University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

1998

CPA's guide to understanding business insurance

Nino Lama

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Lama, Nino, "CPA's guide to understanding business insurance" (1998). *Guides, Handbooks and Manuals*. 627.

https://egrove.olemiss.edu/aicpa_guides/627

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Guides, Handbooks and Manuals by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

A CPA's Guide to Understanding Business Insurance

AICPA

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

A CPA's Guide to Understanding Business Insurance

Nino Lama, JD

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

A CPA's Guide to Understanding Business Insurance

Nino Lama, JD

Notice to Readers

A CPA's Guide to Understanding Business Insurance does not represent an official position of the American Institute of Certified Public Accountants, and it is distributed with the understanding that the author and publisher are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 1998 by
American Institute of Certified Public Accountants, Inc.,
New York, N.Y. 10036-8775

All Rights Reserved. For information about permission to copy any part of this work for redistribution of for inclusion in another document or manuscript, please call the AICPA Copyright Permissions hotline at 201-938-3245. A permissions request form for emailing requests is available at www.aicpa.org by clicking on the copyright notice on any page. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

1 2 3 4 5 6 7 8 9 0 SP 9 9 8

ISBN 0-87051-229-3

FOREWORD

A working knowledge of insurable risks and coverage is a must for today's CPA who is constantly asked to serve in the role of advisor to management. This book provides you with all the know-how to help your clients plan for insurance to cover their specific needs. You can help save your clients money as well as avoid the risk of property loss of a liability claim.

The material for this text has been prepared by Nino Lama, owner-manager of L.A. Lama Insurance Agency, Ithaca, New York. Mr. Lama, JD, Attorney at Law, is also a New York State certified instructor for the Agent's and Broker's Licensing Courses. He has served as an adjunct faculty member at Ithaca College in the School of Business and the School of Finance for the past 15 years.

Mary Schantz
Vice President, Product Development

TABLE OF CONTENTS

CHAPTER 1
INTRODUCTION TO BUSINESS INSURANCE **1**

OBJECTIVES 1

CASE STUDY — ABC MANUFACTURING CORP. 2

THE MEASUREMENT OF RISK 3

NEW YORK STATE LAW ON INSURANCE FRAUD 6

INDICATORS USED BY INSURANCE COMPANIES TO ANALYZE RISK 7
Arson Indicators 7
Indicators of Fraudulent Auto Theft Claims 9
Check Digit Formula 11
Indicators of Fraudulent Auto Damage Claims 12
Homeowners Burglary/Theft Fraud Indicators 14

LOSS EXPOSURES 16
External Loss Exposures 17
Legal Loss Exposures 17
Internal Loss Exposures 20
Governmental Loss Exposures 25

DETERMINING OBJECTIVES IN TREATING LOSS EXPOSURES 27

TOOLS TO TREAT LOSS EXPOSURES 30
Self-Insurance 30
Assumption of Risk 30
Buying Insurance 30

CHAPTER 2
TYPES OF INSURANCE COMPANIES, REINSURANCE,
AND THE INSURANCE CONTRACT **31**

OBJECTIVES 31

MUTUAL INSURANCE COMPANY COMBINATIONS 31

CAPITAL STOCK COMPANIES 32

INDEPENDENT AGENTS 33

COMPARISON OF THE DIFFERENT TYPES OF SYSTEMS 33

COOPERATIVE INSURANCE COMPANIES 34

THE RECIPROCAL INSURANCE EXCHANGE 34

GOVERNMENT INSURERS 35
Additional Insurance Alternative Facilities 36

INSURANCE CONTRACTS 36
Standard Provisions of the Insurance Contract 37
CONCLUSION 38

CHAPTER 3
REAL AND PERSONAL PROPERTY LOSS EXPOSURE 39
OBJECTIVES 39
PERILS — INSURABLE AND UNINSURABLE 40
CAUSE OF LOSS — SPECIAL FORM ENDORSEMENT EXCLUSIONS 41
THE COINSURANCE CLAUSE 43
ILLUSTRATIONS — DETERMINING AMOUNT OF INSURANCE REQUIRED 44
REPLACEMENT COST COVERAGE FORMULA 45
BLANKET INSURANCE 46
PRO RATA DISTRIBUTION CLAUSE 46
Formula for Pro Rata Distribution Clause 46
Illustration — Pro Rata Distribution 46
REPORTING FORM ENDORSEMENT 47
PEAK SEASON ENDORSEMENT 49
ASPECTS OF THE COPE SYSTEM 50
C — Construction 50
O — Occupancy 51
P — Protection 51
E — Exposure 51
CLASS RATING 51
BOILERS 52
SUMMARY 52

CHAPTER 4
INCOME LOSS 53
OBJECTIVES 53
BUSINESS INCOME COVERAGE 53
BENEFITS OF BUSINESS INCOME COVERAGE 54
Extended Period of Indemnity Endorsement 55
LIMITS ON BUSINESS INCOME COVERAGE 55
HOW MUCH COVERAGE? 55

LOSS OF EARNINGS INSURANCE 56

BUSINESS INCOME LOSS RESULTING FROM THE OCCURRENCE OF INSURED PERILS OFF PREMISES 61

RENTAL VALUE INSURANCE 61

ORDINANCE (LAW) COVERAGE 62

EXTRA EXPENSE COVERAGE 62

VALUABLE PAPERS, RECORDS, AND ACCOUNTS RECEIVABLE COVERAGE 63

SUMMARY 63

CHAPTER 5
COMPUTER LOSS EXPOSURES **65**

OBJECTIVE 65

COMPUTER LOSS EXPOSURES 65
Property Loss Exposure 65
Earnings Loss Exposure 67
Liability Loss Exposure 68
Crime Loss Exposure 69

COMPUTER CRIME CONTROLS 69

SUMMARY 70

CHAPTER 6
CRIME INSURANCE **71**

OBJECTIVES 71

COMBINATION CRIME POLICY 72

STOREKEEPERS' BROAD FORM POLICY 72

SUMMARY 73

CHAPTER 7
EMPLOYEE DISHONESTY **75**

OBJECTIVES 75

FIDELITY BONDS 77

THE DISCOVERY PERIOD 78

TYPES OF FIDELITY BONDS 80
Individual Bond 80

Name Schedule Bond 80
Position Schedule Bond 81
Blanket Bond 81

THE 3-D BOND (COMPREHENSIVE DISHONESTY, DISAPPEARANCE, AND DESTRUCTION POLICY) 82

SUMMARY 82

CHAPTER 8
WORKERS' COMPENSATION 83

OBJECTIVES 83

WORKERS' COMPENSATION, IN GENERAL 83

WORKERS' COMPENSATION POLICY 85
Agreement I 85
Agreement II 85
Agreement III 85
Agreement IV 85
Exclusions 86
Duties of the Employer and Employee 86

GOVERNING CLASS RULE 86

ILLUSTRATION (BASED ON ABC MANUFACTURING CORP. CASE STUDY) 87

EXPERIENCE RATING 88

PREMIUM DISCOUNT PLAN 89

DISABILITY BENEFITS LAW COVERAGE (NEW YORK, NEW JERSEY, HAWAII) 89

OSHA (OCCUPATIONAL SAFETY AND HEALTH ACT) 89

SUMMARY 90

CHAPTER 9
BUSINESS LIABILITY 91

OBJECTIVES 91

TORT REFORM 91

APPLICABLE LEGAL PRINCIPLES 92

STANDARD LIABILITY INSURANCE 93

PERSONAL INJURY LIABILITY 94

ACTIONS REQUIRED BY INSURED 95

COMMERCIAL GENERAL LIABILITY 95

PRODUCTS LIABILITY COVERAGE 97
CONTRACTUAL LIABILITY COVERAGE 97
OWNER'S AND CONTRACTOR'S PROTECTIVE LIABILITY 97
MALPRACTICE INSURANCE 98
DIRECTORS' AND OFFICERS' LIABILITY INSURANCE 98
UMBRELLA LIABILITY 98
CASE STUDY 100

CHAPTER 10
BUSINESS AUTO POLICY 101

OBJECTIVES 101
THE STRUCTURE OF THE BUSINESS AUTO POLICY 101
LIABILITY INSURANCE 102
Liability Exclusions 102
NO-FAULT COVERAGE 103
Who Is Covered 103
Medical Expenses 103
Work Loss 103
Other Expenses 104
COMPREHENSIVE COVERAGE 104
Exclusions 104
COLLISION 104
Deductibles 104
Miscellaneous Optional Coverage 105
REVIEW OF AUTO POLICY 105
CASE STUDY 106

CHAPTER 11
PACKAGE POLICIES 109

OBJECTIVES 109
BUSINESS OWNERS' POLICY 109
RATING PROCEDURE 112

CHAPTER 12
LIFE INSURANCE **113**

OBJECTIVES 113

YEARLY RENEWABLE TERM INSURANCE (NATURAL PREMIUM PLAN) 113

LEVEL PREMIUM TERM INSURANCE 113

WHOLE LIFE INSURANCE 114

LIMITED PAY PLAN LIFE INSURANCE 115

MODIFIED LIFE POLICIES 115

VARIABLE PREMIUM PLAN (DUTCH DESIGN) 116

FIXED PREMIUM PLAN 117

ECONOMICAL CONCEPT OF ENDOWMENTS 117

FAMILY INCOME POLICY 118

BUY-SELL AGREEMENT: LIFE INSURANCE AS FUNDING VEHICLE 119

APPENDIX A RISK DEFINITIONS & THE NEW YORK STATE LAW REGARDING INSURABLE INTEREST **121**

INSURABLE INTEREST LAW FROM NEW YORK STATE 121

APPENDIX B PREMIUM COLLECTION PROCEDURES **123**

INTRODUCTION 123

AGENCY BILL 123

RENEWAL PREMIUMS 124

DIRECT BILL 124

PAYMENT OF AUDITS 124

A CPA'S GUIDE TO UNDERSTANDING BUSINESS INSURANCE

OVERVIEW

NOTES FROM THE AUTHOR

Understanding insurance is paramount in avoiding both unnecessary inconveniences and major catastrophes. The ability of a business to resume operations after a fire or other disaster depends on how that business has prepared itself in terms of insurance and risk management.

What we intend to accomplish in this book is to prepare you for what is known as the "shoe box syndrome." This is the term given to the duties of review, analysis, and correction of a client's insurance program by his or her accountant. "Shoe box" refers to the typical style of recordkeeping used for insurance policies by the general public.

Because it is widely perceived that one of the accountant's responsibilities is to sort and manage an insurance portfolio, it becomes necessary for the CPA to acquire basic skills in analyzing insurance. Upon taking the "shoe box" of policies into his or her hands, the CPA also accepts a serious responsibility to the client. A client may expect advice about the adequacy of coverage and the competitiveness of its pricing. By no means are you expected to become an insurance technician. However, our intent is to give you adequate knowledge to be able to analyze an insurance portfolio for coverage and price. You will be given the basic knowledge required to ask penetrative questions.

You, the CPA may also be requested to help obtain insurance proposals from insurers for the client. In this process, the agent or broker will advise you as to what data are required for the preparation of a proposal. Most likely, the information that you will need from the client will include (but not be limited to) property values, dimensions or areas of buildings to be insured, payroll and receipts information, and loss history for the past three to five years.

The owner of the Hope diamond has had an imitation diamond made to wear while the original rests safely in a vault. The reason was simply that the quote for insurance given by Lloyds of London was unaffordable. Likewise, in business, insurance is not always the best method of protecting against a loss of assets or income. The recent dramatic increases in insurance costs provide ample incentive for alternatives, which will be presented to you in this book.

Insurance is a dynamic and powerful industry. It affects our society and our politicians as no other industry does. Insurance companies generate over $300 billion of premiums each year, and they control assets of $1 trillion and employ 2 million people.[1]

[1]Arthur C. Williams, Jr. and Richard N. Heins, *Risk Management and Insurance* (New York: McGraw Hill Book Co., 1985) , p. 5.

BRIEF HISTORY

Although there are records of insurance transactions dating back to ancient times, the development of insurance as we know it today occurred simultaneously with the growth of shipping to the New World. In the late 17th century there existed a cozy coffee house on Tower Street near the waterfront in London. The house was owned by Edward Lloyd.

Lloyd's Coffee House was a regular meeting place for ship owners, captains and those who wished to ship cargo. Also frequenting the house were wealthy entrepreneurs who enjoyed the company of these colorful people as well as the challenge of partaking in the risk of their voyages.

As shippers of cargo and ship owners sought to protect their ventures, the wealthy sought profits by pledging their personal funds against he perils of the sea in exchange for the payment of premiums. The owner of a ship would approach one such "underwriter" who would cover a percentage of the ship's value. The owner would then approach others until 100% of the value of the ship was "underwritten." The voyage would then take place. If the ship returned safely, the underwriters at Lloyd's made a profit. If the ship was lost, the underwriters would be called on to make good their pledge and cover the loss with their personal funds. All this was done with a cover note setting forth the values involved, the ship's name, captain, and destination. At the bottom, each underwriter sealed the note with wax.

The activity at Lloyd's increased rapidly. In 1696, Edward Lloyd began publishing "Lloyd's News." The tabloid gave all the latest "insurance news" and was released three times per week. Today, the Lloyd's of London facility is the largest insurer in the world. It controls the availability and pricing of insurance around the globe.

CHAPTER 1

INTRODUCTION TO BUSINESS INSURANCE

OBJECTIVES

After completing this chapter you will be able to:

- Analyze a client's loss exposures.
- Develop risk management goals.
- Provide advice to management regarding the probable treatment for the loss exposure.

Determining a client's business insurance needs is the first step towards minimizing risks and loss exposures. This introductory information shows you how to take that first step to make sure your clients secure adequate coverage. Included in this chapter is a case study with details of a specific company. This information will be used throughout the book to illustrate the principles involved.

The job of analyzing a client's business insurance needs is a tough one. You'll have to understand the language of insurance, and how the insurance business views the various risks and loss exposures.

We'll break the insurance industry's secret code in this book. Understanding insurance can mean the difference between an inconvenience and a major catastrophe for your business or your client's. A business's ability to reopen its doors after a fire or other disaster depends on how well that business has prepared itself in terms of insurance and risk management.

This book will help prepare you for what's known as the "shoebox review." This is a term for the review, analysis, and correction of your own or your client's insurance program. "Shoebox" refers to the typical style of record-keeping used for insurance policies by the general public. Your clients will expect you to sort and manage their insurance portfolio, so it's necessary for you to acquire basic skills in analyzing insurance. Once you accept the "shoebox" of policies, you take on a serious responsibility to your client. By no means are you expected to become an insurance technician, nor should you ever represent yourself as one. But your client may expect advice as to the adequacy of coverage and the competitiveness of pricing. We'll give you enough knowledge to analyze an insurance portfolio for coverage and price. You'll develop the basic knowledge you need to ask the right questions.

The following case study, which will be referred to in subsequent chapters, includes data needed for the review of loss exposures, the practice of risk management, and the purchase or review of insurance.

It will aid in your understanding of this material to regard this case study as if a client were seeking your advice.

CASE STUDY

ABC MANUFACTURING CORP.

Description of Premises

- Two-story joisted masonry
- Basic rectangular construction, no basement
- Replacement value of building: $560,000, depreciated value $300,000
- Upstairs offices and conference rooms
- Billing, payroll, etc., on IBM PC
- Downstairs, all manufacturing equipment, which includes:
  - High-tech machining tools (computer-controlled), drill presses, lathes, cutters, grinders — protective eyewear required
  - Replacement value of all contents: $1,500,000
- Rear of first floor loading dock with fork lift
- Sprinkler system throughout building
- Constructed in 1965
- Located within corporate limits of city adjacent to creek
- Square footage — 8,000 per floor
- Parking area — 25,000 square feet, not paved
- Flat roof

Description of Operations

- Close corporation
- Business engaged in manufacture of precision-tooled electronic component steel boxes.
- Boxes are built for several customers, including:
  - U.S. government, several universities, major computer manufacturers, manufacturers of aircraft communication/navigation radios
- Caustic acids and industrial oils are used in processing and cleaning; disposed of by insured's employees at local landfill
- Raw materials obtained from one supplier via airfreight
- Finished products shipped via airfreight
- All shipments made FOB point of destination
- Major computer manufacturer is held harmless in sales contract for any liability it incurs due to faulty manufacture or failure to comply with specifications.

Employees

- Engineers and designers: 6
- Supervisors: 3
- Foremen: 6
- Machinists: 13
- Other laborers: 5

- Salespersons: 4
- Executive officers: 3
- Payroll: $978,000
- Receipts: $3,200,000

Vehicles

- 1985 Audi 5000; operated exclusively by president of corporation — value: $20,000
- 1984 Chevrolet van — value: $6,200
- 1976 Ford pick-up truck — value: $2,000

Subcontractors Used

- For building maintenance — "Ace Maintenance"
  - Individual worker — receives annual contract and fee of $10,000 (works alone)
  - Does not carry workers' compensation
- For major repairs to building — "City Construction Co., Inc."
  - Receives payment per job with contract
  - Carries workers' compensation and other insurance

THE MEASUREMENT OF RISK

Insurers are highly specific in their use of insurance terms. Thus, it's essential that we study the basic definitions used in the insurance business. We'll discuss them now. Many of these terms are also contained in Appendix A for your reference.

The most fundamental of all terms used in insurance is "risk." The entire system of insurance is based on it. Risk is defined by the *Dictionary of Insurance Terms* of the Chamber of Commerce of the United States as "chance of loss." This simple definition is the one the insurance industry uses, and the one we will use.

We can divide risk into two categories: pure risk and speculative risk. A business owner may speculate on the expansion of his business into a new territory. The loss may be his investment. The gain could be a successful venture and added revenues for many years. The insurance industry is based on pure risk only. It's the possibility of loss without any possible gain — e.g., that a house may burn. Pure risk exists for everyone, and insurance is one treatment of it. Insurers are professional risk-bearers. They accept risks from the public, in exchange for premium payments. Insurers spend millions of dollars each year to inspect, investigate, and question those seeking insurance.

Here's how the insurance companies gauge which risk to assume and how much to charge for assuming it. The insurance companies measure risk on a scale from 0 to 1. The top of the scale — 1 — represents a definite occurrence. The bottom of the scale — 0 — represents an impossibility of occurrence. The insurers will not deal with risk that is too close to 1 or too close to 0. The following is a illustration of the scale.

(DEFINITE OCCURRENCE)
1

0
(IMPOSSIBILITY OF OCCURRENCE)

"Hazard" is next most important term, after "risk," in the insurance industry. In measuring risk, we must define those factors that contribute to it. We define hazard as any condition that creates or increases risk. There is a direct correlation between hazard and risk. By measuring this correlation, insurers decide whether to insure a business or individual, and how much to charge for the insurance. When the degree of hazard drives the chance of loss towards 1 on the risk scale, the odds are too great against the insurer. An example would be an automobile driver with a recent record of several accidents and convictions. On the other hand, a risk with no hazard approaches 0 on the risk scale, and is also highly unlikely to be insurable. The reason for this is that the insurer could not ethically charge a premium that would cover its own expenses to issue the policy.

We can divide hazard into three categories: physical hazard, moral hazard, and morale hazard.

Physical hazard is any condition of the environment that creates or increases risk. Some typical example: poor wiring in a building, debris accumulation, or broken stairs. These are items that the insurance companies look for to determine the amount of risk involved in writing insurance for a particular business. The greater the presence of hazard, the higher on the risk scale, and the higher the premiums.

Moral hazard is the hazard arising from dishonesty in individuals. This hazard cannot be isolated and repaired. Despite the efforts of law officials and insurers, moral hazard is the greatest hazard of all, and drives risk to the factor of 1. In the realm of property insurance, moral hazards include arson, and fraudulent burglary and theft claims. Moral hazard varies in degree from an outright torching of a building for profit, to simply padding a repair estimate on a dented fender. The net result is billions of premium dollars — your premium dollars, paid out each year by insurers.

The third form of hazard is "morale hazard," which is a form of general disregard for one's own environment. Two examples of morale hazard are poor safety practices in the work place and high absenteeism. Morale hazard can actually be an attitude of carelessness brought on by the existence of insurance.

As the presence of morale hazard shows itself in the physical appearance of the insured's business, the risk scale is driven towards the factor of 1, increasing insurance costs, and limiting the availability of coverage.

Here are two more terms we want to give you. The first is "peril" — the actual negative occurrences to be insured against. Examples: fire, windstorm, theft, collapse, and employee dishonesty. There are hundreds of these, and we'll cover them in coming chapters.

The second term is "insurable interest." It's crucial to understand the implications of this term. Many claims have been denied because there was a misinterpretation of this phrase. "Insurable interest" is not just something insurers have thought up; it is statute law.

An example of insurable interest in property is the interest a homeowner has in his home. It makes sense for a homeowner to buy fire insurance for his own home. If he were able to buy fire insurance on his neighbor's home, it would no longer be pure risk, but gambling, with a

possible payment to a person who had an insurable interest. In the real world, the problem arises in more subtle ways. For an insurance policy to be valid, the entity named on the policy must be completely accurate. E.g., if a store is owned by ABC, Inc., the policy must be written in that name. If, at the time of a loss, a different name appears on the policy — such as a former owner or an individual — the insurer may not have to honor the claim. There could be a steep price to pay for overlooking a seemingly minor detail.

