies, and most would consider their property policy to be a key part of their insurance program. The sad fact, though, is that businesses are more likely to suffer a loss from the dishonest acts of their own employees than they are to experience a fire, yet proper coverage for employee dishonesty claims is one of the most often overlooked parts of an insurance program.

Most broad form (formerly called “all risk”) property policies will cover loss or damage from burglary or theft, but with a condition...the crime must be committed by outsiders; a standard exclusion in property forms bars coverage for loss by theft or dishonesty of employees. And while the standard broad form property policy will cover theft of business property, stock, inventory or fixtures, it will exclude or have very low sublimits on money, securities or negotiable instruments.

To cover these gaps these you need a crime insurance policy. Such a policy, whether purchased on its own or, as commonly found, as part of a package policy, will cover money or securities along with stock or other property. Crime policies will typically have several separate insuring agreements covering different crime perils, but the very first insuring agreement in almost all crime policies is theft by an employee, which fills the gap created by the aforementioned exclusion in the property policy. Employee dishonesty coverage has its own rules that are different from property policies, and it's the section that requires most attention from insurance buyers.

As with any insurance policy, a critical point is choosing an appropriate limit. Most organizations have a pretty good grasp of their maximum exposure from burglary or theft of money or securities; we are pretty much a cashless society now, and most organizations won't have large amounts of currency or negotiable instruments on hand. Employee dishonesty, however, presents a whole different problem. An employee dishonesty loss can involve one employee or several, and the amount of a dishonesty loss can easily add up to a very large sum if it goes undetected over a long period of time, even if each dishonest act only involves small amounts. These claims will often involve otherwise trusted employees who have no previous criminal history and who might not be getting close oversight, so a lot of time can pass before losses are finally discovered.

In fact, insurance industry sources report that the average employee dishonesty cases were open more than eighteen months before being discovered. External audits only discovered 5% of dishonesty cases; more were actually discovered by accident, and the single biggest way fraud was discovered was by tips from informants. The median loss reported was more than \$160,000; that's way beyond pilfering a few paper clips. For smaller companies, where oversight and controls are most likely to be lax, these losses can be crippling or even fatal.

Another thing to understand is what triggers coverage for a dishonesty loss. A property policy covering theft of goods by an outsider is an “occurrence” policy; the actual event or occurrence of a break in and act of theft triggers coverage. Employee dishonesty policies, on the other hand, come in two flavors, “loss sustained” or “discovery”.

The difference? A loss sustained policy is an occurrence policy, covering you for a loss that occurs during the policy period; a discovery form covers you for a loss that is *discovered* during the policy period, no matter when it occurred or over how many prior policy periods.

Each form is an acceptable way to buy employee dishonesty coverage. The major difference between the two triggers is that the discovery option allows the current policy (and limits) to cover loss that occurs during prior periods, where a loss sustained form will limit recovery to the amount of coverage in force when the loss occurs. Put another way, if after some thought you decide to increase your employee dishonesty limits you'll want to buy a discovery form policy; that way the new, higher limits attach immediately and apply to any loss later discovered. If you buy higher limits in a loss sustained form, the new limits only apply to losses occurring after the limit increase.

And the plain fact is that most insurance buyers don't carry high enough limits of insurance for employee dishonesty; many don't carry this coverage at all. Property loss prevention has improved with new technology and improved building codes, and serious fires are much less frequent these days than in the past; organizations are also getting better at casualty loss prevention. Human nature, it would appear, is slower to change. Crime and dishonesty claims continue to rise overall, even regardless of recent economic conditions, which surely must contribute to this long term trend.

Give us a call if you would like to review this in more detail. Low limits or missing crime coverage is an oversight that should be corrected, especially since this is generally not expensive insurance, even for higher limits.

Stock Market and Fiduciary Liability Risk

If you are a trustee or fiduciary for your organization's retirement savings program, including a 401(k) or 403(b) plan, you already know that life isn't getting any simpler. The Employee Retirement Income Security Act (ERISA) imposes significant responsibilities on anyone serving as a trustee or fiduciary for

these plans. Lawsuits against plan fiduciaries have been on the upswing, and some fiduciaries have been found personally liable for plan losses under ERISA. This is especially important to remember at a time when the stock market is in turmoil once again, and employees may be checking their account balances almost daily.

Fiduciary liability risk for plan trustees has expanded steadily over the past couple of decades through a series of court decisions interpreting ERISA. In spite of the best precautions, plan sponsors are always vulnerable to allegations of "wrongful acts" under ERISA and risk incurring, at minimum, the cost of defending themselves. Fiduciary liability insurance is designed to protect against this risk.

As a matter of due diligence plan fiduciaries should work with their investment advisers to periodically review the status of all investment vehicles in their plan, including the rating of all mutual funds. The review process should be documented, even if no changes are warranted.

