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THE INSURANCE NEWSLETTER

Winter 2005-2006

Timing is Everything

Our last issue was delivered to the printer just before Katrina arrived, and you got your copy after she arrived. Keep this in mind, when you think of the essence of the first and the last articles, which were that the market is definitely softening and may well continue that phase until 2007. However, there was one caveat: if TRIA — The Terrorism Risk Insurance Act — is allowed to expire on 12/31/05, all bets are off for continuation of the soft market.

But one critical factor was overlooked: Katrina — and Rita, and Wilma! While the final numbers may not be known for a long time, due in part to a lot of litigation, aside from the sheer difficulty of settling so many devastating losses, it is readily apparent that the cost to insurers will be tremendous. The insurers will do what they can in the way of all kinds of rate increases to bolster their financial positions.

Obliviously, the largest increase to come will be on property insurance within, say, 25 or so miles of the coastline from southern Texas to northern Maine. But all lines of insurance, wherever they may be, are bound to see some sort of increases.

The big test will come after January first, the magic date for renewal of reinsurance contracts. When there's a catastrophe such as has occurred, the reinsurance companies

get hit the hardest, and they will certainly raise all their rates substantially. The insurance companies will then have huge reinsurance costs going forward from Jan. 1, and guess where they're going to get the funds to pay for it? Right. You guessed it. Reinsurance is the tail that wags the dog.

We mentioned TRIA. The last we knew is that the Administration is backing off from letting it expire, but talking about revising it with less government participation. The Senate and the House each have their own versions of how TRIA should be set up after 12/31/05. That would mean a lot of work in effecting new terms — all of which would be time-consuming compared to simply renewing it. And with all the other problems facing the Administration and Congress we can see the possibility of TRIA expiring due to neglect.

If that should happen, businesses everywhere will suffer from very restricted markets. It will really be a disaster for most commercial buyers of any size in virtually any location.

Now for Some Good Timing

In the same pre-Katrina issue, the second article was entitled "Disaster Planning and Preparedness." We mentioned, as types of disasters, terrorism, earthquakes, tornadoes,

hurricanes, mudslides, avalanches, forest fires, floods, crashing computers and lumped together "others", such as fires, explosions, airplane crashes and riots.

We saw how lack of disaster planning by FEMA and others contributed mightily to the devastation by Katrina. That disaster highlighted the need for advance preparation, whether by a federal agency, a city, a state or by any entity — such as your business.

Reread that article. If you didn't save it — for shame — call us and we'll run off a copy for you.

Coverage for Flood

Unless you've been hidden in the Brazilian rain forest for the past few months, you surely know that standard property insurance policies do not cover losses by flood. Let's zero in on just what a flood is, as contrasted with other types of water damage which may be covered. And let's see what's available in the way of flood coverage.

First, a definition of "flood" as noted in the text of "Insurance Words and Their Meaning". "A general and temporary condition of partial or complete inundation of normally dry areas from (1) the overflow of inland or tidal waters, or (2) the unusual and rapid accumulation or runoff of surface waters of any source."

Essentially, what we have is surface waters, as distinguished from water from internal sources, e.g., broken pipes, or from rain coming through roofs or windows broken by windstorm.

The need for flood insurance for home owners is a two step process. Insurance companies do not write it for various valid reasons. It is underwritten by the Federal government thru the National Flood Insurance Program (NFIP) and serviced by various insurers and sold by brokers and agents, such as us. But to get coverage from NFIP, the property must be in an “eligible community” so designated by HUD, after application for eligibility by the community. NFIP rates are mostly below actuarial rates and subsidized by the taxpayers — you and us.

For commercial entities, the NFIP offers coverage in limited amounts: a maximum of \$500,000. on a building structure and \$500,000. on the contents therein. Again, it must be in an eligible community.

The commercial insurance market can enter the picture by way of endorsement to the property policies or as stand alone non-standard policies. For entities with multiple locations and substantial geographical spread, there usually is no problem, but deductibles run pretty high.

Where single locations are involved, it usually is written as excess over an NFIP policy. Note that NFIP policies do not cover Business Interruption or similar time element exposures. Commercial insurance can offer these coverages where they write direct damage for flood.

Note that flood coverage is subject to the most visible form of “adverse selection” of just about any type of insurance: those on a mountain top won’t buy it; those in a valley or on a shoreline will hunger for the coverage. Insurers underwrite with this in mind, just as life insurers

turn down applicants with terminal cancer.

One caveat. Flood insurance doesn’t become effective until 30 days after application, so you can’t make a last minute decision after watching the Weather Channel on TV.