"Insurable interest" problems often occur when vehicles are bought or sold.

NEW YORK STATE LAW ON INSURANCE FRAUD

The following excerpt of New York State law is meant to serve as an example of insurance fraud law.

Sec. 53a-215. INSURANCE FRAUD: CLASS D FELONY. (a) A person is guilty of insurance fraud when he, with the intent to injure, defraud or deceive any insurance company: (1) Presents or causes to be presented to any insurance company, any written or oral statement including computer-generated documents as part of, or in support of, any application for any policy of insurance providing coverage for loss or damage to real or personal property caused by fire or a claim for payment or other benefit pursuant to such policy of insurance, knowing that such statement contains any false, incomplete, or misleading information concerning any fact or thing material to such application or claim; or (2) assists, abets, solicits, or conspires with another to prepare or make any written or oral statement that is intended to be presented to any insurance company in connection with, or in support of, any application for any policy of insurance providing coverage for loss or damage to real or personal property caused by fire or any claim for payment or other benefit pursuant to such policy of insurance, knowing that such statement contains any false, incomplete, or misleading information concerning any fact or thing material to such application or claim for the purposes of defrauding such insurance company.

(d) Insurance fraud is a Class D felony.

Sec. 38-175v. (c) In the absence of fraud, malice or criminal act, no insurance company authorized employee or person who furnished information on behalf of the company or department, shall be liable for damages in a civil action or subject to criminal prosecution for any oral or written statement made pursuant to the provisions of this section.

Here is a sampling of some of the indicators insurers search for in analyzing the amount of risk in an insurance account. In addition to arson and auto theft, there are checklists for auto damage claims and burglaries.

INDICATORS USED BY INSURANCE COMPANIES TO ANALYZE RISK

Arson Indicators

Policy Factors

- New policy with loss occurring within one year of inception.
- New business risk with inexperienced ownership.
- Loss occurring just prior to policy expiration or after notice of cancellation.
- Loss occurring after either a recent increase or decrease in coverage.
- Amount of coverage excessive.
- Agent unfamiliar with risk.
- Multiple policies in effect.
- Premium payment in arrears.

Property Factors

- Deteriorating neighborhood — vandalism.
- Building is vacant or unoccupied.
- Building about to be or has been condemned.
- Property for sale.
- Attempts to break lease.
- Change in type or quality of tenants.
- Liquidation or division of estates or common ownership.
- Tax default.
- Foreclosure proceedings.
- Fire prior to or during renovations.
- Replacement value exceeds market value.
- Deteriorating building — poor maintenance.
- Construction problems — not up to code.
- Property previously damaged with no coverage.
- Property has multiple owners, or just changed ownership prior to loss.
- Multiple liens on property which exceed market value.
- New or substantial amount of competition in immediate area.
- Inventory — too low or too high.
- Recent increase or decrease in employees.

Insured Factors

- Poor credit standing.
- History of previous losses — habitual claimant (burglaries, etc.).
- Experiencing financial difficulties from both personal and business reasons.
- Domestic problems.
- Misrepresentations, fabrications and/or vagueness by insured or other parties.
- Insured changing jobs or getting into another business.
- Property recently purchased from relative, friend or associate.
- Insured pressing for fast settlement.

Fire Factors

- Evidence of arson discovered by authorities or fire is suspicious for reason(s) indicated:
  - — Objects abnormal to occupancy found — e.g., incendiary objects, devices, trailers, etc.
  - — Lack of contents — debris that should be there and not found.
    1. Vacant rooms
    2. Empty closets
    3. Food supplies
  - — Multiple origins or uncommunicated fires.
  - — Fire destroying old, valueless or obsolete contents.
  - — Fires in middle of building or room.
  - — Closet/water heater fires.
  - — Damaged fuel lines/electrical wiring — occurring prior to fire.
  - — Open gas jets discovered.
  - — Suspect fire patterns:
    1. Low point of burning
    2. Holes through floors and no fire beneath
    3. Charring in corners and baseboards
    4. Deep shiny charring to floors
  - — Valued possessions missing
  - — Pets relocated
  - — Doors/windows closed and locked
- Fire protection systems poorly maintained, not serviced or "turned off."
- Security system disconnected, or watchman service discontinued.
- Facts as to origin of fire significantly differ with insured's version.

Indicators of Fraudulent Auto Theft Claims

Policy Factors

- Coverage obtained just prior to loss.
- Only comprehensive coverage was purchased.
- Recent alterations to policy, especially the addition of comprehensive coverage.
- Recent alterations to policy, especially the addition of comprehensive coverage.
- No lienholders on policy, or an individual is named, especially on an expensive auto.
- Insurance agent has never seen the insured vehicle, does not have previous or other business in effect with the insured.
- Location of the agent in relation to the insured's address.
- Registered owner of vehicle different from policyholder.
- Insurance premium paid in cash.
- No collision coverage on an expensive vehicle.

Vehicle Factors

- Late model, expensive vehicle involved.
- Vehicle reported to be expensively customized, or show model, having many new extras or expensive articles in car.
- Vehicle was rebuilt, a previously recovered theft, or subject of prior major collision claim.
- Car is fuel inefficient, difficult to operate, or expensive to maintain.
- VIN doesn't match vehicle
- Vehicle registration is from distant or different state.

Purchase Factors

- Recent ownership of the vehicle.
- Vehicle paid for in cash.
- Vehicle purchased from private individual, an insurance company, salvage yard, or auto repair shop.
- Vehicle purchased out of state.
- Vehicle purchased for considerably less than market value.

Purchase Factors (continued)

- Title or proof of ownership either not available, a duplicate issue, or from a distant place.
- Insured presents an assigned title in name of previous owner, as proof of ownership.
- Previous owner cannot be located or is unknown to insured.
- Seller lives a considerable distance from insured/buyer.

Insured Factors

- Insured is a young, single male.
- Insured has other vehicles insured with other carriers.
- Insured is in an automobile-related occupation.
- Insured is unemployed or has occupation that does not indicate an ability to purchase or maintain this type of vehicle.
- Members of insured's family or household know nothing of the loss.
- Insured is difficult to contact, lack of residence or business phone.
- Insured gives address and phone number of bar, hotel or motel as place where he can be contacted.
- Insured's home address differs from the place of garaging.
- Insured corresponds person to person, avoiding use of U.S. mail.
- Insured is in arrears with lienholders.
- Insured, in a hurry to expedite claim, requests immediate settlement, threatens complaints.
- Insured wishes to retain title.
- Insured wants to retain title and salvage on a total loss where salvage value is minimal.
- Insured vague on providing information on vehicle reported stolen and details of theft.
- Insured has history of theft losses.

Theft Factors

- Insured has failed to report theft to police, or has reported theft to insurance company first.
- Late notice of theft.
- Vehicle alleged to have been stolen prior to titling and registration.
- Vehicle reported stolen and recovered a short time later either burned, stripped of interior, or having extensive damage.
- Recovered vehicle shows no ignition damage, or forced entry damage to doors, glove box, or trunk.
- Reported location of theft differs from insured's normal course of action.
- Person using vehicle at time of theft is not a family member.

Since 1981, a 17-character VIN number appears on all cars, along with a complicated formula for verifying the "check digit" (see computation for formula presented on the next page). Auto thieves now have to be MATH WIZARDS.

Check Digit Formula

The check digit will always be the ninth character in the VIN. Assign to each numeric in the VIN its actual mathematical value and assign to each alphabetic the value specified for it in Table 1.

Table 1

A = 1	J = 1	T = 3
B = 2	K = 2	U = 4
C = 3	L = 3	V = 5
D = 4	M = 4	W = 6
E = 5	N = 5	X = 7
F = 6	P = 7	Y = 8
G = 7	R = 9	Z = 9
H = 8	S = 2	

Multiply the assigned value for each character in the VIN by the weight factor specified for it in Table 2.

Table 2

1st = 8	7th = 2	13th = 6
2nd = 7	8th = 10	14th = 5
3rd = 6	9th = 0 (check digit)	15th = 4
4th = 5	10th = 9	16th = 3
5th = 4	11th = 8	17th = 2
6th = 3	12th = 7	

Add the resulting products and divide the total by 11.

The remainder is the check digit. If the remainder is 10, the check digit is X.

EXAMPLE 1-1

VIN characters	1	G	4	A	H	5	9	H	4	5	G	1	1	8	3	4	1
Assigned value	1	7	4	1	8	5	9	8	4	5	7	1	1	8	3	4	1
Multiply by	8	7	6	5	4	3	2	10	0	9	8	7	6	5	4	3	2

Add products 8+ 49 +24 +5 + 32+ 15+ 18+80 +0+ 45+ 56 +7 + 6+ 40+ 12 + 12 +2 =411

Divide by 11 411/11 = 37 4/11

Check Digit 4 (Compare to character in 9th position).

Indicators of Fraudulent Auto Damage Claims

Policy Factors

- New business.
- Assigned risk.
- Recent addition of collision/comprehensive coverage.
- Frequent policy changes.
- Claim prior to auto inspection (New York).
- Claim received prior to application.

Vehicle Factors

- New vehicle and registration.
- Late model expensive car.
- Unusual lapse between registrations.
- Vehicle involved in prior thefts or accidents.
- Car has become unpopular for any reason, i.e., gas guzzler, bad press, etc.
- Insured had difficulty in obtaining title.
- Insured's vehicle (New York) only inspected at location distant from work or home.

Purchase Factors

- Vehicle purchased from either an insurance company, salvage yard, body shop, or individual with history of accidents/claims.
- Car purchased in a bar.
- Vehicle purchased from an unknown source.
- Seller lives a considerable distance from insured.
- Cash transaction/lack of lienholder on new or expensive car.

Insured Factors

- Insured is in an automobile-related occupation.
- Insured's occupation does not indicate his/her ability to purchase or maintain this type of vehicle.
- Insured completes self-repairs or restoration.
- Insured's address is a transient type of location (hotel, motel, boarding house).
- Lack of residence and business phones.
- Insured is vague concerning his occupation or employment information.
- Home address differs from place of garaging.
- Loss frequency — particularly auto accidents with no police reports and total thefts.
- Insured lives with lienholder.
- Insured requests immediate settlement.
- Principal driver not in residence at an address where vehicle is registered.
- Insured insists upon doing business in person.
- Insured refuses telephone-recorded interview.
- Insured offers gratuity to expedite claim.
- Insured threatens complaints and is hostile from inception of claim.
- Registered owner differs from policyholder.

Accident Details

- Heavy damage — no injury.
  - Unexplained reasons for one-car accident.
  - No witnesses.
  - If two-car accident:
    - — Both drivers file policy report/claim at same time.
    - — Both drivers give identical versions of accident.
    - — Both autos towed to same body shop.
    - — Drivers, passengers, witnesses, appear to know each other.
    - — More than what is usually known about a driver and his auto (e.g., insurance policy number, type of coverage, residence/work numbers, driver's license or VIN numbers, etc.) is reported on initial report of loss.
    - — Both parties present at shop during appraiser's inspection.
    - — Other car is a rental.
    - — Auto involved in a previous claim.
    - — Auto appears to have damage similar to prior claim.
    - — Clear case of liability to gain quick settlement.
    - — Details of accident do not correlate with amount or location of physical damage.
    - — Lack of police report in severe loss.
    - — Police report of officer's observations differs from insured's statements.

Homeowners Burglary/Theft Fraud Indicators

Policy Factors

- Date of loss within one year of policy inception or within 60 days of renewal date.
- Two or more policies covering same property.
- Limits of coverage excessive.
- Prior losses with G.A. or other company are similar.
- No scheduled items — yet valuable item reported stolen.
- Policy limits raised or coverage added just prior to theft.
- Scheduled items added to policy just prior to theft.

Theft Factors

- No sign of forced entry.
- No police report.
- Police report is a desk report, no on-site inspection by police at the time of loss.
- Police report differs from insured's version.
- Claim reported before police were notified.
- Items reported stolen are normally kept in safe deposit box.
- Premises are protected by alarm, but alarm did not activate.
- Circumstances of theft are unusual, lack common sense.

Insured Factors

- Insured wants claim expedited. Threatens complaints, attorney or suit.
- Insured knows claim procedures.
- Insured reported similar items stolen in past.
- Insured reports numerous and expensive items stolen from car.
- Insured has financial difficulties or personal problems (recently separated or divorced).
- Insured is willing to compromise early — seeks fast cashout or inordinately small settlement.
- Insured refuses replacement of items.
- Insured vague about where, when and how items were purchased.
- Insured is not familiar with operation or use of items reported stolen.
- Items claimed are not consistent with insured's lifestyle, place of residence, standard of living and occupation.
- Insured's occupation involves items reported stolen.
- Theft occurred on premises where insured was alone.
- Insured has questionable loss history.
- Insured handles all business in person, thus avoiding use of mail.
- Insured's reported losses include total contents of business or home, including items of little value, numerous family heirlooms and substantial amount of cash.

Property Factors

- No receipts, cancelled checks, or charge account invoices available, especially on recently purchased items.
- No original receipts produced, only copies.
- Receipts and appraisals are from same store in same amount.
- Receipts are in whole dollar amounts.
- Receipts show no tax amount or tax is incorrect.
- Receipts are consecutively numbered and immediately available.
- All receipts appear to have same handwriting.
- Receipts show that deposit was paid but balance was not.
- Receipts are blank, no store logo.
- Receipts show expensive items purchased from distant place.
- Receipts show expensive items purchased over short period of time.
- Credit card receipts have incorrect or no approval code.
- Articles stolen shortly after purchase.
- Articles stolen are all premium products.
- Numerous cash purchases for expensive items.
- If a gift, insured vague on how acquired or provides source which is difficult to prove (e.g., from deceased relative).

LOSS EXPOSURES

A CPA cannot conduct an insurance review for a client without concurrently reviewing the loss exposures that the client faces. The outcome of this study of loss exposures will determine whether the client is properly insured.

The handling of loss exposures is "risk management."

In the study of each loss exposure, we'll ask these questions:

- What is the loss exposure?
- Why should the loss exposure be treated — i.e., what are the objectives?
- How can the loss exposure be treated?

Every firm faces four basic loss exposures — external, legal, internal, and governmental.

External Loss Exposures

External loss exposures are those sudden and often violent occurrences that all businesses are exposed to on a daily basis. Some examples are hurricanes, tornadoes, floods, and earthquakes.

These loss exposures are typically insured because they occurred too frequently and are too powerful to be assumed by any single business without use of the insurance system.

Legal Loss Exposures

Legal loss exposures are those presented by the legal system of torts. The Law of Torts deals with the enforcement of duties existing between individuals as members of society. As a business serves the general public and makes profit by doing so, it is held to a high standard of performance regarding the rights of the public.

Premises Exposures. Exposures to loss can arise either out of the use of the client's premises for business or from related activities away from the business premises. A firm that invites the public to its place of business has certain defined duties to respond to, namely:

- To exercise reasonable care for the safety of the invitee;
- To warn the invitee of any dangerous conditions that are not open and obvious and of which the owner has knowledge;
- To make inspections at reasonable internals to discover and remedy dangerous conditions that such inspections should reveal.

Injuries to persons or damage to property that result from a business's neglect will result in a loss to the firm.

In addition to its responsibilities to individuals on the premises, a business also has defined responsibilities to those outside the premises. Some examples are:

- *Signs*: Must be erected safely and in accordance with local ordinance.
- Streets and sidewalks: Cannot create unsafe conditions (cracking sidewalk with heavy vehicle).
- *Snow and ice*: Business may not create a hazard; removal of snow and ice must be done in such a way as to not increase hazard.
- *Parking lots*: Business must maintain parking lot and entranceways.
- *Pollution*: Business will be liable as well as subject to injunctive remedy.
- *Natural conditions of the land*: Business is liable for use of pools, ponds, and so forth if the public is invited. It is liable if the feature is considered to attract children.

Operations Exposures. All businesses are required to operate with the exercise of reasonable care to avoid injury or property damage to others. This applies on and off the premises. Loss exposures under the operations of a business arise from:

- The movement of personnel, machinery, equipment, and stock about the premises.

- The movement of personnel, machinery, equipment, and stock off the premises.
- The use of automobiles, trucks, road equipment, watercraft, and aircraft.

Product Liability Exposures. Retailers, wholesalers, and manufacturers are all responsible for injury, illness, and property damage caused by the use of their products if the products are dangerous, defective, or improperly labeled.

Manufacturers, wholesalers, and retailers have exposures resulting from the following imposed duties regarding products.

Duty of a Safe Design. Although a product may be made of sound materials and with proper workmanship, an injured person may sue alleging an inherently unsafe design. Products designed without proper consideration for safe use are a source of loss exposure for a business. The landmark case involving unsafe design in a product is the Ford Pinto case of *Richard Grimshaw v. Ford Motor Company.*

Duty to Safely Manufacture, Construct, Assemble, and Package. Manufacturers, assemblers, and processors are responsible for manufacturing their products free from defect. Manufacturers, processors, or packagers are held responsible for the safe packaging of products. Cases in the pharmaceutical industry dealing with tainted products come under this category.

Duty to Warn and Instruct. The manufacturer, retailer, or wholesaler is responsible to warn the consumer of the dangers of using a product that is, by its intended design and use, dangerous. Manufacturers must warn of hidden dangers and are expected to label products clearly regarding dangers (for example, "Keep out of the reach of children," "Do not use near open flame," etc.).

Strict Liability. The courts have moved to adopt an acceptance of "strict liability" regarding product liability cases in most states. The trend towards strict liability began in the California Supreme Court case of *Greenman v. Yuba Power Products, Inc.* That case led to the "Restatement (second) of Torts," Section 402A:

> One who sells any product in a defective condition unreasonably dangerous to the user or consumer or to his property is subject to liability for physical harm thereby caused to the ultimate user or consumer, or his property, if (a) the seller is engaged in the business of selling such a product, and (b) it is expected to and does reach the user or consumer without substantial change in the condition in which it is sold.
>
> The rule stated in Subsection (1) applies although (a) the seller has exercised all posible care in the preparation of his product, and (b) the user or consumer has not bought the product from or entered into any contractual relation with the seller.

The effects of this change in law are:

- Anyone in the chain of sale may be sued: retailer, wholesaler, packer, manufacturer.
- Anyone in the chain of sale may be sued regardless of the lack of negligence.
- Anyone in the chain of sale may be sued even though all possible care and diligence were practiced in regard to the product.
- The burden of proof has been shifted from the plaintiff (the consumer) to the defendant (anyone in the chain of sale).

There is currently no statute of limitations on the age of the product. The statute of limitations begins only at the time of injury or occurrence causing injury. Lawmakers are currently attempting to deal with the liability crisis.

Completed Operations Exposures. Businesses that perform a service rather than sell a product have the loss exposure of completed operations. It is to be understood that any business that sells both products and services will incur loss exposures of both product liability and completed operations.

For example, contractors such as builders, cleaners, excavators, and painters have severe completed operations loss exposures and those who have completed operations loss exposure are responsible for bodily injuries and property damages caused by jobs finished and relinquished to the customer; like the products loss exposure, there is currently no statute of limitations for completed operations.

Contractual Liability Loss Exposures. Contractual liability loss exposures are those legal loss exposures that can be found in contractual obligations that appear in, for example, rental agreements, leases, construction contracts, purchase orders, and sales proposals. When two organizations do business together, the terms of their contract may require one of them to assume the liability of both and assume any lawsuit arising out of their venture together. Often municipalities and large corporations will include the requirement that any firm doing business with them assume their legal loss exposures.

Directors' and Officers' Loss Exposure. "I had knowledge of what was cooking.... I had to limit the number of boards I was on, and that's the one I decided to get off," says Hicks B. Waldron, Chairman of Avon Products, Inc., who quit the board of troubled Allegheny International, Inc.[1]

The directors and officers of a corporation face special loss exposures peculiar to their positions. They may incur loss as a result of breaches of duty stemming from error, absence, omission of duty, and negligence. The loss exposures are from stockholders that may sue and demand reimbursement from the board members for damages resulting from acts or omissions. In addition, the board may be held liable for various damages by competitors, creditors, the SEC, and the government.[2]

The current chances of a director or officer of a corporation being sued under one of the above-mentioned circumstances is 1 in 5. Suits brought against directors and officers usually fall into the following categories:

- Suits brought by stockholders on behalf of the corporation to enforce corporate rights against those executives who allegedly breached their corporate duties. These suits may arise because the officer and/or director was involved in a conflict of interest with respect to the corporation, caused the corporation to become involved in illegal acts commonly referred to as *ultra vires* acts, misused corporate funds, and similar acts involving the quality of their judgment.

[1]Laurie Baum, "The Job Nobody Wants," *Business Week* (September 8, 1986), pp. 56–61.

[2]Robert I. Mehr and Emmerson Commack, *Principles of Insurance from Irwin Series of Insurance and Economic Security* (Homewood, Ill.: Richard D. Irwin, 1980), p. 298.

- Suits brought by third parties (other than stockholders) alleging similar wrongdoing. This class of plaintiffs may include the federal and state governments, competitors, and others.[3]

Often, business owners and managers are asked to serve on the boards of nonprofit organizations as a community service. It must be noted here that the directors and officers of such organizations as clubs, fraternal organizations, and condominium associations are also exposed to this loss exposure.