Employers who automatically enroll their employees in 401(k) or 403(b) defined-contribution retirement plans have other issues. The Labor Department's 2007 final regulations on "qualified default investment choices" under the Pension Protection Act of 2006 can be useful. Section 404(c)(5) of the act provides that, in situations where participants have an opportunity to direct their investments but fail to do so, fiduciaries will be entitled to fiduciary protection if those participants are invested in a qualified default investment alternative. The qualified default investment choices are: "life-cycle" funds, in which the asset mix is adjusted to reflect the number of years until the employee's expected retirement; balanced stock/bond funds; and professionally managed accounts, a diversified portfolio managed by an outside advisor. By sticking to the qualified defaults for employees who do not direct their own investments, employers now are protected from fiduciary liability.

That doesn't mean you won't be sued. The cost for Fiduciary Liability insurance is usually quite reasonable, and can be paid for by the plan. Cost is highly dependent upon the size of your retirement plan, your claim history, and your plan's investment lineup; a

plan offering company stock, for example, will likely be deemed a higher risk than one that does not.

As a bonus, fiduciary liability policies typically cover liabilities related to all kinds of employee benefits programs, not just retirement plans. They can, for example, cover health and welfare plans and nonqualified executive-compensation plans. Just be sure to disclose in your application to the underwriter which plans you offer, and want to have covered.

Unexpected Privacy Threats

It seems that most offices these days have moved heavily to digital information and document management. Hand in hand with that are privacy concerns. Businesses are generally aware of these and of the need to safeguard sensitive information, but new threats continue to emerge.

Here's a problem few are aware of. Do you have a copy machine in your office? Perhaps it's a single function copier, perhaps a multifunction machine, one that will scan, copy, print, perhaps fax documents. What you may not realize is that machine has a hard drive, and copies of all the documents that pass through that machine can be found there.

That's not a problem as long as it stays in your office, but most copiers are leased these days. What happens when your lease runs out and you get a new machine, and dispose of the old one? Few businesses ever think to wipe the information on the hard drive in an old copier.

Privacy experts report a hot market for used copiers, presumably driven by the information that may be found on their hard drives. Personnel records, medical information, social security numbers and financial data have all been found on hard drives of old copiers; financial institutions and medical offices are a particularly rich source of such data, but any employer is vulnerable.

Bottom line, be careful when disposing of old copiers; you need to be sure the hard drive is wiped clean before it leaves your possession.

More About Floods

Floods were in the news again this past Spring, as seems to be common these days. Now the National Hurricane center is forecasting an unusually active and severe hurricane season; their track record with these types of forecasts has generally been good.

Aside from Spring thaws, surface water flooding is often caused when heavy or steady rains overwhelm the ground's ability to absorb the downfall, or a storm wastewater system's ability to carry it all, or even when a water main breaks. There is much public awareness of flood risk when major tropical storms strike each summer and fall but flooding also can occur from something as common as a severe thunderstorm or several days of rain from a stalled weather system, particularly if the ground already is saturated, and particularly in flat or low-lying areas. The hazard increases if nearby property is paved and unable to absorb its share of the water, which is why flooding often occurs in developed areas.

National Flood Insurance Program (NFIP) records show that, of the 90 worst floods during the past 30 years, only 43% were caused by hurricanes or tropical storms. Most floods were from localized severe thunderstorms or prolonged rains. And nearly a quarter of all claims through the NFIP are for property in zones that are considered low to moderate risk. That last figure may be somewhat misleading, since flood insurance for property outside known flood zones is generally available from standard markets, and there are no records of what's been paid by standard insurers for floods in low hazard zones.

The NFIP does have statistics about the average damage (as a percentage of building replacement cost) caused by flood waters of varying depth. These averages are based on a one story residential property. Here they are:

Average damage with less than 1 foot of water = damage amounting to 11% of replacement cost
One foot of water = 22% of replacement cost
Two feet of water = 31%
Four feet of water = 48%
Six feet of water = 58%

Eight feet of water = 69%

Ten feet of water = 80%

These numbers are worth another look; a foot of flood water in a one story dwelling does damage equal to almost a quarter of the replacement cost value of the building. It doesn't take a lot of water to do a lot of damage. The NFIP also notes that the cost of damage per square foot for a multistory building is higher than a one story building, although a lesser percentage of replacement cost. Commercial structures show the same pattern.

If your property is on top of a hill, you might not need flood insurance. If you are on the upper floors of a multistory building, you might not need it. But if you can walk out your door and see property that's at least as high as yours, you probably do need some coverage for the risk of flooding. Flood risk has to be considered even for properties not located in high hazard flood zones, especially considering the low cost of this coverage compared to what it might cost

you out of pocket to pay for the damage even a minor flooding incident could cause.

A Glimpse into the Future

The National Flood Insurance Program (NFIP) expired March 28th due to congressional inaction on the bill to extend it. Claims for existing policies were honored, but no new policies were issued and existing policies were not renewed after that date. Congress then went on their Easter recess.

On April 16th, back, refreshed and ready for work, Congress passed a bill extending jobless benefits; tacked onto this bill was a provision that retroactively extended the NFIP through May 31st. As of that date, the NFIP has lapsed, again. As this issue goes to press, once again no new policies are being issued, and existing policies are not being renewed.

Remember, if you will, these are the same folks who will now be managing your health care.