There are certain types of policies that cover property that is essentially movable and can presumably be moved out of the way of an impending flood. The best example is the automobile policy. Various types of floaters also come into this category of movable property. When you see the warning on the Weather Channel, just pack your DaVinci and your Rembrandt in your car and head for the hills.

A Caveat Worth Noting

We’ve written a lot about the D&O market in recent issues. It’s hard to predict what effect, if any, the post-Katrina market hardening will have on D&O insurance.

However, the little discussion on flood insurance is relevant. Many D&O policies contain an exclusion of coverage due to “failure to maintain insurance”. So, if a flood, for example, causes extensive damage to uninsured property, and the directors and/or officers are sued because it was not insured — well, guess what happens to those lucky directors and /or officers!

Of course, this exclusion isn’t confined to lack of flood insurance. It can apply to any uninsured loss. We understand that failure to maintain a proper amount of Business Interruption Insurance has been the subject of some denials of coverage under D&O policies.

A Sticking Point

All through the long-term soft market of 1987-2000, as well as the very recent short-lived soft market,

several classes of businesses did not participate in the benefits of the soft market — at least not to the extent that other businesses did. We’re referring to builders, general contractors and sub-contractors in the construction industry.

One bedeviling area is that of building defect claims that often arise years after the work was done. They may refer to original construction or to repair or maintenance work done years later.

It’s important for individuals and businesses employing building contractors of any sort to be sure to verify the existence and adequacy of the contractor’s liability insurance — and workers’ comp as well. And to keep records of such work for a long period of time. Claims for defective work have a way of surfacing many years later — akin to malpractice claims against obstetricians that surface when the baby reaches maturity.

Another Angle to Catastrophes

We learn from disasters. We learned this after Hurricane Andrew in 1992; it was reinforced by the Northridge earthquake a bit later; and now it really was brought home.

OK, we’ll end the suspense and tell you what we learned. When there’s a catastrophe affecting many properties in a given area, there’s a major spike in the cost of materials and labor, — sometimes as much as 40% due to shortages caused by the overwhelming and sudden demand. The law of supply and demand has not been repealed.

For a while, some insurers were offering a form for insuring buildings called “guaranteed replacement cost.” That would solve the problem, but that form is virtually non-existent today.

The next best thing is to overinsure by, say, 20% or 25%. There

are policies available that would pay up to 120% of the policy limit in the event of total destruction. Obviously, it's not a freebie.

One other outcome of catastrophes: in the event of very severe damage to a building, it may be less expensive to tear down what little is left of it and rebuild from scratch, rather than attempt to just repair the damage. It's almost like our throw-away world for personal possessions; don't repair, buy a new one.

This brings up a major point in insurance on buildings — an often neglected coverage called “Operation of Building Laws,” including Demolition Cost and Increased Cost of Construction. Here's how it works.

You have a building whose present cost of construction is, say, \$500,000. You dutifully buy \$500,000. of insurance with a Replacement Cost Endorsement, and you feel comfortable about it.

Not so fast. There's a feature in your local building code that compels the destruction of the remaining parts of a building that suffers damage exceeding, say, 50% of the value of the building. (Percentage may vary in different localities.) You have a fire — or damage by any insured peril — to the extent of 60% of the value of the building. So you collect \$300,000. But you're not allowed to repair it; you have to knock down the undamaged portion and rebuild it in entirety.

Your regular policy without the Building Law coverage will pay you only \$300,000. — the amount of damage by fire. The Building Law endorsement will bring your payment up to \$500,000, the replacement cost of the building as it was.

Now you have a cost of say, \$25,000, to demolish the remains. The Demolition Cost feature reimburses you for that.

But the building code requires

you to add certain features you didn't have before. Maybe an elevator, a ramp, another bathroom, thicker walls, safety glazing, heavier roof shingles, whatever. To meet these requirements, the Increased Cost of Construction comes in to reimburse you for, say, \$250,000. more. Total \$775,000, if you have at least that amount with the necessary Building Law coverage. Without it, your check for \$300,000 won't go very far.

What you had better do — if you haven't done it recently — is have your attorney advise you exactly what your local building code currently provides in the event of damage, so you can know how to act accordingly by advising us and authorizing us to arrange your insurance accordingly.

And by the way, don't overlook the possibility of your house being affected by the code: it's not only for business property, although that's the major concern.

A Must for Almost All Businesses

We're proud of the fact that most of our clients do insure Business Interruption or another “Time Element” coverage that may be more suitable for their type of operation. But we're not proud of the fact that many of our clients do not have a special endorsement that we'll describe.

Business Interruption policies measure the loss or damage in terms of the dollars lost over a period of time, usually the time it takes — or should have taken with the exercise of due diligence and dispatch — to rebuild, repair or restore the damaged property so that it can resume its economic function.