Professional Liability Loss Exposure. The Tort system of law requires that all individuals act in a way that displays due diligence and care. The law requires that the degree of care be equal to what can be expected of the general public. But the professional must perform on the level of the group to which he or she belongs.

Some examples of individuals who bear the professional liability loss exposure are: CPAs, insurance agents, attorneys, engineers, computer program designers, financial planners, stock brokers, real estate brokers, physicians, surgeons, dentists, nurses, psychologists, psychiatrists, and veterinarians. It is under this loss exposure that "malpractice" suits are brought against professionals.

Liquor Legal Loss Exposure. The courts hold businesses that serve alcohol, such as restaurants and taverns, liable for acts of their patrons following the consumption of alcohol at their establishments. What is often not understood, however, is that any business, such as a retail store or business office, may also fall subject to a similar suit for serving alcohol at some function. For example, if a person drinks alcohol at a holiday party given by an employer and is involved in a serious automobile accident following the party, and the accident is attributable to the consumption of alcohol, the employer may be held responsible to the employee and others injured in the accident. Recent court cases have extended this liability to homeowners who serve alcohol to guests in their homes.

In most states, Dram Shop Acts or Civil Liberty Acts impose a strict liability on establishments that serve alcohol when such a sale results in damage to a third party.

Internal Loss Exposures

Internal loss exposures can be classified into the following categories:

- Employee dishonesty,
- Injury of employees, and
- Computer losses: damage to the system and computer fraud.

Employee Dishonesty. Every year, employees in business supplement their take-home pay with take-home fraud benefits. They divert $40 billion of their employers' funds to their own use, and the bets are that this figure will increase each year in the foreseeable future.[4]

Employee dishonesty is a major loss exposure for all businesses.

[3]Harry F. Brooks, "Protecting Corporate Executives and Directors," *American Agent and Broker* (February 1986), pp. 76–77.

[4]Harry F. Brooks, "Risk Management," *American Agent and Broker* (October 1986), pp. 8–11.

Injury of Employees. When the Occupational Safety and Health Act (OSHA) of 1970 was passed, the following information was dispersed as evidence of the need of improved safety on the job:

- Both the frequency and severity of occupational accidents was increasing rapidly.
- There were 10 million injuries and 14,000 deaths occurring on the job each year.
- One billion, seven hundred million dollars in lost wages resulted from these injuries and deaths each year.
- These losses resulted in a $9 billion loss in the gross national product.[5]

In 1900, society responded to the terrible working conditions imposed on women, children, and men with the passage of workers' compensation laws. These laws eliminated the burden of occupational injury and disease from the worker and placed it with the employer. Prior to workers' compensation laws, it was practically impossible for an injured worker or his family to obtain any help from the employer.

If a worker was injured on the job, the employer had three defenses that would exonerate him from the responsibility of aiding the employee or his family. They were:

- *Contributory Negligence*: Any contribution to the injury by the employee himself relieved the employer 100%.
- *Assumption of Risk*: If the employee took the job and remained on the job, he assumed all the risks and hazards and the employer was relieved 100%.
- *Fellow Servant Rule*: If a fellow employee contributed to the injury in any way, the employer was relieved 100%.

If the employer was not excused from his responsibility by any of these defenses, then the employee could sue his employer for damages in a court of law. This, of course, was impossible, as the injured worker had no funds to retain counsel and would be in fear of his future employment if the suit were attempted.

The workers' compensation laws greatly changed this situation by clearly stating that all employee injuries and occupational diseases are to be assumed by the employer as part of the cost of doing business. Although these laws were clearly necessary, they impose a serious loss exposure to business unless properly identified and treated. The workers' compensation laws require that the employer provide the following benefits to employees covered under the law:

- *Medical Expenses*: Medical expenses must be paid by employers or their insurance companies if insurance is carried. Medical expenses for an on-the-job injury are to be paid throughout the lifetime of the employee, regardless of the future employment of the employee. There is no deductible taken nor any percentages of payment allowed. Medical expenses are paid based on a schedule of prices prescribed by law.
- *Loss of Income Benefits*: The employers or their insurance companies, if insurance is carried, must supply replacement of income payment to the injured employee. The amount of payment required is 66% of the employee's average gross paycheck. The reason that a percentage is allowed is that these benefits are nontaxable, and the law

[5]U.S. Dept. of Labor Occupational Safety and Health Administration, *All About OSHA*, revised 1985.

does not intend to encourage malingering, but rather every effort to recover and become part of the working force again.

- *Rehabilitation and Vocational Training*: The workers' compensation law requires that the employers or their insurance companies, if insurance is carried, pay the costs to retrain an injured employee to a job that can be performed if the employee is permanently limited in abilities as a result of a job-related injury or disease.
- *Cash Awards*: Cash awards are required for the permanent loss of a part of the body or loss of use thereof. The following is an example taken from one state's compensation law:

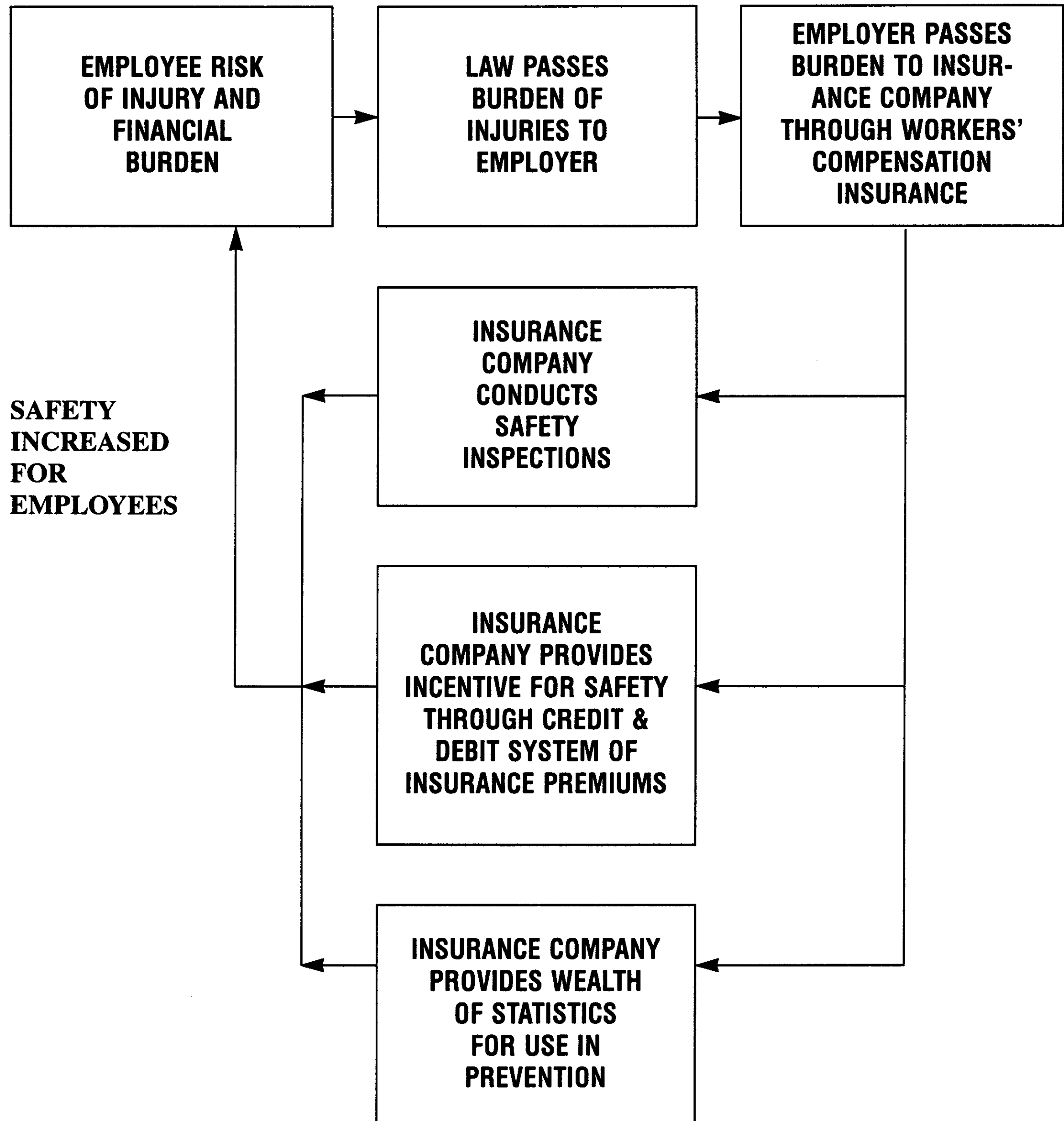
  The compensation for the loss of a member, such as an arm or a leg, is a multiple of the weekly disability benefit, which is paid in a lump sum:

SAMPLE COMPENSATION RATES

Member Lost	Number of Weeks
Thumb	60
First finger	35
Hand	175
Arm	230
Great toe	40
Any other toe	15
Leg	200
Eye	125
Hearing, one ear	50
Hearing, both ears	175

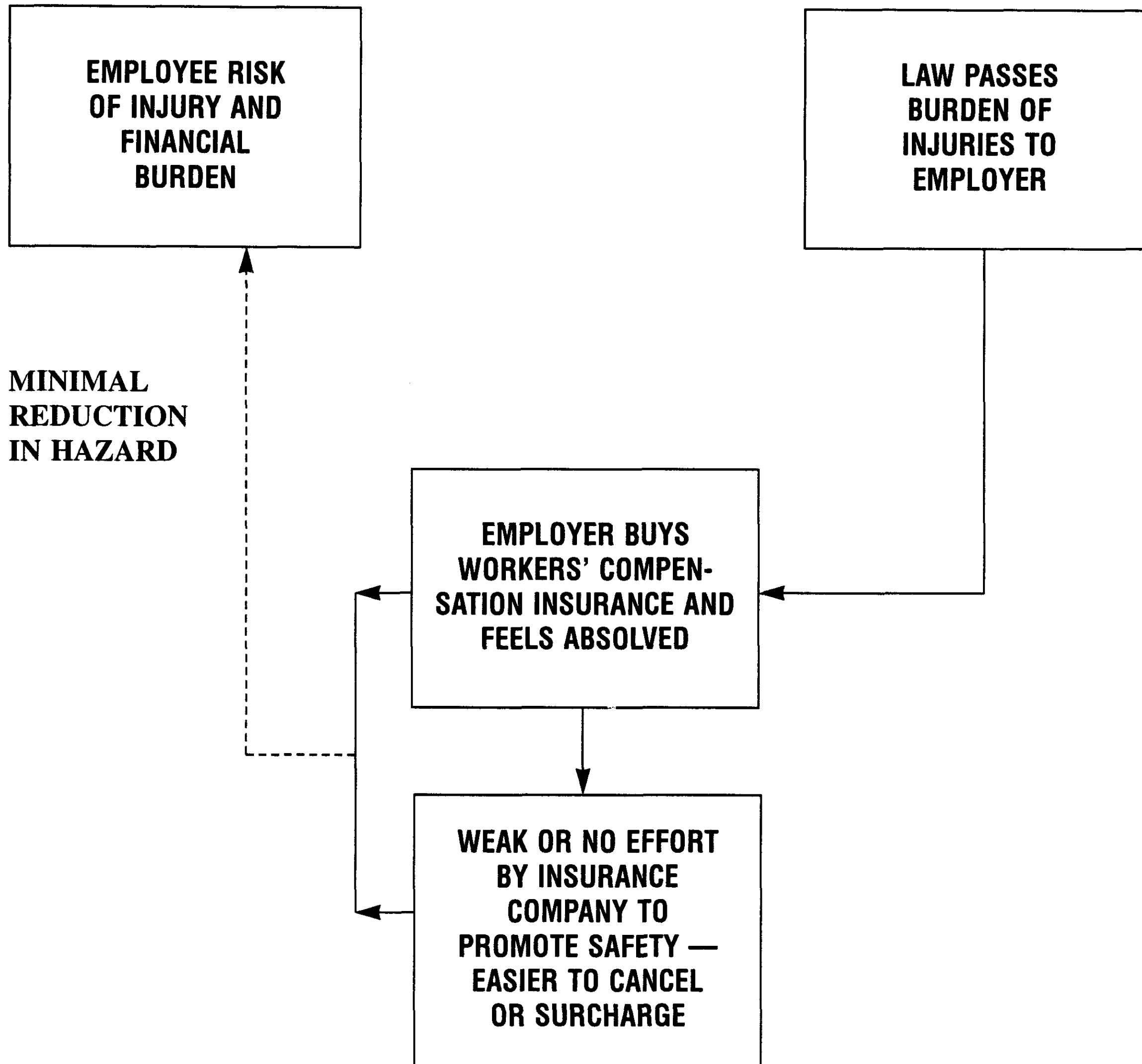
WORKERS' COMPENSATION LAWS

— THE POSITIVE —



WORKERS' COMPENSATION LAWS

— THE NEGATIVE —



- *Death Benefits*: In the event that an employee is killed in a job-related injury, the workers' compensation law requires that employers or their insurance companies, if insurance is carried, provide two death benefits:
  - — The first death benefit is to cover the reasonable costs of burial. Depending on the state, the benefits to be paid range from $700 to $4,680.
  - — The second death benefit to be paid is in the form of income to the survivors of the deceased employee.

Governmental Loss Exposures

The loss exposures presented to business by government include:

- Fines;
- Closure;
- Prosecution;
- Added costs in construction;
- Taxes (not a topic in this book).

Fines. The following is a synopsis of the standard fines imposed by OSHA.

Violation	Fine
• Failure to post OSHA documents	$1,000
• Failure to eliminate a cited violation	$1,000 per day
• Receiving advance notice of an OSHA inspector	$1,000 and/or 6 months jail
• Hampering or assaulting an OSHA inspector	$5,000 and/or 3 years jail
• Willful or repeated violation (if death does not result)	$10,000
• Willful violation (death results), supplying OSHA with false documents	$10,000 and/or 6 months jail
• Murder of an OSHA inspector	$10,000 and/or life jail
• Assaulting an OSHA inspector with a deadly weapon	$10,000 and/or 10 years jail
• Second willful violation (death results)	$20,000 and/or 1 year jail

Although these are the standard fines imposed by OSHA, they are by no means the limit. In 1985, OSHA fined Union Carbide $1.4 million for safety violations. The fine came after an OSHA inspection of the plant, in Institute, West Virginia.

Closure. If OSHA develops information that leads it to believe there is imminent danger to employees, it has the power to close a business immediately. This can be done by the inspector on site. Other situations may also give rise to closure of a business by governmental officials other than OSHA's. If a business is believed to be polluting, or otherwise causing harm to society, it may be forced to close by the process of injunction.

Prosecution. The following examples are from *Business Week*, February 10, 1986 (Jonathan Tasini, "The Clamor to Make Punishment Fit the Crime," p. 73):

- The owner of four Florida companies engaged in toxic waste disposal is fighting charges that could subject him to a long jail sentence for endangering the lives of two of his employees.
- Two Waterbury, Connecticut, men were convicted of violation the Federal Clean Air Act by failing to remove asbestos before demolishing a building.
- In Middlesex County, Massachusetts, the district attorney is investigating whether criminal charges are warranted against officers of a company after a worker died from inhaling toxic gas.
- A New Mexico investigation is under way into the construction-site deaths of two workers.

Added Costs in Construction. Some of the newer building requirements may be:

- Fire proof construction (rather than frame or masonry;
- Sprinkler system;
- 54" hallways;
- Full handicap access;
- Safety glass; and
- Fire escapes.

Insurance may or may not cover these items. If the insurance is inadequate, it may preclude rebuilding altogether.

DETERMINING OBJECTIVES IN TREATING LOSS EXPOSURES

Now that we've looked at loss exposures, let's take a look at determining goals in the treatment of loss exposures. The treatment of loss exposures is conducted with two sets of objectives: Pre-loss objectives and post-loss objectives.

Pre-loss objectives are to:

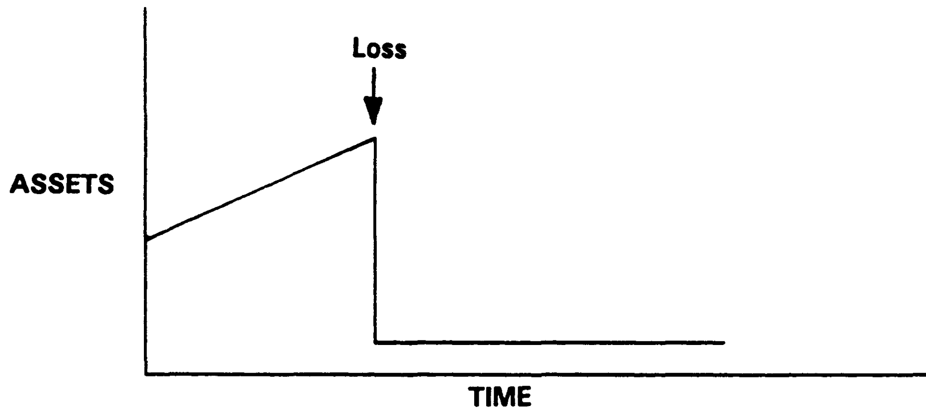
- Anticipate losses that may happen and avoid them.
- Reduce anxiety — maintain morale by eliminating or reducing the fear of loss.
- Meet externally imposed obligations — codes, product regulations.
- Maintain social responsibility — reduce or prevent losses that could affect society.

Post-loss objectives are to:

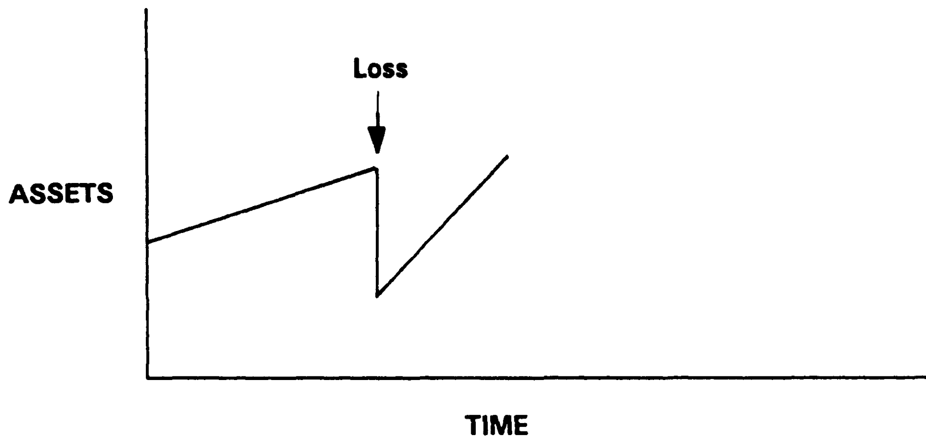
- Resume business with reduced assets.
- Continue with as little interruption as possible.
- Obtain funds to replace lost earnings or continue operations with no increase in cost.
- Continue growth.
- Protect investors, suppliers, employees, customers, area residents, and government.

POST-LOSS OBJECTIVES

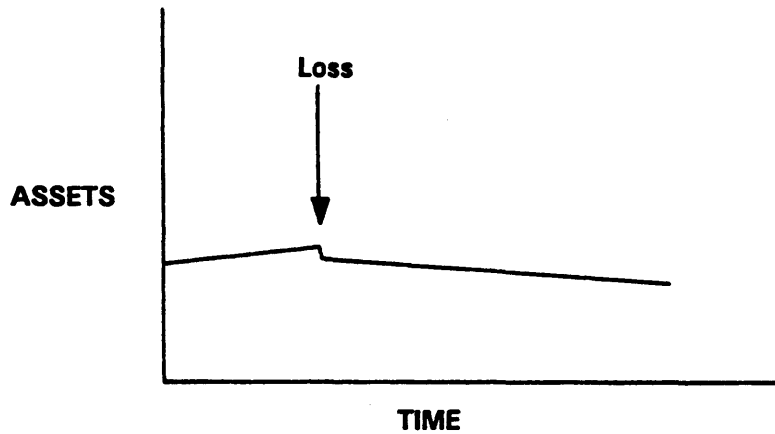
1. Survival — minimal objective.
   To resume business with reduced assets.



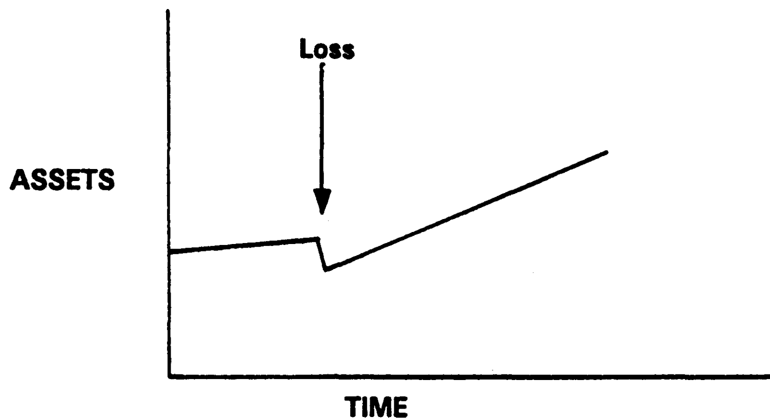
2. Continuity of operations — more ambitious objective.
   To continue with as little interruption as possible.



3. Earning stability — obtaining funds to replace lost earnings.
Or to continue operations with no increase in cost.



4. Continued growth — more ambitious.
A firm that is in a growth pattern should not be satisfied to simply remain stable after a loss, but wish to maintain its trend.



TOOLS TO TREAT LOSS EXPOSURES

Now that we've determined loss exposures and set objectives, it's time to decide how to meet our goals. What tools will we use to treat the loss exposures that we've uncovered?

Basically, there are three choices: self-insurance, assumption of risk, and buying insurance.

Self-Insurance

It must be understood that the mere absence of insurance is not self-insurance. Self-insurance is a complex undertaking that involves several steps. They include:

- Determination of loss exposures.
- Prediction of loss impact, severity, and frequency.
- Implementation of maximum risk management efforts.
- Funding of self-insurance reserves.
- Posting of surety bonds to business affiliates and governments.
- Procurement of reinsurance contracts over the self-insurance funds.

Assumption of Risk

The assumption of risk is understanding that certain risks of everyday business must simply be considered as part of the cost of doing business. Some examples of this practice would be:

- A contracting firm that assumes the loss of small tools.
- A firm with a large fleet of vehicles that assumes the loss of damage to their own vehicles.
- A retail store that assumes the loss of small merchandise to shoplifters.
- A real estate firm that assumes the loss or theft of "for sale" signs.

Buying Insurance

When risk cannot be self-insured or assumed as part of the cost of doing business, insurance remains as the instrument for the transfer of possible loss. The balance of this book will deal with the insurance industry, its operations, and available products.

CHAPTER 2
TYPES OF INSURANCE COMPANIES, REINSURANCE, AND THE INSURANCE CONTRACT

OBJECTIVES

After completing this chapter you will be able to:

- Advise management about the effects of reinforcement.
- Advise management about the availability of government-sponsored insurance.

Now that we've studied how to identify loss exposures, we're ready to study their treatment. The focus of this book is insurance. We'll therefore begin reviewing insurance as the most popular treatment of loss exposures for business.

To begin our discussion of insurance, we'll examine the different types of insurance companies and their agents. We'll also discuss the insurance contract in this chapter. This information will provide you with tools to use when helping a client select an insurance company or agent, or when making selections for yourself.

We'll also discuss the government's part in the insurance business that affects you and your client.

One question that often comes to mind when a person is studying an insurance program is "Who are all these people?" In one "shoe box" of policies, there are usually five or six different insurance companies, three or four different insurance agents and brokers, and even a government agency or two! In this chapter, we'll study the "who's who" and "what's what" of the insurance industry.

MUTUAL INSURANCE COMPANY COMBINATIONS

The most commonly encountered insurer is the mutual insurance company. Mutuals write about 21% of the property and casualty insurance in the United States. They are typically smaller companies, although there are some exceptions like Prudential and Metropolitan, which are mega-mutuals.

The interesting thing about mutuals is that ownership is vested with the policyholders. As owners, the policyholders share in the company's profits as well as losses. The mutuals share their profits with the policyholder in one of two ways: dividends, or lower policy costs in the fol-

lowing year. Mutuals that pay dividends are classified as *participating* mutuals. If you examine the front page of a client's policy, you will see "This is a participating policy," or "XYZ Insurance Company, a participating mutual." It's important to know, however, that dividends are never guaranteed. They are issued at the sole discretion of the insurer's board of directors. The dividends are calculated after the close of the year. Dividends received by your client are to be treated as a retroactive reduction in the cost of insurance for the past year.

If, on the other hand, the front page of a policy says something like, "XYZ Insurance Co., a nonparticipating mutual," then your client can count on not receiving a dividend. This type of mutual will ideally share its profits with its owners in the form of less expensive insurance.

A mutual insurance company may also reserve the right to share its losses with the policyholders. When a mutual elects to do this, it's called an *assessable* mutual. The assessable reserves the right to assess its policyholders additional premiums for the year past. There are two types of assessment possible: an open assessment and a limited assessment. An open assessment policy lets the company collect an unlimited proportionate amount from every policyholder in the company until any deficit is covered. A limited assessment policy lets the mutual collect an assessment limited to a certain percentage of the premiums already paid by the client.

A mutual insurance company may be incorporated as either *participating* or *nonparticipating*, as well as either *assessable* or *nonassessable*. For example, a mutual insurance company may be participating-nonassessable, nonparticipating-nonassessable, participating-assessable, or nonparticipating-assessable. It's important to understand the differences in initial cost, net cost, and risk among these combination mutuals.

CHART SHOWING DIFFERENCES IN COST

Mutuals	Participating	Nonparticipating
Assessable	Medium Cost	Least Expensive
Nonassessable	Most Expensive	Medium Cost

CAPITAL STOCK COMPANIES

The capital stock company is another, larger type of insurance company. Capital stock company insurers control about 76% of the insurance market, yet are not as numerous as mutuals. Stock companies are owned by stockholders, so profits and losses are shared with the stockholder, rather than with the policyholder. The primary purpose of a capital stock company is to create profits for its owners, the stockholders.

The capital stock companies are often credited with fostering what is known as the independent agency system.

INDEPENDENT AGENTS

An independent agent is one who maintains contracts of representation with more than one insurance company. The agent is the owner of his business and is free to place insurance policies with whichever insurance company will best suit the customer's needs. In effect, the independent has responsibilities both to the client and to the insurance company.

COMPARISON OF THE DIFFERENT TYPES OF SYSTEMS

The features that differentiate insurance agents and brokers are:

- Who owns the business — the agent or the company?
- Does the agent have the power to bind the company to coverage?
- Does the agency represent more than one company?
- Can the agent pay claims?
- Does the agent pay his or her own expenses?
- Does the agent or broker primarily represent the client or the company?

Use this chart (placing appropriate "yes" or "no" in the boxes) as a basis to determine how you or your clients are serviced by the insurance company.

SYSTEM	Owns the Business	Binding Authority	Represents More Than One Company	Pays Claims	Pays Own Expenses	Represents Client Primarily	Maintains Contact with Company
Company Agent							
Captive Agent							
Broker							
Independent Agent							

COOPERATIVE INSURANCE COMPANIES

Cooperative insurance companies are often considered the most consumer-oriented insurance facilities. There are two types of cooperative companies: consumer and producer.

Consumer cooperatives are formed by groups of individuals or businesses that share similar risks and want insurance at low cost, or at cost. There are hundreds of such companies doing business today. A large percentage were formed in the mid-1800s by farmers who couldn't get fire insurance from the larger mutuals or stock companies. Some of these are still very small, writing under $200,000 per year in premiums. Others now write millions of dollars in annual premiums and cover all types of businesses.

Producer cooperatives are formed by those who want to provide their members with an efficient marketing tool. Blue Cross and Blue Shield are good examples. These organizations are sponsored by doctors and hospitals.

THE RECIPROCAL INSURANCE EXCHANGE

The reciprocal insurance exchange controls about 2-1/2% of the insurance market. This is not really an insurance company, but rather an organization formed by a group of individuals or firms sharing similar risks. Members agree to insure a share of the risk of the entire group with their own assets. These exchanges are an unincorporated form of a cooperative insurance company.

EXAMPLE

Each of 1,000 textile mills owns a plant worth $500,000. All 1,000 mills join to form a reciprocal insurance exchange. Each needs and subscribes for $500,000 of fire insurance. Each in return accepts its share of $500,000 on the remaining 999 members. If one mill is destroyed, each member will pay $500.50 to equal the $500,000 loss suffered by the one member.

With a reciprocal, each member contributes funds annually into an account that is controlled by the manager of the reciprocal. At the end of the year, if credit remains in the account, it can be withdrawn. Profits, therefore, are taken in the form of premium refunds.

Lloyd's of London is the most famous example of a reciprocal. The structure of Lloyd's had not changed much since its inception hundreds of years ago. It started in a coffee house where ship's owners and rich merchants met to take gambles on the fate of their voyages. Merchants would cover ship's voyages with their own assets, in exchange for premium payments. Today, Lloyd's of London acts as a meeting place for those needing insurance, and those willing to undertake all or part of the risk against their own personal assets.

Lloyd's is not an insurance company, and it doesn't issue an insurance policy. As they did 300 years ago, underwriters at Lloyd's issue a cover note, signed by each member taking part of the risk. Surprisingly, there are some 30 American Lloyd's in operation in the U.S., which have no connection with the Lloyd's of London, but function in much the same way.

GOVERNMENT INSURERS

When there's a need for insurance against perils that insurers will not insure against, various government programs are created to provide for the need. The federal government offers insurance of several types. Typically, it covers risks that the private sector will not cover, because of either the size of the risk or the high degree of risk.

Below is a list of federal government insurers and what they insure:

- *Federal Crop Insurance Corporation (FCIC)* — Offers insurance to protect farmers against crop failures resulting from perils of nature.
- *Veterans Administration (VA)* — Offers life insurance to members and veterans of the armed forces.
- *Department of Health and Human Services* — Offers coverage for death, disability, medical care, and old age through the old-age survivors and disability insurance program operated by the Social Security Administration.
- *Federal Deposit Insurance Corporation (FDIC)* — Provides bank deposit insurance.
- *Federal Savings and Loan Insurance Corporation (FSLIC)* — Protects savings accounts in federal savings and loan associations and in state-chartered thrift and home financing institutions.
- *Mortgage and Property Improvement Loan Insurance Program* — Provides mortgage insurance to aid home buyers and mortgage lenders, both urban and rural.
- *Securities Investor Protection Corporation (SIPC)* — Protects customers' securities held by registered broker-dealers up to $50,000.
- *National Credit Union Administration* — Insures credit union accounts.
- *National Flood Insurance Program* — Provides flood insurance coverage for dwellings and businesses.
- *Federal Crime Insurance Program* — Provides crime insurance for dwellings and businesses.
- *National Insurance Development Corporation (NIDC)* — Provides reinsurance for insurance companies that offer riot coverage in high-risk areas.

Various state governments are also in the insurance business. State insurance programs include:

- Hail insurance;
- Workers' compensation funds;

- Auto insurance plans;
- Unemployment insurance;
- Medical malpractice;
- Title insurance; and
- Life insurance pools.

Additional Insurance Alternative Facilities

Here are some alternatives to government of private insurance.

Risk Retention Groups. An alternative to buying insurance from an insurer or the government is membership in a risk retention group.

Formed under a 1986 Act of Congress, risk retention groups allow groups of similar organizations to contribute to a common fund to cover all losses and expenses incurred by the group. Reinsurance is then placed over the fund through a commercial insurer.

Captive Insurers. These are insurance companies formed by industry groups for the sole purpose of insuring themselves.

Risk Purchasing Groups. These permit groups of similar companies to band together and by the use of purchasing "clout" obtain liability and other coverages at a more favorable price and terms.

INSURANCE CONTRACTS

We'll begin our discussion of insurance contracts by talking about the elements that make up any contract. We'll show you how these elements relate to insurance contracts. Remember that a contract is a promise or agreement enforceable by law; an insurance policy is a contract between the policyholder and the insurance company.

The elements of a contract are:

- *Parties to the contract must be legally capable of contracting.* A party to the contract cannot be a minor, insane, or intoxicated. (In the insurance industry, the company that contracts with a minor is bound to that contract whereas the minor is not. This is important, since thousands of minors buy auto insurance policies.)
- *There must be an offer and an acceptance.* In property and casualty insurance, the application made by the insured is the offer. The acceptance is the issuance of coverage by the insurance company. While the final contract is being executed, the insurer will issue a binder, which is a temporary memorandum of the contract, showing that the policy holder is covered.

  For life insurance, offer and acceptance are as follows:

- — Application with payment is the offer. Acceptance is the issuance of the life insurance policy.
- — If there is application without payment, the issuance of the policy by the life insurance company is the offer and payment of the first premium is the acceptance. On the renewal of a property and casualty policy, issuance is the offer, payment or silence is the acceptance.

- *There must be equal knowledge on both sides of all material and relevant facts pertaining to the contract.* The insurance company certainly has complete knowledge of the terms of the policy. Upon acceptance of the policy, it is deemed that the policyholder also has such knowledge. At the time of a claim, ignorance of policy terms and conditions by the insured will play no factor in the outcome of the claim.

  If the insured has *concealed* or *misrepresented material facts* in the application for insurance, the policy may be void, as the insurance company was not informed of all material information relating to the contract.
- *The contract must be based on valuable consideration.* Money must have been paid.
- *The contract must be legal in form.* This includes the requirement that only forms that have been approved by the State Insurance Department as to content and form may be used.
- *The contract must be legal in purpose.* This includes the requirement for the existence of *insurable interest.*

The following is the definition of an insurance contract:

> A contract under which one party is obligated to make good the loss suffered by a second party through the occurrence of a designated event.

Standard Provisions of the Insurance Contract

An insurance contract consists of two major parts: The declarations page and the coverage forms. The *declarations page* is the first page of the policy. On it are representations of information given to the insurance company, which include:

- Name of the insured;
- Address of the insured;
- Type of entity the insured is (individual, partnership, or corporation); and
- Additional interest, such as mortgageholder, etc.

The following additional information, supplied by the insurance company, is also included on the declarations page:

- Coverage dates;
- Company name;
- Company type (mutual, stock, participating, etc.);

- Type of policy (fire, auto, etc.); and
- Coverage forms applicable, listed by form number.

The *coverage forms* are attached to the declarations page and set forth:

- Perils insured against;
- Policy conditions;
- Extensions of coverage; and
- Exclusions.

CONCLUSION

Now that you've taken a look at the people in the insurance shoe box, it's understandable how insurers walk a fine line between profit and catastrophe in providing a vehicle for the transfer of our risks. Their inherent structures, their products, and their splitting of risks with each other are the tools they use to stay solvent and intact for the conduct of the business they're in. Society could not expand without the insurance industry. Without the possibility of transferring serious risks over to insurers, few businesses, other than megacorporations, could exist.

CHAPTER 3

REAL AND PERSONAL PROPERTY LOSS EXPOSURE

OBJECTIVES

After completing this chapter you will be able to:

- Review with clients the major perils that may affect their businesses.
- Identify those perils that can be insured against and those that cannot.
- Assist clients with the selection of needed property insurance.
- Advise the client as to the availability of government subsidized or sponsored insurance programs that may benefit them.
- Review with clients the possible impact of the coinsurance clause on a loss settlement between the client and the insurer.
- Explain to clients the benefits and pitfalls of the Replacement Cost clause in property insurance.
- Explain to clients the benefits and pitfalls of Blanket Insurance Coverage.
- Decide if a reporting form insurance plan or a peak season insurance plan would save the client premium dollars and make better use of premium dollars spent.
- Assist clients with calculating insurance costs.

On a daily basis, your clients are exposed to loss from external threats, fire, theft, weather damage, etc. These are perils every business must contend with. External loss exposure insurance coverage can help provide a barrier against the results of these perils. This chapter will give you the background to help plan for the kind of external loss exposure coverage needed.

You must be able to select the insurance that will reduce or eliminate perils for your client's business, as well as your own. We'll discuss how to best do this, and we'll also demystify the area of co-insurance, replacement cost endorsements, and pro-rata clauses. We'll also delve into the world of premium computation.

Insuring against property loss requires examining the perils inherent in a particular enterprise, evaluating the various types of insurance available, and deciding what type of coverage is needed to properly insure those perils.

We'll begin by discussing insurable and uninsurable perils, and then we'll go on to the standard fire insurance policy and additional coverage that is available. We'll then illustrate how to figure certain insurance costs.

PERILS — INSURABLE AND UNINSURABLE

The intent of insurance is to cover those perils that are sudden, accidental, and measurable in frequency and severity. Perils that are certain to happen, like land movement or wear and tear, are not usually insurable. Likewise, perils where damages could be beyond measurement or prediction, such as war or nuclear accident, are not insurable.

How do you know what is insurable and what's not? There are many schedules published by insurers and risk management firms, of which the one shown below is an example.

The best rule of thumb in determining whether a peril is insurable is that insurers will usually insure a peril that's sudden, accidental, or fortuitous (happening by chance). For example, on the list of insurable perils are fire, lightning, vandalism, and explosion. On the other hand, wear and tear and damage caused by termites are not insurable perils.

The following schedule is a review of the perils that face a dynamic business. Indicated in the review is whether the peril in question is typically insurable or typically not insurable. If a peril is typically not insured, then other methods of treatment are required, including self-insurance and simple avoidance.

Peril	Typically Insured	Typically Not Insured
Fire, lightning	X	
Electrical disturbance		X
Falling objects	X	
Land movement		X
Sound and shock waves		X
Settlement, erosion		X
War, rebellion		X
Water damage from flood	X	
Weight of ice, snow	X	
Windstorm	X	
Glass breakage	X	
Breakdown		X
Collision of conveyance	X	
Contamination		X
Corrosion, wear, tear		X
Employee negligence		X
Explosion	X	
Failure of environmental control		X
Fauna — rodents, insects		X

Peril	Typically Insured	Typically Not Insured
Installation hazards	X	
International destruction — jettison	X	
Perils of the sea — pirates	X	
Physical change — shrinkage, evaporation		X
Rupture of tank or vessel	X	
Smoke damage	X	
Spillage, leakage		X
Structural defects		X
Transportation — overturn collision	X	
Unintentional error — employee, computer		X
Vandalism	X	
Riots, civil disorders	X	

Source: *Risk Management and Insurance*, C. Arthur Williams, Jr. and Richard M. Heins.

CAUSES OF LOSS — SPECIAL FORM ENDORSEMENT EXCLUSIONS

You can consider the Building And Personal Property Coverage Form as a foundation for property insurance. It spells out the basic agreements between the insured and the insurance company. To determine which perils will be insured, we need to build on this foundation by adding forms called "causes of loss" forms. The choice of forms is up to the policyholder. That's why it's so important to understand the fine print. The choice can literally make or break a client when a loss occurs.

The first possible choice is the most basic, called the Causes Of Loss Basic Form. This form covers the perils of fire, lightning, explosion, windstorm, hail, smoke, damage caused by aircraft or vehicles, riot or civil commotion, vandalism, sprinkler leakage, sinkhole collapse, and volcanic action.

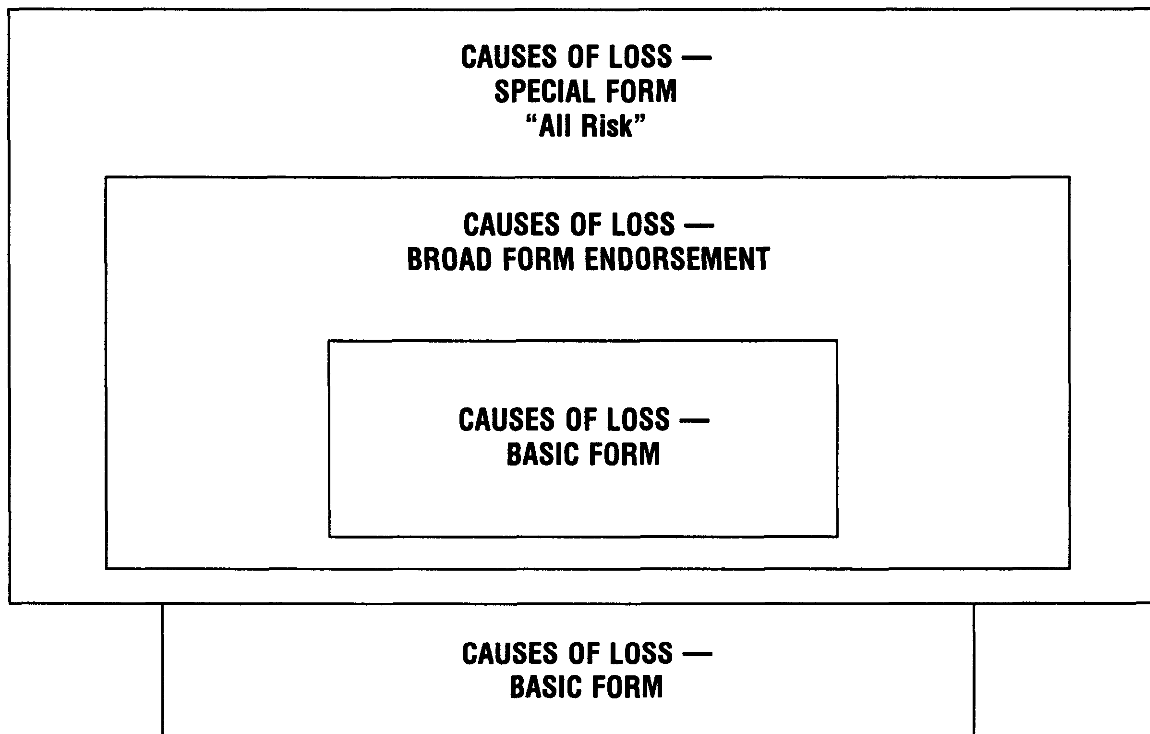
Building from here, the next option is the Causes Of Loss Broad Form. In addition to everything covered in the Basic Form, the Broad Form adds coverage for breakage of glass, falling objects, weight of ice or sleet, and water damage.

The Special Form Endorsement, the third type of form, is often referred to as the "all risk" form. The term is somewhat a misnomer because there is really no such instrument as a true "all risk" form. The Special Form Endorsement dispenses with listing the perils covered and simply states that *all* perils will be covered. There is, however, a listing of *exclusions*.