As an example, a fire or other insured peril is of such extent that it takes five months to rebuild

the building and another month to restock. Then it has a Grand Reopening with all the hoopla — big ads in the papers, spot announcements on local TV, etc. But the Grand Reopening laid an egg! It then takes several months of heavy promotion before all (or most) of the former customers are wooed back to their former buying habits. Business is just plain lousy for one, two, three, or more months after the reopening. But the B.I.I. Policy period of indemnity ended with the reopening date.

The shortfall can be corrected by attaching the “Endorsement Extending the Period of Indemnity,” sometimes just referred to as the “lag” endorsement.

The lag period can be extended in multiples of 30 days, with the additional rate per 30 days decreasing as the number of 30 day periods purchased increases. For example, a 30-day lag may increase the premium by 10%, while a 90-day lag may increase it by 25%. If one feels the need for, say a 5-month or 6-month lag, extending it for a full year would add a negligible premium.

It should be noted that the lag period starts at the later of: (1) the time it would take, with the exercise of due diligence and dispatch, to rebuild, repair and restock, or (2) the actual date of resumption of operations.

The fact that no coverage is available for the permanent loss of customers following an interruption due to fire — although such permanent loss is often an eventuality — highlights the importance of loss prevention. As we've often noted in these pages, almost every type of loss produces some kind of consequential loss that is uninsurable.

If your B.I.I. Policy doesn't have a lag endorsement — or if you don't know whether or not it does — you know where to reach us. And don't let time lag until you call us!

Globalization

This is a word you've seen in print more often during the past year than in an entire decade of the past century. Foreign exposures of one sort or another aren't just for Exxon Mobil or Microsoft. Increasing numbers of our clients have some foreign exposures, whether sales, outsourcing of work processing, R&D facilities, foreign suppliers or whatever.

Some insurance needs are similar to their domestic cousins, e.g. property insurance, foreign credit insurance. And don't overlook Contingent Business Interruption on foreign suppliers for example.

But other exposures are unique. The field of political risk insurance has several components, some of which involve severe risks wherein insurance may or may not be available, depending in part on the countries involved. In this category, of course, are war and terrorism.

But also in the field of political risk insurance are such exposures as: inconvertibility of foreign currency, expropriation of property, freezing of bank accounts, cancellation of export or import licenses, or any similar ac-

tion by foreign governments.

There are markets, either in this country or elsewhere, for most of these exposures, depending, of course, on the countries involved. We can access these markets, either directly or, in some cases, through foreign intermediaries. It ain't always easy, but that's the way our world has shrunk.

A Few Tidbits

As noted previously, the final figures on the "wicked women" — Katrina, Rita, Wilma — may not be in for quite a while. However, barring a ridiculous court decision holding insurers liable for flood damage, despite clear policy exclusions, insurers should be able to meet their obligations and survive financially. Failures, if any, will be few.

However, the above may not be true of the reinsurance market, wherein the reinsurers will be hit harder and some may well go under. That, of course, could weaken the structure of their customers, the regular insurers. Note that a few billion \$ in new capital poured into new and existing reinsurers in Bermuda in

contemplation of getting higher post-Katrina rates.

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The world of e-commerce has a need for its own specialized insurance coverages: property insurance for its own data, loss of proprietary information, third party liability for damage to others, e.g. spreading a virus. And various other exposures not included in one's regular policies. (See last issue for a greater description).

Generally speaking, this area of cyber liability is a hard and tricky market with many exclusions. Policies are not standard, meaning that there are very few court cases that have established decisions to follow. But you still need whatever coverages that can be gotten.

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On Workers Comp, don't exclude coverage for the principals unless absolutely sure of coverage under health insurance policies. (Not the usual case).

On Auto policies, cars owned by principals do not belong on the corporate policy.

FINANCIAL SERVICES UPDATE

In early 2004, we announced our affiliation with the Michael Farr Agency to market life insurance, annuities and other financial service products to Forrest Sherer customers and throughout the First Financial Corporation network. We have been very pleased with the professionalism and creativity of Mike and Nancy Farr, and we have seen sales in this area grow substantially (more than double.)

We then added two more talented and experienced people to our financial services department, Mark Lammers and Jeff Hallam, the beginning of 2005. Absolute Care specialized in Long-Term Care insurance, and we recently completed the acquisition of their Long-Term Care accounts. Mark and Jeff are recognized as leaders in this type of insurance throughout the State of Indiana (they are also licensed in Illinois.) They joined Forrest Sherer to market financial service products to our large customer base, as well as develop new customer contacts. They will work with the Michael Farr Agency to gain access to leading life insurance and annuity markets and will obtain their Series 6 and 63 licenses in the near future.

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