The Special Form Endorsement covers all risks of physical loss *except*:

- Building ordinance
- Earth movement
- Governmental action
- Nuclear perils
- Power failure
- War
- Water
- Flood
- Earthquake
- Smoke from industrial operations
- Wet or dry rot
- Changes in temperature
- Marring or scratching
- Settling, cracking
- Mechanical breakdown
- Insects
- Wear and tear
- Deterioration
- Smog
- Rust
- Mold
- Birds
- Rodents or other animals

PROPERTY INSURANCE — BUILDING A SYSTEM OF COVERAGE



THE COINSURANCE CLAUSE

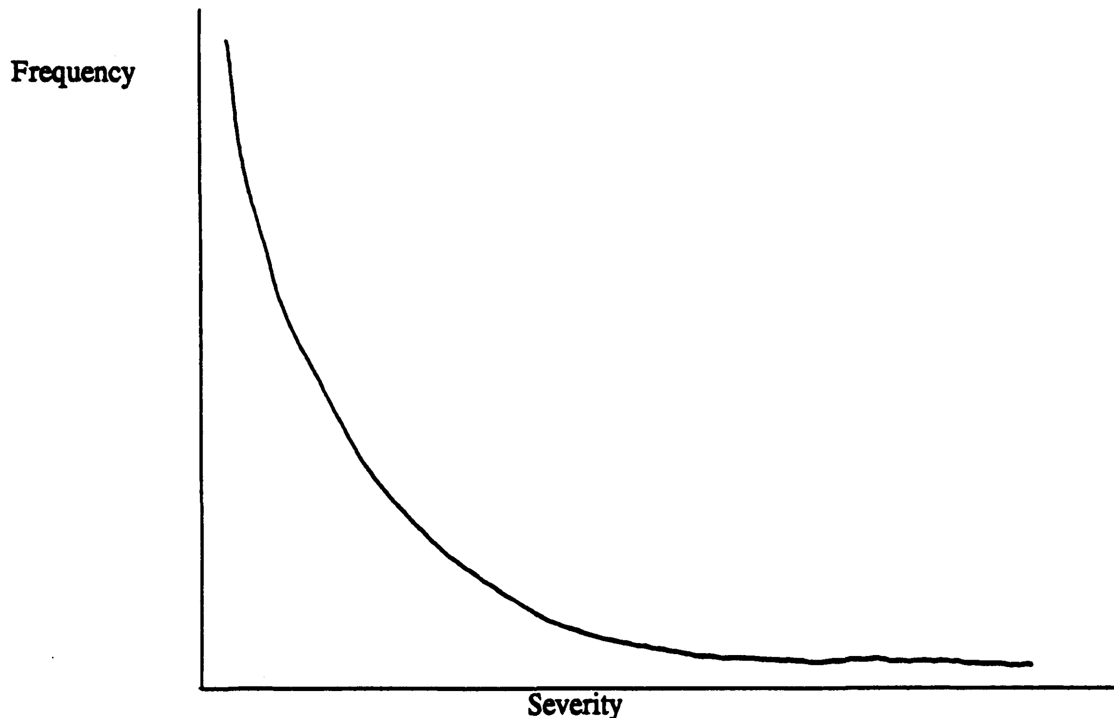
As you can see from studying the graph shown below, most claims are small ones. Because the general public is aware of this, the tendency is to buy just enough insurance to cover the likely small claim. But if everyone followed this tendency, the insurance companies wouldn't last long. To protect themselves, insurers instituted the coinsurance clause.

Coinsurance is an incentive for consumers to buy larger amounts of insurance. A discount is given if the client accepts coinsurance on his policy.

Coinsurance can be used to your client's advantage. However, if it is not understood, coinsurance can cause a disaster.

When coinsurance applies, it will say so on the policy. It might also be indicated on the coverage forms attached. The coinsurance will be expressed as a percentage, such as 80, 90 or 100%. The percentage is the amount of insurance that your client promises to carry at all times in relation to the actual cash value of the property. The definition of actual cash value is replacement cost minus physical depreciation. Coinsurance does not apply in the event of a total loss.

The following is an illustration of the relationship between the frequency and severity of fire and related insurance claims.



ILLUSTRATIONS — DETERMINING AMOUNT OF INSURANCE REQUIRED

If the actual cash value of a building is $100,000, and there's an 80% coinsurance clause, then the client must carry at least $80,000 of coverage. The coinsurance formula is: The amount carried on the policy divided by the amount required, multiplied by the loss, equals to the settlement.

Assumptions:

— Actual Value of Buildings $100,000

— Coinsurance Clause 80%

TO DETERMINE AMOUNT OF INSURANCE REQUIRED:

$100,000 × 80% = $80,000

COINSURANCE FORMULA

$$\frac{\text{Amount Carried (C)}}{\text{Amount Required (R)}} \times \text{Loss (L)} = \text{Settlement (S)}$$

ILLUSTRATION # 1 USING FORMULA

If the client carried $80,000 coverage, and has a loss of $20,000, he'll collect the entire loss.

Assume:

— Same Assumptions as Above

— Loss of $20,000

$$\frac{C}{R} \times L = S$$

$$\frac{\$80{,}000}{80{,}000} \times \$20{,}000 = \$20{,}000$$

Result: Since insured carried the required amount of insurance, full settlement can be expected.

ILLUSTRATION # 2 USING FORMULA

Here, the client has bought the property for $40,000, and buys that amount of insurance coverage. But when we apply the coinsurance formula, we end up with a fraction of $40,000 over $80,000, which reduces to 1/2 times the loss of $20,000. Thus, the client only gets paid half of the claim.

Assumptions:

— Same Assumptions as Above

— Building Purchased for $40,000

— Insurance Carried: $40,000

$$\frac{C}{R} \times L = S$$

$$\frac{\$40{,}000}{80{,}000} \times \$20{,}000 = \$10{,}000$$

Result: Since insured did not carry the required amount of insurance, full settlement can be expected.

It is important to remember that coinsurance may be removed from a policy by the addition of an "agreed amount" endorsement.

REPLACEMENT COST COVERAGE FORMULA

A fairly recent development in insurance is the replacement cost clause. This clause lets a person insure his property for full replacement, without anything deducted for depreciation. In effect, it's "new for old" coverage. To get this kind of coverage, two things have to happen. First, the policy has to have a replacement cost clause written into it. The Broad Form and Special Forms usually have it built in.

Second, the policyholder has to insure to at least 80% of replacement value of his property. This is more than needed to meet the coinsurance clause. Recovery is limited to the amount actually spent either in repairing or replacing damaged property, or replacement cost, whichever is less.

The replacement cost coverage formula is as follows:

$$\frac{\text{Amount carried}}{\text{Amount required}} \times \text{Loss} = \text{Settlement (never less than Actual Cash Value)}$$

Illustrations — Replacement Cost Clause and Coinsurance Clause

Assume:

— Coinsurance: 80%

— Actual Cash Value $100,000

— Replacement Cost Value $300,000

— Amount Carried $180,000

— Amount Required — Replacement Clause $300,000 × 80%: 240,000

— Amount Required — Coinsurance Clause $100,000 × 80%: 80,000

— Loss — Actual Cash Value: $50,000

— Loss — Replacement Value: $100,000

ILLUSTRATION # 1 — COINSURANCE CLAUSE

$$\frac{\$180{,}000}{80{,}000}$$

Result: No coinsurance penalty since amount carried was more than that required for coinsurance.

ILLUSTRATION # 2 — REPLACEMENT COST CLAUSE

$$\frac{\$180{,}000}{240{,}000} \times \$100{,}000 = \$75{,}000$$

Result: $75,000 is $25,000 more than if there were no Replacement Cost Coverage; however, the full replacement value would not be received.

BLANKET INSURANCE

If your client owns or operates two or more locations, blanket insurance might be the solution. Blanket insurance is one policy with one limit of coverage covering all locations. This simplifies your client's insurance policies, and allows for possible credits for the dispersion of risk and the size of the single policy. It also creates a flexibility of coverage for business contents that move from location to location.

PRO RATA DISTRIBUTION CLAUSE

If your client goes with blanket coverage, he must buy 100% insurance to value to obtain proper coverage. To prevent policyholders from just buying enough insurance to cover a total loss of one location, and then naming all locations on the policy (banking on the probability that only one location will be lost), insurers instituted the pro rata distribution clause.

Formula for Pro Rata Distribution Clause

The formula is the actual cash value at the location in question, divided by the total actual cash value at all locations, times the amount of insurance carried. This equals the insurance available at that location.

ACV, Loc. 1 divided by Total ACV × amount of insurance = ins. at Loc. 1

This formula is applied for any location at which there is a loss. In addition, the policy may also have coinsurance, or may have a replacement cost clause.

Illustration — Pro Rata Distribution

Our client is carrying blanket coverage of $320,000 on five locations. When we apply the formula to location one, we take the value at that location, divided by the total value at all locations, and

multiply the fraction times the policy limit. That gives us coverage of $40,000 at location one, or a shortage of coverage of $10,000.

Assume:

— Blanket Coverage Carried	$320,000
— Actual Cash Values (ACV)	50,000
Location 1	50,000
Location 2	50,000
Location 3	100,000
Location 4	150,000
Location 5	50,000

Required: Calculate amount of insurance available for Location 1

Illustration — Location 1

Formula:

$$\frac{\text{ACV Loc 1}}{\text{ACV Total}} \times \text{Amount of Insurance Carried} = \text{Insurance at Loc 1}$$

($50,000 + 50,000 + 100,000 + 150,000 + 50,000)

$$\frac{\$50{,}000}{400{,}000} \times \$320{,}000 = \$40{,}000$$

Applying the formula, the amount of insurance available for each of the remaining locations would be as follows:

LOC # 2 $\frac{50{,}000}{400{,}000} \times 320{,}000 = 40{,}000$

LOC # 3 $\frac{100{,}000}{400{,}000} \times 320{,}000 = 80{,}000$

LOC # 4 $\frac{150{,}000}{400{,}000} \times 320{,}000 = 120{,}000$

LOC # 5 $\frac{50{,}000}{400{,}000} \times 320{,}000 = 40{,}000$

Although the policy complied with the 80% coinsurance requirement, all locations were short on coverage by a substantial amount.

REPORTING FORM ENDORSEMENT

If your client's business has inventories that fluctuate, keeping enough insurance, but not too much, can be a real challenge. If your client buys $100,000 of fire insurance on his inventory, and inventory drops to $90,000, that client is paying for insurance he doesn't need. But if his inventory goes

up to $110,000 in the next month, there's an uninsured exposure. The answer to this problem is the reporting form endorsement. Your client can have this attached to his fire insurance policy.

Instead of paying the full annual premium for a level amount of insurance coverage, the policyholder pays a deposit premium at the beginning of the policy. Each month the insured reports the actual inventory amount for the previous month. A monthly rate per $100 of value is applied against the reported value and the earned premium is deducted from the deposit amount. If the deposit was not enough to carry the client through the year, the insured will begin paying for the coverage each month after the deposit is used up. Likewise, if the deposit was too much for the year's coverage, the insured gets a credit at the end of the policy term.

If the client fails to make a monthly report, coverage will be limited to the amount declared on the last report. It's important to note that the insured is contractually obligated to make full and accurate reports of values.

Here is a sample reporting form.

SAMPLE REPORTING FORM

Deposit Premium:

→ **$4,500**

Monthly rate per $100: .18

Month	Amount Reported	Premium Earned	Credit/Debit
JAN	$100,000	$ 180	($ 4,500 Deposit) ← $ 4,320 CR
FEB	150,000	270	4,050 CR
MAR	210,000	378	3,672 CR
APR	256,000	461	3,211 CR
MAY	308,000	554	2,657 CR
JUNE	410,000	738	1,919 CR
JULY	489,000	880	1,039 CR
AUG	406,000	731	308 CR
SEPT	317,000	571	263 DUE
OCT	282,000	508	508 DUE
NOV	186,000	335	335 DUE
DEC	148,000	266	266 DUE
		$5,872 Total Premium	

PEAK SEASON ENDORSEMENT

If a client has a time-proven regular variation in inventory values, the peak season endorsement might save on premiums while ensuring adequate coverage. Some examples of clients that would fit this bill include ski shops, boat dealers, toy stores, resorts, and any other seasonal business. With a peak season endorsement, the insurance company, at the request of the insured, plots the monthly changes in inventory, and charges premiums based on the actual exposures.

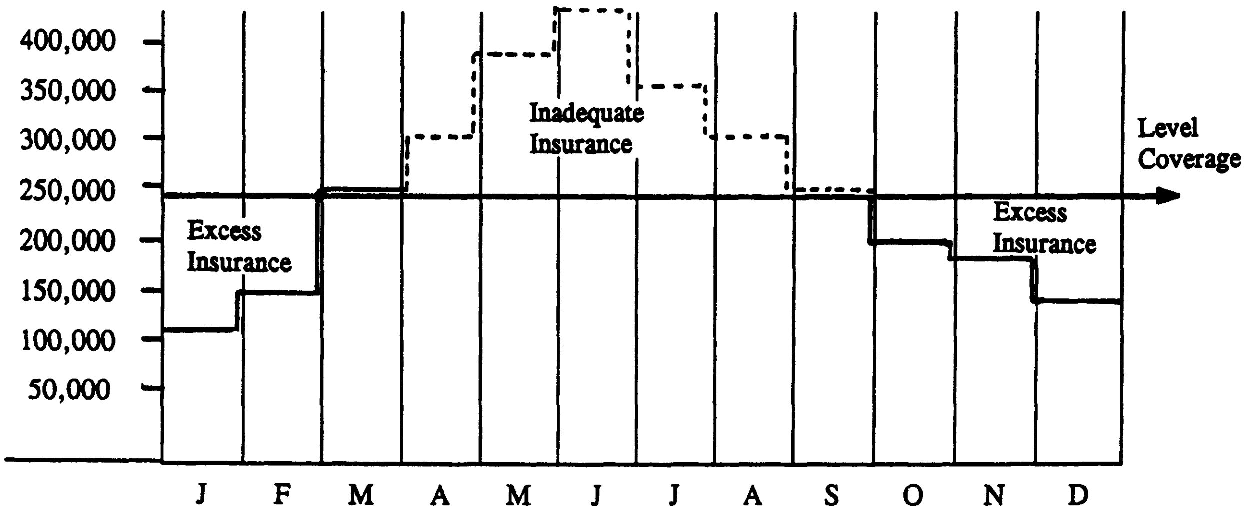
Here's an example:

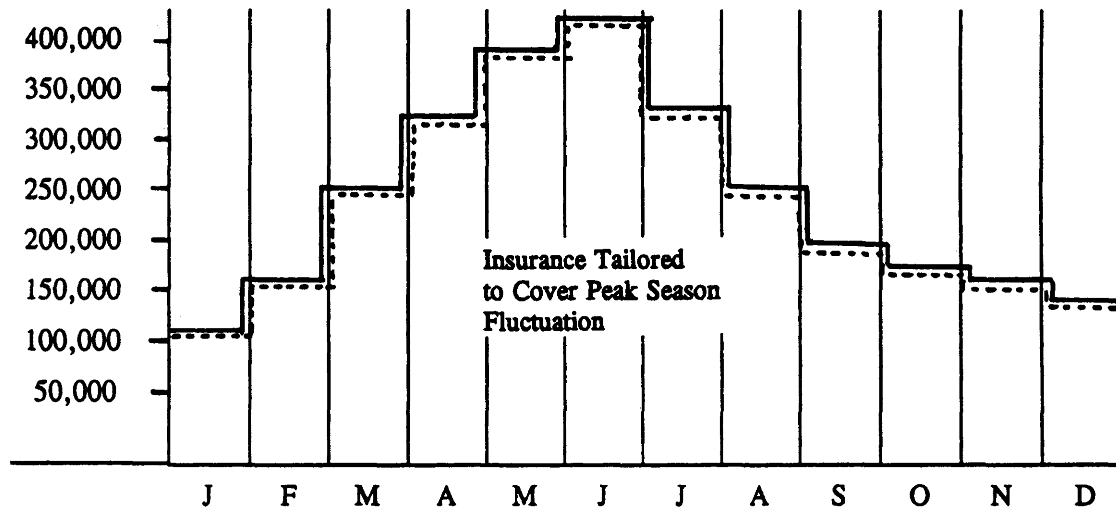
INVENTORY VALUES:

Jan	— 100 K	July	— 350 K
Feb	— 150 K	Aug	— 300 K
Mar	— 250 K	Sep	— 250 K
Apr	— 310 K	Oct	— 200 K
May	— 380 K	Nov	— 175 K
Jun	— 400 K	Dec	— 150 K

REGULAR POLICY VS. PEAK SEASON ENDORSEMENT

Regular Policy — $250,000





ASPECTS OF THE COPE SYSTEM

Considering the millions of different building types in the U.S., how does the insurance industry figure how much to charge for each one? A fairly straightforward system is used. The standard rule in insurance rates is that they must be non-discriminatory, adequate, and non-excessive. The method used by the industry can be summarized by the letters COPE.

C — Construction

Fire insurance rates and allied coverages are dependent upon the type of construction of the building in question. This includes the rates charged on the contents of the building as well. Buildings are categorized as follows:

- *Frame.* Combustible construction such as wood — highest rates;
- *Joisted Masonry.* Masonry walls, but to frame roof and/or partitions);
- *Masonry/Noncombustible.* Masonry walls, and noncombustible roof and partitions made of concrete or metal with no wooden joists; or
- *Fire Resistive.* Fully noncombustible with materials other than concrete, such as steel enclosed in concrete — lowest rates.

O — Occupancy

The use of the building affects the cost of the property insurance. Low-risk uses like offices have the lowest rates. High-risk uses like chemical storage or inside use of highly combustible solvents will have the highest rating. Note that one of the highest rates is applied when there is *no* occupancy: vacant buildings.

P — Protection

The more protection a property has, the lower the rates. Protection refers to several characteristics of a business:

- Distance to fire station;
- Distance to fire hydrants;
- Fire alarms;
- Sprinkler systems;
- Watchman;
- Fire extinguishers on premises; and
- Accessibility in all seasons.

E — Exposure

This refers to the risks presented to the insured property from buildings and nature or the environment surrounding the business in question. For example, a fine masonry building might have to pay high rates, if it's built up against a neighbor's building that's ranked high in the measure of risk.

CLASS RATING

Businesses in the retail, wholesale, and light processing categories fall under a rating system called class rating. This system develops general classes by using the COPE system, and groups businesses into like categories, with the same rate per $100 of insurance.

The following example illustrates class rating:

Grocery Store

Protection: Within 500 feet of a fire hydrant, within three miles of a fire station

Construction: Frame

Occupancy: Grocery store with no cooking on premises.

If a building, due to size, occupancy, or special construction, will not fit into one of the class rates, a specific rate will be developed just for that property. This is called the "specific rating system." Under this system, a qualified engineer from a bureau subsidized by the insurance industry inspects the building. Once the report is finished, the bureau publishes the rate for public use. All the insurers that subscribe to the bureau will use those rates when insuring that building and its contents.

Sample rates might be:

Item	Rate per $100 of Insurance
Basic Group 1	$ 1.50
Basic Group 2	.33
Total Class Rate	$ 1.83

Result: $100,000 of insurance would cost $1,830 per year.

BOILERS

If a building is heated by a boiler, you should be aware of a gap in property insurance with respect to the coverage of the peril of explosion. The property forms exclude coverage for damage from bulging, bursting, or explosion of steam vessels such as steam or hot water boilers. To cover this exposure, boiler and machinery coverage may be added to the client's portfolio of insurance. It'll cover boilers and furnaces, refrigerator systems, vulcanizers, air tanks, and compressors and air conditioning systems. The policy will cover the sudden and accidental tearing asunder of the insured object. In addition, the policy may, for added premium, cover other perils, such as bulging, burning, or cracking of the objects insured.

The boiler and machinery policy can be endorsed to add coverage of a business interruption resulting from a peril insured on the policy.

SUMMARY

You should now be able to work through your client's property coverages, including review of the perils insured, the amounts covered, and the requirements imposed on the client by the insurer. Suggesting the use of reporting forms or peak season coverage can greatly streamline your client's insurance. Further, it's important that you understand the implications of systems like coinsurance and replacement cost clauses, so that you can advise clients on how to use them to his advantage.

CHAPTER 4

INCOME LOSS

OBJECTIVES

On completing this chapter, you will be able to:

- Determine if the client has time element coverages in his insurance portfolio.
- Determine if the type of time element coverage is appropriate for the client's particular type of business.
- Recommend to the client the proper time element coverages.
- Explain to the client the various types of coverage available and discuss the necessity of these coverages with the client.
- Advise the client about the necessity of coverage for valuable papers and records.
- Explain the need and use of insurance coverage for accounts receivable.

When your client has to close his doors due to unexpected happenings, such as a fire, he is out of business, and without income. It is not enough to have insurance to cover the damage to his business, he must have time element coverage to help defray his loss of income. The information in this chapter provides the know-how to handle insurance for the loss of income.

Time element coverages can mean the difference between reopening after the fire or other occurrence, or not. Even after a complete review and careful selection of property coverages, a business that doesn't have the right time element coverages has a slim chance of ever recovering. Time element coverage should, therefore, not be considered optional, but a basic requirement of your own or your client's insurance portfolio.

There are also some special coverages used to protect valuable papers, records, and accounts receivable. These coverages and their terms and conditions are actually great-grandchildren of the ancient ocean marine contract.

BUSINESS INCOME COVERAGE

Following a loss substantial enough to cause the partial or total closure of a business, the firm faces several challenges. Let us consider a loss suffered by ABC Manufacturing.

Considerations:

1. *Is the peril that has occurred covered by insurance?* If it is a fire, then the basic policy covers the loss.
2. *Is the insurance enough?* An understanding of the coinsurance clause and the use of the replacement cost clause when purchasing the insurance will make sure that there is adequate coverage for a partial or total loss.
3. *How will the firm survive while waiting the months it may take to rebuild the building, restock the shelves, and revive the flow of customers? What expenses must be met during this period void of sales or income?*

Recall the case study information given in Chapter 1. Assume:

- The loss was caused by fire.
  - — The fire has caused a complete shut-down of the manufacturing plant.
  - — There is adequate replacement cost coverage on building and contents.
  - — This answers questions 1 and 2.

Now we face question 3. Following the fire, the following are expenses that will stop:

- Purchase of metal stock used in manufacture of precision component steel boxes.
- Nonessential payroll (minor maintenance, cleaning, file clerks).
- Utilities (heat, electric, phone).
- Shipping and transportation costs.

The following are expenses that will not stop following a fire and must be paid:

- Insurance premiums.
- Installment loans.
- Mortgage payments (the mortgageholder may allow the firm to make "interest only" payments during the down-time. However, if the mortgage is in its early years, this may represent a very minor relief).
- Essential payroll: engineers and designers, supervisors, highly experienced machinists, key salespersons, executive officers.
- Automobile supplied to president of corporation.

BENEFITS OF BUSINESS INCOME COVERAGE

It should be clear to you that even though the property insurance was adequate, the firm may never survive this loss without some way to replace lost revenues. Business income coverage, sometimes called use and occupancy insurance, covers the consequential interruption of operations and

loss of earnings resulting from an insured peril. The coverage for lost income is triggered by the occurrence of a peril that's covered under the property insurance.

Business income coverage will provide the following benefits:

1. Maintain insurance coverage in force by providing funds to pay premiums.
2. Maintain the firm's credit standing by providing funds to pay installment loans.
3. Maintain the firm's credit standing by providing funds to meet mortgage payments.
4. Provide funds to maintain essential payroll to avoid the prospects of key employees' obtaining employment with the firm's competitors.
5. Maintain automobiles essential to the recovery of the firm.
6. Provide funds for other items essential to the recovery of the firm.

Business income coverage pays lost income to the client for as long as it takes to rebuild, repair or replace. But the insurance will pay only as long as it should take the insured to do so with the exercise of due diligence and dispatch.

Extended Period of Indemnity Endorsement

For an additional premium, the insured may elect to have the extended period of indemnity endorsement added to the business interruption form. This endorsement covers a period beyond any repair or rebuilding required to restore business to its normal pace in regard to customers and sales.

LIMITS ON BUSINESS INCOME COVERAGE

The basic business income form won't pay for a drop in sales or loss of customers, contracts or goodwill. Nor will it pay for delays in repair because of strikes, or the imposition of local or state ordinances. Coverage is also limited to two weeks' worth when the insured's business is shut down because an insured peril, e.g., a fire, happened in an adjacent building, and access is blocked by the authorities. No more than 30 days' coverage is allowed when the business is down because of damage to electronic media or data. Coverage for this can be extended to 90 or 180 days for an additional premium.

HOW MUCH COVERAGE?

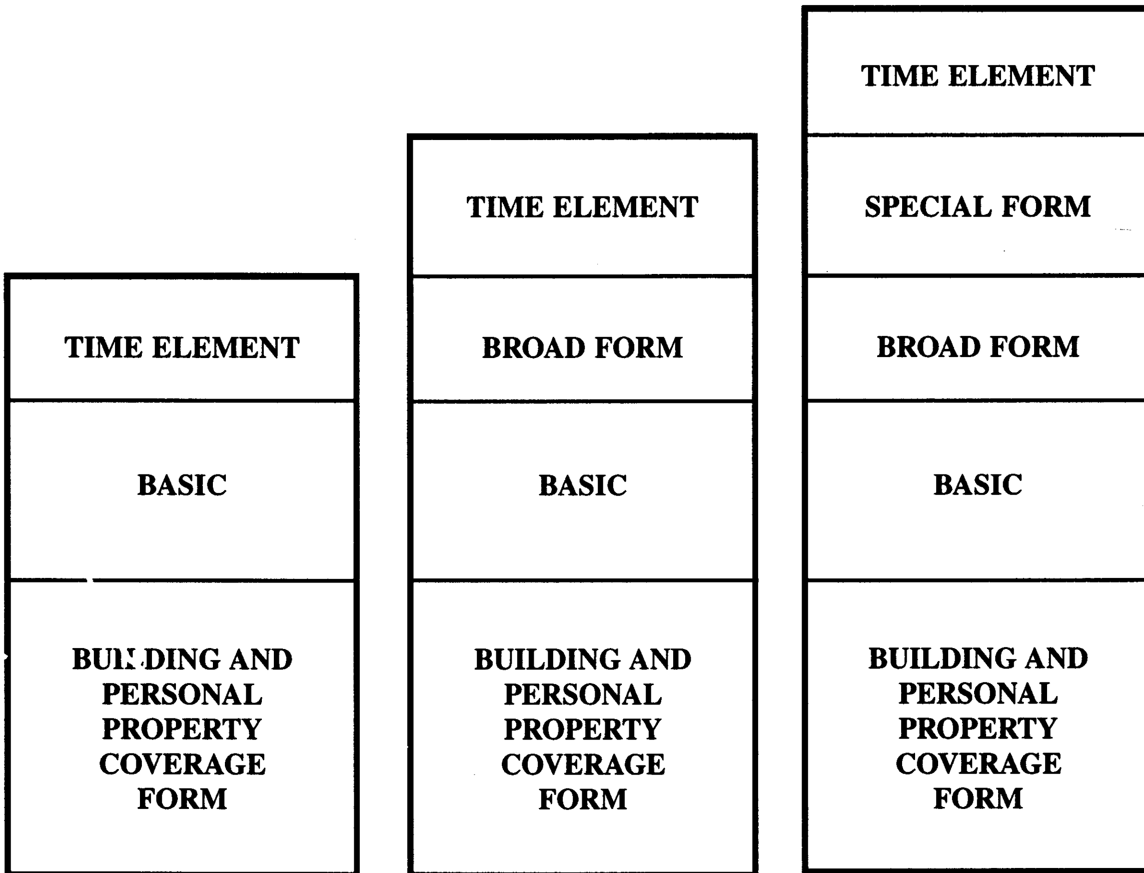
Having acknowledged the absolute need for this type of coverage, how do you figure the right amount to be carried? Here's where your client will be happy to have you involved.

The insurance companies, at the insured's request, will provide a worksheet for calculating how much coverage to carry. It's a rather complicated formula. We've included a copy.

LOSS OF EARNINGS INSURANCE

A simplified form of business income coverage is available for small businesses. Owners of retail, wholesale, and other small mercantile businesses can opt to buy loss of earnings insurance. Loss of earnings is a type of business income coverage. Its main advantages are the absence of coinsurance, and the ability to tailor coverage to requirements. The policyholder, upon figuring out the amount of coverage needed to survive a shut-down of three, four, or five months, can buy an amount of coverage that will be paid over a period of three, four, or five months.

BUILDING A SYSTEM OF INSURANCE



BUSINESS INCOME REPORT/WORK SHEET

Your Name ______________________________ Date ______________

Location ____

____

This work sheet must be completed on an accrual basis in conformity with generally accepted accounting principles.

Indicate the inventory valuation method used by your company:

_______ Specific Identification Method
_______ Average-Cost Method
_______ First-In, First-Out (FIFO) Method
_______ Last-In, First-Out (LIFO) Method
_______ Other (specify):
____

APPLICABLE WHEN THE AGREED VALUE COVERAGE OPTION APPLIES:

I certify that this is a true and correct report of values as required under this policy for the periods indicated and that the Agreed Value for the period of coverage is $_________, based on a Coinsurance percentage of _______%.

Signature ______________________
Official Title ______________________

APPLICABLE WHEN THE PREMIUM ADJUSTMENT FORM APPLIES:

I certify that this is a true and correct report of values as required under this policy for the 12 months ended ____________.

Signature ______________________
Official Title ______________________

Agent or Broker ______________________
Mailing Address ______________________

CP 15 15 11 85 Copyright, ISO Commercial Risk Services, Inc., 1983

BUSINESS INCOME REPORT/WORK SHEET
FINANCIAL ANALYSIS

Income and Expenses		12 Month Period Ending . . . 19___ Manufacturing	12 Month Period Ending . . . 19___ Non-Manufacturing	Estimated for 12 Month Period Beginning . . . 19___ Manufacturing	Estimated for 12 Month Period Beginning . . . 19___ Non-Manufacturing
A. Gross Sales...............................		$ ______	$ ______	$ ______	$ ______
B. DEDUCT:					
Finished Stock Inventory (at sales value) at Beginning................................		– ______		– ______	
		______		______	
C. ADD:					
Finished Stock Inventory (at sales value) at End......................................		+ ______		+ ______	
D. Gross Sales Value of Production............		$ ______		$ ______	
E. DEDUCT:					
Prepaid Freight......	______				
Returns & Allowances	+ ______				
Discounts...........	+ ______				
Bad Debts	+ ______				
Collection Expenses..	+ ______				
Total......................................		– ______	– ______	– ______	– ______
F. Net Sales			$ ______		$ ______
Net Sales Value of Production...............		$ ______		$ ______	
G. ADD: Other Earnings from your business operations (not investment income or rents from other properties):					
Commissions or Rents	______				
Cash Discounts Received.........	+ ______				
Other...............	+ ______				
Total Other Earnings........................		+ ______	+ ______	+ ______	+ ______
H. Total Revenues		$ ______	$ ______	$ ______	$ ______

I. DEDUCT: The cost of the following (net of any cash discounts received):

1. Cost of Goods Sold:
   Inventory (including stock in process) at beginning of year .... $ ______

   ADD: Cost of the following purchased during the year:
   Raw Stock Consumed...... ______
   Factory Supplies Consumed .... + ______
   Merchandise Sold .... + ______
   Other Supplies Consumed (including transportation charges).................. + ______

   Total Purchase Costs...... + ______
   Cost of Goods Available for Sale............ $ ______

   DEDUCT: Inventory (including stock in process) at end of year...................... – ______
   Cost of Goods Sold.......... $ ______

2. Services purchased from outsiders (not your employees) to resell, that do not continue under contract.............. + ______

Total (Mining Properties — see next page).. – ______ – ______ | – ______ – ______

J.1. Net Income and Expenses (Business Income Basis for Coinsurance if a Coverage Modification does not apply) .... $ ______ $ ______ | $ ______ $ ______

J.2. Combined (for firms engaged in both manufacturing and non-manufacturing operations)................................ $ ______ | $ ______

K. Business Income Basis for Coinsurance if a Coverage Modification does apply — see reverse side .... $ ______ | $ ______

L. Amount of Insurance Required (Multiply the amount in J.1., J.2. or K. by the coinsurance percentage specified in the Declarations)............ $ ______

Copyright, ISO Commercial Risk Services, Inc., 1983

BUSINESS INCOME REPORT/WORK SHEET
COVERAGE MODIFICATION

	12 Month Period Ending . . . 19__	Estimated for 12 Month Period Beginning . . . 19__
NET INCOME and EXPENSES (item J.1. or J.2.) . .	$ ______	$ ______
1. If Ordinary Payroll Limitation form is attached:		
DEDUCT: All Ordinary Payroll Expenses. .	– ______	– ______
If "90 days" or "180 days" is indicated for Ordinary Payroll Limitation: ADD: The largest amount of Ordinary Payroll Expense incurred during the specified number of days............	+ ______	+ ______
Total	______	______
2. If Power, Heat and Refrigeration Deduction form is attached: DEDUCT: Power, heat and refrigeration expenses that do not continue under contract	– ______	– ______
BUSINESS INCOME BASIS FOR COINSURANCE (Transfer to Line K. on previous page)...........	$ ______	$ ______

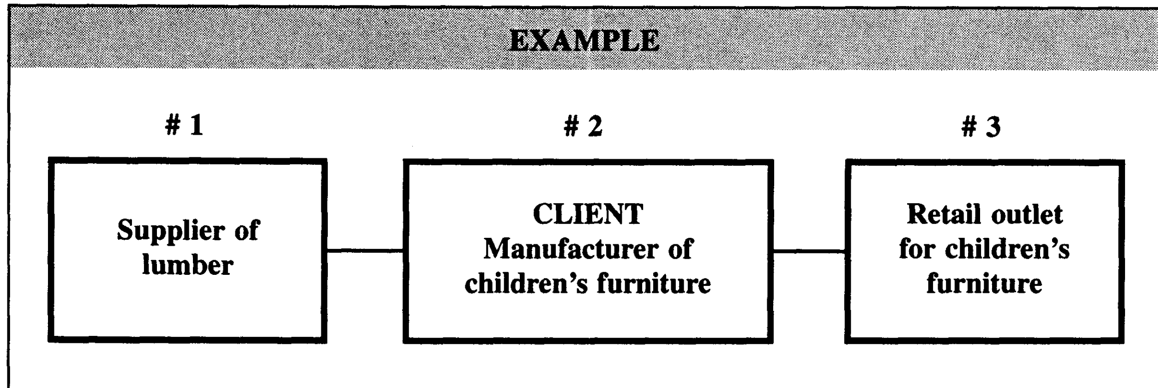
MINING PROPERTIES: In the Total for Line I include the following:

Royalties, unless specifically included in coverage.....	$ ______
Actual depletion, commonly known as unit or cost depletion (not percentage depletion)..................	+ ______
Welfare and retirement fund charges based on tonnage	+ ______
Hired Trucks..	+ ______
Subtotal..	$ ______

Copyright, ISO Commercial Risk Services, Inc., 1983

BUSINESS INCOME LOSS RESULTING FROM THE OCCURRENCE OF INSURED PERILS OFF PREMISES

Some clients may have a severe loss exposure resulting from the occurrence of perils at the locations of suppliers of materials. Others may have a severe loss exposure resulting from the occurrence of perils at the locations of other firms that they depend on for the sales and distribution of their product.



Let's assume that the client in question is a manufacturer of children's furniture. If a fire were to occur at location #1, the supply of materials to our client would end. As a result, our client's production would be forced to cease, thereby causing loss of income.

Likewise, if a fire were to occur at location #3, our client would lose the outlet for his product, again causing loss of income.

These situations require *contingent business income coverage.* There are two forms of insurance available to cover these loss exposures:

1. *Contingent Business Income Form #1.* Insures loss of income resulting from the occurrence of an insured peril at the location of the policyholder's supplier of materials.
2. *Contingent Business Income Form #2.* Insures loss of income resulting from the occurrence of an insured peril at the location of the policyholder's retail outlet. The cost of these endorsements is based upon the fire rates of the locations in question.

RENTAL VALUE INSURANCE

Another form of time element coverage is rental value insurance. Most leases release the tenant from payment of rent when their premises have become unfit for use because of a fire or other peril. The loss of rent exposure is to a landlord what business interruption is to a manufacturer or other business.

Loss of rents coverage can be attached to a property insurance policy, and is also found as an extension of coverage in some fire forms. Like business interruption insurance, rental value insurance is limited to two weeks when an adjacent neighbor's loss blocks use of the insured's premises. Coinsurance applies, as does the monthly limitation of 1/12 per month of available coverage.

ORDINANCE (LAW) COVERAGE

This coverage is added to the property policy for an additional premium. It includes three essential coverages: contingent liability from the operation of building laws, demolition costs, and increased cost of construction.

Contingent liability from operation of building laws coverage pays for the value of the undamaged portion of a building that has to be torn down after a fire because of building laws.

The demolition costs coverage pays for the bulldozers, backhoes, and dump trucks that will be needed for the demotion and the removal of all the debris.

The increased cost of construction coverage can also be referred to as the "excess of replacement cost" endorsement. We have a building partially destroyed because of insured peril. Then, because of building laws, the remaining portion of the building has to be torn down. Now a building permit must be applied for with the local authority. The insured will face all of the current building codes. If the building is insured for replacement cost, the policy will pay to replace, with like kind and quality, the same floor plan and materials. New codes, though, may require additional items, such as fire-proof construction, wider hallways, sprinkler systems, and handicapped access. The replacement cost coverage will not pay to add these items if they weren't part of the building before the fire. Coverage would then fall short by thousands of dollars. Business income coverage may contain a coinsurance clause. When it does, the policy will so indicate on the declarations page. Coinsurance percentages will typically range from 70 to 90%. The increased cost of construction coverage endorsement covers the expenses incurred to meet new building codes, and this coverage can be bought only if the other two coverages are bought. This endorsement often comes with a 100% coinsurance clause.

EXTRA EXPENSE COVERAGE

Some businesses cannot stop serving customers even if the business is destroyed. Such businesses include accounting firms, newspapers, and insurance companies. Such businesses must arrange for alternate quarters and equipment on suffering a property loss. Extra expense insurance is required to fill this coverage gap, and can be added to a property insurance policy.

VALUABLE PAPERS, RECORDS AND ACCOUNTS RECEIVABLE COVERAGE

The cost of reproducing valuable records that have been destroyed is not covered by property insurance, so the valuable papers and records policy is needed to cover this. The form can be added to an insurance portfolio to cover the actual costs of reproducing records. The coverage can apply to blueprints, card catalogs, mailing lists, files and so on. Coverage under this type of policy is extremely broad — it's all-risk coverage, excluding war, vermin, wear and tear, gradual deterioration, and inherent vice.

If records of accounts are destroyed, the insured suffers the following losses:

- Loss of material upon which records were kept.

  — Covered under the property coverage of the policy.

- Expense to reproduce, if possible.

  — Covered by *Valuable Papers and Records Coverage.*

- Inability to collect monies due because of the destruction of accounts receivable records.

  — Covered by *Accounts Receivable Coverage.* Such coverage is "all risk" and covers accounts receivable records kept on the insured's premises. The policy may include a *warranty* requiring that the records be kept in a designated cabinet or vault when not in use.

SUMMARY

Time element coverages are often perceived as optional. You must stress to business owners that this is not the case.

CHAPTER 5

COMPUTER LOSS EXPOSURES

OBJECTIVE

After completing this chapter, you will be able to:

- Advise management about the steps to take to ensure adequate protection against computer loss exposure.

COMPUTER LOSS EXPOSURES

Many of your business clients use computers in their operations. Their use varies from minor to complete dependency. The loss exposures presented by the growth of computer usage in today's business environment are difficult to identify and measure. The insurance industry admits that not all the ramifications are yet known.

The depth and complexity of computer fraud against business is so hard to estimate that computer crime has been labeled the "invisible crime." This chapter will show you steps to control loss, as well as the specific insurance to cover computer loss exposure.

Computers present four basic loss exposures to business: *property, earnings, liability*, and *crime*.

It's amazing how many clients consider the computer as just another piece of office equipment. They don't realize that the computer involves unique exposures. Loss of the computer system can be devastating to a business. As a company's dependency on the computer increases, so does the risk of loss.

The computer is one area where risk management — an ounce of prevention — are very important. Some of the inherent characteristics of computers make it possible for most businesses to implement basic risk management techniques. We'll cover some typical loss control steps you can recommend to a client.

Property Loss Exposure

The property loss exposure deals with the losses to hardware and software. Computer hardware is subject to the same perils as most office equipment. However, computers are also subject to "special" perils not common to more traditional office items, such as

- Electrical disturbances;
- Magnetic disturbances;
- Extremes of temperature;
- Humidity;
- Dust; and
- Static electricity.

EXAMPLE 5-1

A computer, worth $735,000, was being operated for diagnostic purposes in a medical clinic. An electrical "spike" burst through the computer (momentary surge of 2,000 volts). The usual voltage used by the computer was 440. The total damages were $110,000. As it was not lightning, but an artificially generated surge, the insurance policy on the computer would not pay the claim.[1]

For small businesses, the most likely treatment of these exposures is insurance. The insurance industry has produced an insurance policy to cover most of the perils we worry about. It's called the EDP (electronic data processing) policy.

For a large business with hundreds of thousands or even millions invested in hardware, certain loss control steps must be taken in addition to purchasing insurance. Here are the steps one large firm took after investing $20 million in a new system:

- The computer building was made into a controlled environment, treating temperature, dust, and humidity.
- Fire control was installed that included a halon system and backup water sprinkler systems.
- EDP insurance was purchased for $20 million, with a deductible of $1 million.
- A special replacement cost clause, titled "upgraded value" was negotiated with the insurer. The special clause allowed the company to collect the full amount of insurance coverage in the event of a loss, even if the system was worth much less at the time of the loss because of obsolescence. This enabled the company to purchase an up-to-date system in the event of a disaster.

This special clause raises an interesting question. Computers have traditionally dropped in price with time while improving in power and capacity. So computers can easily become overinsured in one year. If your client intends, in the event of a disaster, to replace its existing computer with an essentially identical model, the amount of insurance coverage can be decreased each year as the value of the computer decreases. This will save your client money on insurance premiums. But this may not be practical for many clients, due to the fast obsolescence of computers. Thus, "upgraded value" coverage is extremely important.

[1]Harry F. Brooks, "Risk Management and the Computer," *American Agent and Broker* (February 10, 1985), pp. 11–14.

Software (data and media) is extremely subject to loss. Media is the material on which data is stored, including tapes, floppy disks, and cards, and is usually insured under the EDP policy.

Data is that which is stored on the media. The value of data can vary, and can be so high that insurance is out of the question. In many cases, risk management and loss control steps are the best treatment for data loss exposure. For small businesses, the best treatment is to duplicate the data, and remove the duplicate from the premises each night. A duplicate tape won't help if it remains on the premises and is destroyed in a fire or other disaster. A common problem in small businesses is that the daily procedure of duplicating or backing up is not followed, sometimes for weeks.

Software is subject to all the loss exposures of ordinary office contents along with the following additional loss exposures:

- Simple loss;
- Theft;
- Accidental erasure;
- Malicious tampering;
- Magnetic disturbance; and
- Rough handling.

Earnings Loss Exposure

Destruction of a computer can impair business earnings, just as the loss of any key piece of equipment can. The loss exposure to earnings created by the computer arises mainly from the possibility of shutdown resulting from damage to the computer upon which the business is dependent for such functions as production sales, billings, and recordkeeping. Although a computer may be quickly purchased to replace the lost or destroyed unit, and media may be bought, the restoration of data and the delays in receipt of replacements may cause losses in income far exceeding the entire value of the computer systems.

The best treatment of the loss of earnings exposure is a combination of risk management and insurance. Risk management procedures could include these loss control steps.

- Preserve the computer, as discussed earlier.
- Duplicate all data, as discussed earlier.
- Prevent a bottleneck from developing when more than one location is served by a computer system.

It's a good idea to develop a flow-chart of information. For example, if a company has six locations that feed information into a central computer, which then feeds information to other locations, there would be a possible bottleneck situation at the central computer. Destruction or failure of the central computer could cause all other locations to cease, leading to the maximum possible loss of income. One way to minimize this exposure is to change the flow of information to avoid that bottleneck.

The insurance treatment of earnings loss exposure can be accomplished with the EDP policy. The policy may be endorsed to include the extra expense, that is, time element coverage (discussed in the previous chapter). Examples of these extra expenses include down time for personnel who must be paid but cannot work, and the expense of renting computer time at another facility.

Liability Loss Exposure

As computers are used in more and more crucial functions in business, they create a special legal loss exposure for those businesses that use them. When a business relies on data produced by a computer system for decisions regarding business practices, a flaw in programming or hardware could produce such dire results as to cause the business to eventually close. If your client uses a computer system to advise customers, a flaw in the system could bring numerous lawsuits.

The legal loss exposure caused by use of computers is very complex. The firms most exposed include computer programmers, software designers, systems analysts, and those that use the computer as a basis for consulting. The major question being answered in courtrooms is whether damages caused by the use of computers fall under strict product liability rules or malpractice.

Strict product liability imposes loss exposure on the manufacturer and seller of the system. Malpractice imposes the loss exposure on the user.

The best treatment of the legal loss exposure is a combination of risk management practice and insurance. Risk management steps include:

- **Avoidance**. Measure the possible profits and benefits expected from the use of the system and weigh them against the possible lawsuits that may arise out of the use of it. For example, a physician once asked a consulting firm to design a diagnostic computer program that he could use in his practice. The firm refused the job because it felt the risk of lawsuit was too great.
- **Control**. Since most lawsuits allege misrepresentation by the computer maker, software vendor or user, the business should control the sales force, and limit promises to those that can definitely be met on a timely basis.
- **Transfer**. Arrange legal hold harmless agreements with customers. Issue very limited warranties on the service being performed.

The insurance treatment of this loss exposure is to buy the "appropriate errors and omissions" policy. This is a malpractice form of insurance. It may be hard to buy such insurance, though, since the field of computer science is still relatively new and insurers have no data on which to gauge the risks involved, and may be unwilling to provide this type of coverage. Further, the cost of insurance for this loss exposure may be prohibitive.

Example 5–2

A market research company, using a computer system to study markets, used the data supplied by the computer to advise a customer on where to open new stores. Based on this information, the customer proceeded to open the new stores as indicated and failed in all the stores. This is an actual case and is representative of a whole new level of legal loss exposures. Those most susceptible to lawsuits in this area are:

- Computer programmers;
- Software designers;
- Systems analysts; and
- Those using computers to assist in consulting.

Crime Loss Exposure

The development of this new technology has provided new ways to commit the old crimes of embezzlement, theft, and fraud. Computer crime cuts across several loss exposure categories:

- Property and money loss;
- Loss of earnings; and
- Liability due to unauthorized use.

Computer crime continues to grow. Traditional business practice was to maintain control at one central location. The center was usually under the direct supervision of owners or upper management. But with the advent of computers, phone lines, and modems, control is often diluted, and crucial data is often available to many managers at many, often remote, locations. The use of passwords often fails.

Both crime controls (see below), and insurance are part of the treatment for this exposure. The EDP policy includes coverage for both theft of hardware and damage to hardware by vandals. The policy also covers theft and vandalism of media. Loss of data can also be insured, including the cost to recreate the data.

COMPUTER CRIME CONTROLS

There are five controls recommended to avoid computer crime:

1. Data security;
2. Program security;

3. Communications and terminal security;
4. Documentation security; and
5. Physical security.

Data Security. Data security is concerned with integrity (verification that data is received from authorized sources), protection (restriction of access to sensitive data), and recoverability (off-site storage of data, updated daily).

Program Security. Program security is concerned with program changes. Any changes in programs must be authorized and documented.

Communication and Terminal Security. Communication and terminal security deals with stopping crime from outside use of modems and telephone lines.

Documentation Security. Documentation security ensures that access to reports and operating manuals is limited to authorized personnel.

Physical Security. Physical security deals with the ability to access computer hardware by the use of, for example, locks that open to fingerprints or voice patterns.

SUMMARY

Many client consider the computer as another piece of office machinery, but the loss exposures involved are far-reaching and complex. Treatment usually involves a combination of risk management and insurance.

CHAPTER 6

CRIME INSURANCE

OBJECTIVES

After completing this chapter, you will be able to:

- Decide whether to advise management to select crime insurance.
- Determine the appropriate crime insurance to select.

Moral hazard, that is, crime, is the most difficult to deal with because it pits the intelligence of the dishonest against that of the unsuspecting general public. The most often used treatment for crime exposure is insurance.

As you continue to build your client's insurance protection against business peril and exposure, careful consideration must be given to the area of crime insurance. Crime coverages are often included in package policies, and they are also issued as individual policies. It is important to consider your clients' exposures to determine if a package policy is sufficient or a more tailored individual policy is needed. This chapter takes you from basic crime coverage to the more sophisticated types, allowing you to help your clients determine the necessary level of coverage.

Let's begin by defining the terms "burglary," "robbery," and "theft." We need to do this because it is important to an understanding of the various crime policies. Burglary, robbery and theft are not interchangeable when it comes to buying crime insurance. For example, if a client buys robbery insurance, and is burglarized, the loss is not covered.

Burglary is the wrongful taking of property using forced entry, while the premises are closed for business. There are visible signs of entry.

Robbery is the wrongful taking of property using violence or the threat of violence.

Theft is the wrongful taking of property, including, but not limited to burglary or robbery.

When an insurance policy uses one of these terms it refers to the exact meaning of the term. Coverage will depend on the occurrence of that particular peril.

We'll limit our discussion to those policies that will most likely serve your client: the Combination Crime Policy and the Storekeeper's Broad Form Policy. These will handle the crime insurance needs of most businesses.

COMBINATION CRIME POLICY

The combination policy offers ten different coverages that can be bought in any combination and with different limits of coverage for each part.

The combination crime policy covers:

- Money and securities;
- Merchandise;
- Furniture; and
- Fixtures and equipment.

Available coverages include:

- Employee dishonesty — covers losses caused by employees who steal money or property from their employer, and can be bought naming employees, naming positions, or as a blanket coverage of all employees;
- Forgery and alteration — covers instruments like checks, drafts or promissory notes that are drawn by the policyholder and subsequently forged, causing a loss;
- Theft, disappearance and destruction — covers money and securities, for just about any cause of loss;
- Robbery and safe burglary;
- Premises burglary — applies to merchandise, furniture and fixtures of the insured — if the client elects the "Special Property" form, this coverage may already be there;
- Computer fraud — covers the loss of money, securities and other property from the criminal use of computers;
- Extortion — covers loss of money, securities, or any other property from acts of extortion against the policyholder;
- Premises theft and robbery outside the premises;
- Lessees of safe deposit boxes — covers (1) securities against theft, disappearance, or destruction, and (2) other kinds of property against burglary or robbery — different amounts of coverage can be bought for both (1) and (2); and
- Securities deposited with others — against theft, disappearance or destruction.

STOREKEEPERS' BROAD FORM POLICY

The storekeepers' broad form policy is also a combination of crime coverages. It's designed for an insured with a single location and no more than four employees. It covers:

- Blanket employee dishonesty;
- Forgery and alteration;

- Theft, disappearance and destruction;
- Robbery and safe burglary; and
- Premises burglary.

Coverage is bought in increments of $1,000, $1,500, $2,000, or $2,500 for each coverage part.

SUMMARY

We've now covered the most popular crime policies. By reviewing the various coverage, exclusions, and limitations, it should be possible to help a client select coverage to treat the crime loss exposure. We as CPAs will usually be asked to review the client's crime coverage for adequacy and correctness. We should pay special attention to the compliance with coinsurance percentages or limits. Further, the client should be made aware of the actual perils that are insured.

CHAPTER 7

EMPLOYEE DISHONESTY

OBJECTIVES

- Understand the basic function of a bond.
- Describe how a bond works to protect the employer.
- Explain the difference between insurance and bonding.
- Describe the various forms of fidelity bonds and recommend the proper bond for use by the client.

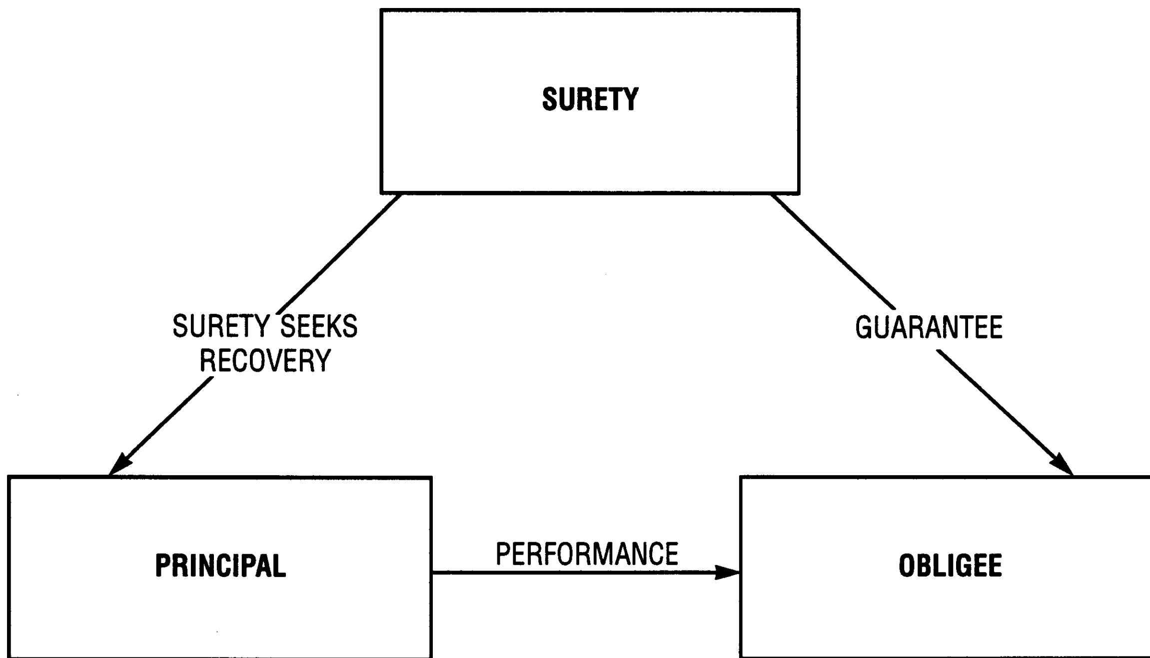
Now that we've covered the exposures that imperil a business from the outside, it's time to examine a great source of loss that comes from an exposure within: theft of money and personal property by employees. This costs employers billions of dollars each year.

This chapter begins the study of the treatment of internal loss exposures, the most common of which is bonding. Keep in mind that bonding resembles banking more than insurance. The field of bonding is separate from insurance, but since insurance companies are the primary providers of bonds, this becomes part of the insurance package that you need to address when discussing and investigating your client's insurance portfolio.

Bonds should be a necessary part of the insurance portfolio. When we covered crimes, one exclusion was found in almost all policies: the dishonest acts of employees. Thus, the need for bonding is clear, especially when employees have access to the business's funds, inventory, or personal property.

How does bonding work? In insurance, there are two parties to the contract: the policyholder and the insurer. The policyholder seeks insurance so as to transfer a known risk to the insurer. The insurer, based on statistics, collects enough premiums from all policyholders to cover future anticipated losses. In bonding, however, there are three parties to the contract: the surety, the principal, and the obligee. The principal is the party that will perform some act or duty. The obligee is the party that stands to suffer a loss if the principal fails to perform as required. The surety is the bonding company that issues the bond, or an insurance company acting as a bonding company. The function of the surety is to guarantee the correct performance of the principal to the obligee. If the principal fails, the surety will make good the loss to the obligee. Unlike insurance, the surety doesn't absorb the loss, but seeks complete and immediate reimbursement from the principal. The surety is not providing insurance coverage, but is actually lending its good name and financial standing to the relationship between the principal and the obligee. For this service, the surety charges a premium, based on the cost to issue the bond.

BONDING
The Three Parties to the Contract



COMPARISON BETWEEN INSURANCE AND BONDING

Insurance	Bonding
Company assumes total risk	Company assumes no risk
Two parties to the contract	Three parties to the contract
No collateral required or involved	Collateral contract
Salvage after a loss is minor consideration	Salvage after a loss is major consideration
Rates based on statistics	Premium — service fee
Losses paid from premium pools	Losses paid from principal's assets
Usually no discovery period to report losses after termination of policy	Generally there is a discovery period

FIDELITY BONDS

The fidelity bond is the bond that guarantees to the employer that an employee will act in an honest manner. The employee, then, takes the position of the principal. The employer is the obligee. If the employee fails in his duty to be honest to the employer, the surety pays the loss to the employer, and then seeks immediate and full recovery from the dishonest employee.

Fidelity bonds *cover the loss* of the following as a *result of employee dishonesty:*

- Money;
- Securities;
- Property of the employer; and
- Property of others held by the employer.

The bond covers *any unlawful taking of property* by an employee, including acts of:

- Larceny;
- Forgery;
- Theft;
- Wrongful abstraction;
- Willful misapplication; and
- Fraud or dishonesty.

For the bond to pay the employer for a loss, the employee need not physically commit the act. The loss will be covered if an *employee assists outsiders* in defrauding the employer.

EXAMPLE 7–1

An employee intentionally leaves a back window unlocked so that accomplices may enter the employer's premises at night to steal.

The bond does not cover losses resulting from errors made by an employee.

EXAMPLE 7–2

A clerk gives a $100 bill in change for a $10 purchase with a $20 bill.

The following employees may bonded:

- Employees in regular employ;
- Employees who receive pay; and
- Employees over whom the employer maintains control.

The following may *not* be bonded:

- Brokers;
- Factors;
- Commission merchants;
- Consignees;
- Contractors;
- Other agents or representatives (except by special endorsement to the bond);
- Partners;
- Directors or trustees of a corporation (unless also an officer or employee); and
- Employees cancelled by a previous surety resulting from the commission of a crime.

It is very important for an employer to be aware of the *cancellation of coverage provision* in a fidelity bond. Termination of bond coverage on a dishonest employee occurs when the employer discovers the dishonest act. This termination applies whether or not the crime is reported to the surety. The risk involved here is that should the employer, as an act of forgiveness or generosity, not proceed with the claim against the dishonest employee, the next crime committed against the employer by that employee will not be covered.

THE DISCOVERY PERIOD

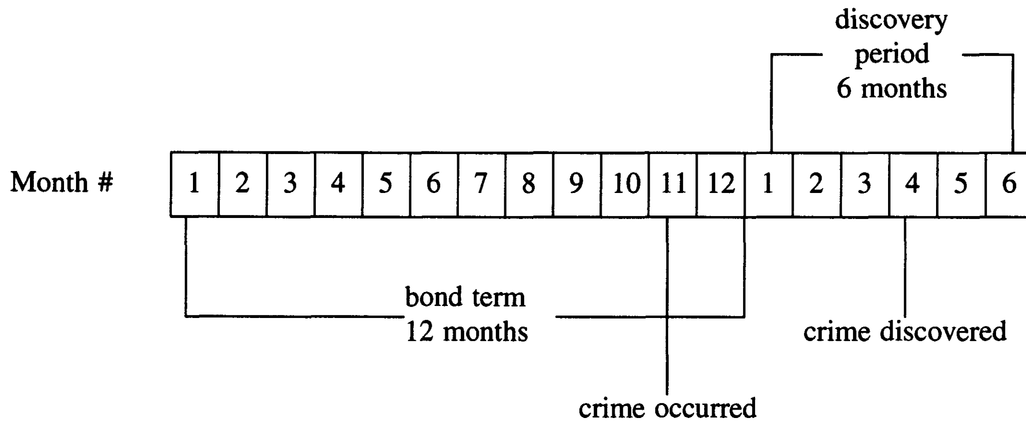
Bonds have a discovery period, which is time after the bond has expired during which a loss discovered will be covered if it took place when the bond was in force. The illustration below shows a six-month discovery period. In the example, a crime happened in the 11th month of the bond, but it wasn't discovered until the fourth month after the bond expired. But because the loss occurred during the bond period, and was discovered during the discovery period, the loss will be covered.

Now take a look at the diagram showing Superseded Suretyship. Assume that bond #1 provides coverage of $8,000, and bond #2 provides coverage of $10,000. If a client replaces bond coverage with no gap in time between bonds, superseded suretyship applies. This provision provides coverage for a loss that occurred during the previous bond, but was not discovered until after the discovery period of the previous bond. The new bond will cover the loss, but for an amount of no more than the lesser of the two bonds. In the example, the loss, although covered by the new bond with a $10,000 limit, would be covered for no more than $8,000.

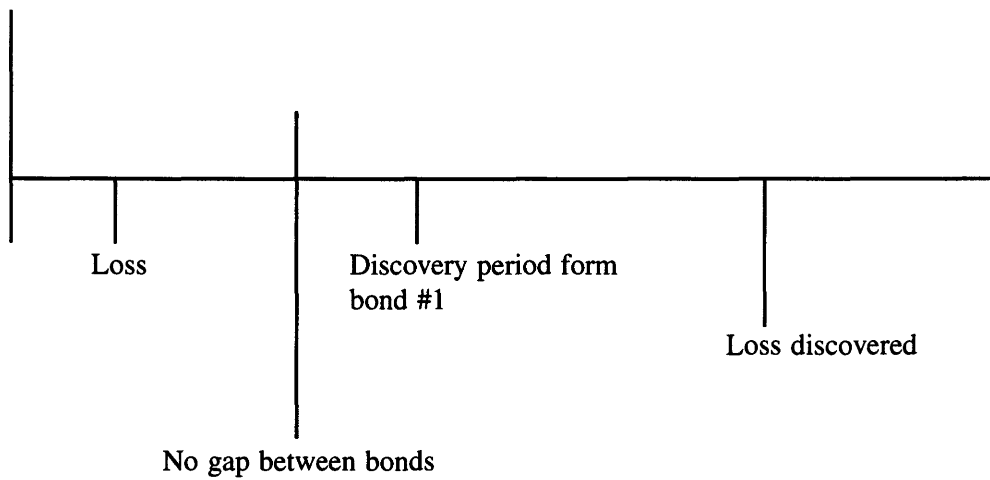
Fidelity bonds exclude coverage for losses based solely on a shortage of inventory. For the bond to pay, the employer has to prove that the dishonesty of an employee caused the loss. Further, fidelity bonds have a non-accumulation of liability clause. This clause states that a loss caused by an employee that takes place over several years will be covered by one times the face amount of the bond and that the bond amount will not be accumulated over the years of the loss. An example showing how this clause works follows the discovery period examples.

EXAMPLE 7–3

DISCOVERY PERIOD



Superseded Suretyship (Loss Under a Prior Bond Provision)



EXAMPLE 7–4

NONACCUMULATION OF LIABILITY CLAUSE

Bond Coverage on Employee: $100,000

Loss:

Year 1:	$ 10,000
Year 2:	$ 50,000
Year 3:	$ 60,000
Year 4:	$ 70,000
Year 5:	$190,000
Total bond coverage:	$100,000

TYPES OF FIDELITY BONDS

Fidelity bonds can be written in one of four ways. The can be written on an individual basis, a name schedule basis, a position schedule basis, or a blanket basis. Here are some examples.

Individual Bond

The individual bond is a single bond issued on one employee, John Doe. Mr. Doe is bonded for his job as a gas station attendant for an amount of $10,000.

EXAMPLE 7–5

John Doe, gas station attendant	$10,000

Name Schedule Bond

Here is one bond issued, naming several employees by name, showing their positions and amounts covered.

EXAMPLE 7–6

John Doe	Manager	$25,000
Jane Snow	Assistant Manager	$20,000
Bill Know	Office Clerk	$10,000

Position Schedule Bond

The position schedule does away with the names of individuals, and instead lists the positions that are bonded. This is especially convenient for an employer that has a regular turnover of employees. The bond shows how many persons are bonded for each position. There's automatic coverage allowed for new positions created, of up to $5,000 for 30 days.

This type of bond has a unique coinsurance clause. The formula is: the number of individuals in the positions shown on the bond, divided by the number of individuals actually in that position, times the loss, equals the settlement. For example, if the employer declared 15 checkout clerks on the bond, and at the time of the $5,000 loss there were 20 clerks, the loss would not be covered in full. 15 divided by 20 times $5,000 equals a settlement of $3,750, or a shortage of $1,250.

EXAMPLE 7-7

Check-out Clerks	15	$ 5,000
Stock Handlers	7	$ 5,000
Managers	4	$10,000
Supervisors	2	$20,000
Bookkeepers	2	$30,000

Blanket Bond

Blanket bonds cover all the employees of a firm on a blanket basis. There are two types of blanket bonds: the blanket position bond and the commercial blanket bond. Either bond will reimburse the employer, even in cases where the employer cannot determine which employee caused the loss.

COMPARISON OF TERMS

Blanket Position Bond	Commercial Blanket Bond
Discovery period 2 yrs.	Discovery period 1 yr.
Bond amount available for each employee	Single bond amount applies no matter how many employees involved
Minimum: $2,500 Maximum: $100,000	Minimum: $10,000 Maximum: None

THE 3-D BOND (COMPREHENSIVE DISHONESTY, DISAPPEARANCE, AND DESTRUCTION POLICY)

The *3-D Bond* is actually a combination of insurance and bond coverages. It consists of *five insuring agreements*:

1. *Employee Dishonesty Coverage.*

   This coverage may be selected as either the Blanket Position Bond or the Commercial Blanket Bond.

2. *Coverage on Premises.*

   This coverage is actually the crime policy, Money and Securities Crime Coverage. It is an "All Risk" coverage, including mysterious disappearance coverage, on money and securities on premises.

3. *Coverage Off Premises.*

   This coverage is the crime policy, Money and Securities Crime Coverage, coverage B, off premises.

4. *Money Order and Counterfeit Paper Currency Coverage.*

   This insuring agreement covers the insured for the loss suffered from the acceptance of counterfeit or forged instruments in exchange for a purchase or service.

5. *Depositors' Forgery Coverage.*

   This insuring agreement covers:

   - Loss caused by forgery of an issued instrument.
   - Loss caused by the alteration of a check, draft, promissory note or bill of exchange drawn by or on the insured's account.
   - Loss caused by the payment to an imposter or fictitious payee drawn on the insured's account.

In addition, it can provide up to 18 optional insuring agreements. They can be purchased in any combination, with separate limits applying to each chosen agreement.

SUMMARY

We've now covered the most commonly used bonds. Along with covering possible future losses for the employer, bonding of employees is also a form of mild deterrent to crime. Many sureties require that the employees to be bonded complete a financial statement of their personal assets and liabilities. This, along with an explanation of the fidelity bond, may cause a would-be embezzler to reconsider. In any event, a client that allows employees to handle valuables should carry the appropriate bonds. Some fidelity coverages can be attached to the business package policy. Others are issued separately.

CHAPTER 8

WORKERS' COMPENSATION

OBJECTIVES

After completing this chapter, you will be able to:

- Advise management about whether an independent contractor is a "true" independent contractor.
- Determine when workers' compensation is needed.
- Determine, on audit, how premium charges will be made.

Workers' compensation is another financial burden that your clients must shoulder. The workers' compensation policy is the insurance industry's answer to the law, and it protects employers from financial exposure when an employee is hurt while working. This chapter will provide you with the know-how to make sure your clients are covered for potential employee injury.

We'll discuss the provisions of the workers' compensation policy, as well the rating procedures of the typical policy, including the audits the insurance company performs on a policy each year. We'll also cover the typical disability benefits law coverage, which treats off-the-job injuries and illnesses that result in disability. Finally, we'll talk briefly about the Occupational Safety and Health Act — OSHA — of 1970. It's important to review this law with your clients, because the law itself requires that all employers know it.

WORKERS' COMPENSATION, IN GENERAL

Before beginning our discussion of the workers' compensation policy, let's look at the sources of workers' comp insurance. In all of the states but six, the insurance companies provide the majority of coverage. In the other states — Ohio, West Virginia, Nevada, North Dakota, Wyoming and Washington — the only source of coverage is the state itself, which provides the coverage through what are called state insurance funds. In many states the insurance companies actually compete with the state fund for business. In New York, for example, the state fund offers attractive discounts, and actively competes with the insurers. The New York state fund controls over 30% of the workers' compensation insurance market.

The question of who must carry workers' comp insurance is often asked by business people. The cost is usually significant, so if it isn't required by law, it is not something a business wants to carry voluntarily. The simplest way to answer the question is to say that anyone with an "employee"

must comply with the law, except when the employee is (1) a domestic or household employee who works less than 40 hours a week, (2) a priest, rabbi, or Christian Science reader, (3) a babysitter, or (4) a casual worker on an owner-occupied single family dwelling. The definition of "casual worker" is left to the discretion of the worker's compensation board. Each case is determined individually, and it's almost impossible to get a determination by the board on an overall basis. All other employees must be covered by workers' compensation.

A business will often hire people who are not regular employees to perform work on the premises. These people may represent themselves as independent contractors, and the business owner may have doubts as to whether these people come under the workers' comp law. True independent contractors are:

- Individuals with employees of their own, who carry workers' compensation on the employees;
- A registered partnership that has operated for three years and has no employees; or
- A corporation that carries workers' compensation insurance.

The right to control the work to be done is the principal determinant of whether one is an independent contractor. In addition, to be considered an independent contractor, the contractor must generally use his own materials and tools, and receive no direct instruction from the business owner. If there's any doubt as to whether someone is an employee, the appropriate workers' comp board should be consulted. In most states, business owners need not carry workers' comp on true independent contractors.

There are two important reasons why businesses must know whether an individual is a true independent contractor or would be considered an employee in the eyes of the worker's comp board. First, if the board does not consider someone an independent contractor, a job-related injury will entitle that individual to full workers' comp benefits, regardless of whether the business carries workers' comp insurance. Few businesses could afford this loss exposure, which could include loss of earnings for life. Second, if someone is not an independent contractor, the insurer that covers the business's other employees will be entitled to premiums based on the contracted labor cost for that individual. This would lead to insurance costs over those anticipated.

The risk management technique that should be employed is to enter into a written contract with an independent contractor. The agreement should require the contractor to provide his own insurance. Evidence of insurance must be provided to the business owner.

Minor children have added protection under this law, which could be an added loss exposure for an unwary employer. If a business hires a minor in contravention of labor regulations, a major uninsured loss exposure is created. Most workers' comp laws require that if an illegally hired minor is injured, the workers' comp insurance must pay benefits. In addition, as punitive damages, the employer must match every payment that the insurance company makes. An employer who has no workers' comp insurance will pay twice the normal benefit. Remember, there is no insurance available to cover punitive damage awards.

A business will often have employees in more than one state. It's important to determine under which state's laws the benefits will be paid, since laws vary from state to state. When a job is transitory, and the employee is in another state on a temporary basis, benefits will be paid for an

injury under the laws of the home state. When a job is at a fixed location, for example, a long-term construction project, the laws of the host state will apply.

WORKERS' COMPENSATION POLICY

The workers' compensation policy consists of four insuring agreements:

Agreement I

Agreement I consists of two coverages.

Coverage A. This agreement covers the employer's legal obligations under the workers' compensation law. It provides coverage for medical benefits, loss of income benefits and additional expenses.

Coverage B. This is the employer's legal liability coverage. It covers the employer for lawsuits brought for work-related injuries that for any reason are not covered under insuring agreement I-A for which there is an allegation of negligence against the employer.

Agreement II

This agreement provides coverage for the employer for the costs of legal defense, including attorney's fees, and court costs.

Agreement III

This agreement, called "definition," stipulates that when the words "workers' compensation" appear in the policy, the entire workers' compensation law is meant to be inserted, including those laws and any occupational disease laws of any state shown on the declarations page of the policy.

Agreement IV

This agreement stipulates that the policy covers only injuries occurring during the policy period. It also contains the inspection and audit clause. This clause states that the insurance company and any rating organization have the right to audit the following for up to three years after the policy period and during the policy period:

- Payroll books;
- General ledger;
- Vouchers;
- Contracts; and
- Tax returns.

This agreement also gives the insurance company the right to physically inspect the insured's premises.

Exclusions

When the policyholder is a partnership, the policy excludes operations of one partner that are not operations of the partnership. Other exclusions are: locations otherwise insured, domestic or agricultural employees (unless specifically shown on the policy), liability assumed orally or by contract, and punitive damages.

Duties of the Employer and Employee

Under the law, the employer has certain duties. He must report all injuries to the insurance company as soon as possible. The employer must also report injuries to the state compensation board. Failure to report to the board on time will result in a penalty. The employer must also submit to inspections and audits by the insurance company.

An employee has 30 days to notify the employer of injury, and 90 days to notify the employer of an occupational disease.

GOVERNING CLASS RULE

A business will often ask the CPA to handle the preparation of a worker's comp audit and premium report. We'll review the standard rating procedure for the policy, as well as the typical audit system. The illustration below will aid in the discussion.

To determine the rating basis for the policy, the employees must be classified by occupation. The governing class rule of workers' compensation law requires that all employees are to be rated according to the governing class. The governing class is typically the most hazardous class.

For example, if a firm is engaged in farming and the sale of canned fruits, the workers' compensation rate of farming would be applied to the entire operation.

Exceptions to this rule are:

- Clerical workers;
- Draftsmen;
- Outside salespersons; and
- Drivers.

In addition to these exceptions, all construction operations are rated individually.

For example, a house builder will have classifications on his policy for operations of:

- Carpentry;
- Plumbing;
- Electric;
- Masonry; and
- Roofing.

ILLUSTRATION (BASED ON ABC MANUFACTURING CORP. CASE STUDY)

Governing Class	Class Code #
Precision Machined Parts Manufacturer	3629
Exceptions:	
Draftsmen	8810
Salesperson	8742

Turning to our example, we have a governing class of precision machined parts manufacturer, class code #3629. In addition, we have the following exceptions:

Engineers, designers, and draftsmen	Code #8810
Salespersons	Code #8742

The rest of the employees will be rated under the governing class. Included under this code will be:

- Supervisors;
- Foremen;
- Machinists;
- Other laborers; and
- Executive officers involved in supervision and labor.

Premiums are based on a rate per $100 of payroll prescribed by the workers' compensation board.

The rating of the policy would be as follows:

POLICY YEAR — 1/1/87–1/1/88

Class	Code	Rate	Payroll	Premium
Draftsmen	8810	.20	$180,000	$ 360
Salesmen	8742	.60	80,000	480
Precision Machined Parts Mfg.	3629	2.28	718,000	16,370
				$ 17,210

ACTUAL PAYROLL BY WORKERS' COMPENSATION CLASS

- Draftsmen — $220,000 (anticipated was $180,000)
- Salesmen — $130,000 (anticipated was $80,000)
- Precision Machined Parts Mfg. — $828,000 (anticipated was $718,000)

The workers' compensation earned premium (actual cash) will be calculated as follows:

Draftsmen:

Anticipated:	$180,000 (.20)	= $360
Actual:	$200,000 (.20)	= $44
Amount Due:	$ 80	

Salesmen:

Anticipated:	$80,000 (.60)	= $480
Actual:	$130,000 (.60)	= $780
Amount Due:	$300	

Precision Machined Parts Manufacturing:

Anticipated:	$718,000 (2.28)	= $16,370
Actual:	$828,000 (2.28)	= $18,878
Amount Due:	$ 2,508	

TOTAL AMOUNT DUE ON AUDIT: $2,888.

The increase in premium can be severe when a large project is involved. The client must be made aware of the effect of increases on payroll on worker's comp premiums.

Audit premiums are due within 30 days of billing, and are not financed by insurers or finance companies.

EXPERIENCE RATING

When a business's workers' comp premium regularly exceeds $750, an experience factor will be developed for his specific policy. The factor reflecting the client's loss experience is then applied to the premium. A good experience (few claims) will result in a factor less than 1 (e.g., .90). But if the client experiences losses, the factor will be greater than 1 (e.g., 1.50). These factors are multiplied by the workers' compensation premium. The first amounts to a 10% discount, while the second amounts to a 50% surcharge.

PREMIUM DISCOUNT PLAN

Reflecting the principle of graded expenses, another discount is applied to large employers, called the premium discount plan. This is a small discount allowed for the size of the premium. In most states it's available only when a policy premium exceeds $1,000.

DISABILITY BENEFITS LAW COVERAGE (NEW YORK, NEW JERSEY, HAWAII)

Another mandatory coverage for employees is the disability benefits law coverage policy.

The disability benefits laws require that an employer provide payment of loss of wages resulting from an employee's inability to work as a result of an injury or illness off the job (nonjob-related).

The required benefits are:

- 50% of the weekly wage.
- Maximum benefit of $145 per week.
- Maximum period of benefits: 26 weeks.
- No benefits paid for the first 7 days of disability.
- Employee must have been employed by the employer for the previous 28 days.

The above terms are an example of the typical law. (This particular example is the New York State Law.) The disability benefits law coverage policy meets these requirements for the employer.

OSHA (OCCUPATIONAL SAFETY AND HEALTH ACT)

The intent of OSHA is to guarantee all workers a safe work place. All employees are protected by OSHA *except*:

- Coal miners (protected under different laws);
- Atomic energy workers (protected under different laws);
- Local government employees (protected under state laws);
- Household domestics; and
- Religious workers.

Under OSHA, the duties of the employer are as follows:

- Comply, and initiate programs to comply, with OSHA regulations.
- Inform all employees of the protection afforded to them under the Act.

- Train employees to use personal protective devices and equipment.
- Make certain that only trained employees will use special equipment.
- Permit inspection by OSHA officials.
- Inform employees of all hazards to which they are exposed.
- Report all accidents that injure five or more employees or kill any one employee.
- Maintain records of all injuries or work-related illnesses.

Employees' rights under OSHA are:

- OSHA regulations must be posted in an obvious location.
- An inspection may be requested by an employee who feels that danger exists. The employee has the right to meet privately with OSHA officials.
- Employees *must* have complete access to records regarding hazards in the workplace.
- Employees *must* be informed of all OSHA citations against the employer.
- The employee is guaranteed confidentiality if he or she makes a complaint against the employer.

The OSHA inspector's rights are:

- The inspector must be given full access to all premises.
- The inspector may require an escort.
- The inspector is in complete control of the inspection.
- The inspector may speak with any employee.
- The inspector may examine any records.
- The inspector may photograph any area.
- The inspector may require the firm to shut down.
- The inspector may issue a citation on the spot.

SUMMARY

We've briefly covered a complex topic. Worker's comp laws are the subject of great debate, some calling the system a salvation for employees and others criticizing it as causing employers to shirk their responsibility to protect employees. Some feel that benefits to workers are inadequate. Notwithstanding all of this, the workers' comp laws are in force, and your client must comply with them.

CHAPTER 9

BUSINESS LIABILITY

OBJECTIVES

After completing this chapter, you will be able to:

- Recommend to management the purchase of specific coverages.
- Respond to gaps in coverage by considering the available alternatives.

Without business liability insurance, your clients cannot function, yet based on the very nature of the coverage, this has become a topic plagued by disagreement. Today's society is litigation happy, resulting in an increase in liability suits for any business that provides a service or products directly or indirectly to the public. As a result, insurance premium rates have soared — from 20 to 1,000%.

Businesses need to carefully plan to make sure they are adequately covered, but not over-insured. The coverage and premiums have to be considered, and this is where your clients need your advice. This chapter will enable you to help clients determine their insurance liability needs.

Insurers have sometimes refused to provide coverage for operations considered too hazardous.

Because self-insurance is impossible, businesses have two options in dealing with liability exposures: to avoid projects that could incur liability, or to buy liability insurance, if it's available and affordable.

Building a system of liability coverages that goes beyond the standard liability coverage for business will depend on three factors: needs, availability of coverage, and affordability. In this chapter, we'll describe the many types of liability coverage offered by the insurance industry.

In reviewing your client's (or your) legal liability coverage, you should analyze legal loss exposures, then select the property coverages.

There are current efforts to reform the tort system. We'll review the proposals.

TORT REFORM

Following are some of the proposed reforms to the tort system:

Limit "Joint and Several" Liability. In many states, an injured party may sue several people or firms in one action. If it is proven in court that several parties were responsible or contributed

to the injury, each will be held liable for damages. If one or many cannot pay their share, those remaining will be forced to pay larger amounts to cover the shortage regardless of their proportionate share of blame. Those with "deep pockets," such as a successful business, may be forced to pay the largest share of damages even if their contribution to the injury was the least.

Limit "Pain and Suffering" (Noneconomic) Awards. Large awards are often given to plaintiffs for physical and mental suffering in addition to actual economic losses.

Limit the "Collateral Source" Rule. This rule states that the defendant cannot benefit from the fact that the plaintiff has received payment for the same claim from some other source.

Limit the Use of Contingency Fees by Attorneys. Attorneys often charge a fixed percentage of settlement for their services taken from their clients' total awards such as 30%, 40%, and sometimes even 50%.

Limit Punitive Damages Awards. Punitive damage awards are awards given in excess of damage awards in an attempt to "punish" the defendant. It should be noted that punitive damages are typically not covered by any insurance.

Limit Lump-Sum Payments of Awards to Plaintiffs. Reformers would propose that defendants be allowed to pay awards over a period of time in installments rather than all in one lump payment.

APPLICABLE LEGAL PRINCIPLES

Here are several legal terms that are important to our discussion.

Respondeat Superior. "Let the Master answer." *Black's Law Dictionary* defines this principle as follows:

> This maxim means that a master is liable in certain cases for the wrongful acts of his servant, and a principal for those of his agent.
>
> In terms of business practice, this means that the owner of a business may be held liable for the commission of acts against the rights of others performed by his employees, agents, or subcontractors.

Res Ipsa Loquitor. "The thing speaks for itself." *Black's* defines this principle as follows:

> Rebuttable presumption that defendant was negligent, which arises upon proof that instrumentality causing injury was in defendant's exclusive control, and that the accident was one which ordinarily does not happen in absence of negligence.

Punitive Damages. Punitive damages are damages awarded against a defendant in excess of actual economic damages suffered by the plaintiff.

The Law of Torts. *Black's Law Dictionary* defines "tort" as:

> Wrong; injury; the opposite of right. So called, according to Lord Coke, because it is wrested, or crooked, being contrary to that which is right and straight.

A tort is a legal wrong committed upon the person or property independent of contract. It may be either:

- A direct invasion of some legal right of the individual;
- The infraction of some public duty by which special damage accrues to the individual; or
- The violation of some private obligation by which like damage accrues to the individual.

In the former case, no special damage is necessary to entitle the party to recover. In the two latter cases, such damage is necessary.

STANDARD LIABILITY INSURANCE

The system of liability insurance is the insurance industry's response to the individual's and business' need to be protected under the tort laws. Unlike property insurance losses, where the loss is easily definable in both time and amount, liability losses are difficult to anticipate. Traditional liability coverages have been written on an occurrence basis. When coverage is written on this basis, a loss will be covered so long as the event took place during the policy period. The insurer is then obligated to defend and pay for any loss that arises from that event at any time in the future. When coverage is allowed on an occurrence basis, the insurer may have little ability to measure reserve, and to charge enough premiums for any one year because events of past years may cause claims to be filed at any time in the future.

Many states have adopted the "claims made" form of liability coverage. This obligates the insurance company to pay for claims made against the policyholder while the policy is in force. The suit or claim has to be reported to the insurer during the policy period. This lets the insurer know what claims it has to face for any one year, and enables it to properly reserve and charge premiums to cover losses for that year. States that have approved the claims-made format, offer the choice of claims-made or occurrence coverage to policyholders and underwriters. Claims-made coverage is typically found in policies covering product liability and malpractice insurance.

The liability insurance policy is written to cover:*

- Bodily injury liability (including wrongful deaths);
- Property damage liability
  - $100,000 - each occurrence, bodily injury and property damage
  - $100,000 - each occurrence, personal injury
  - $300,000 - aggregate
  - $ 50,000 - fire legal liability
  - $ 5,000 - medical expenses
- Supplementary benefits. Liability policies provide the following in addition to the policy limits for settlements:
  - All costs of defense, including attorney's fees, investigation, court bonds.
  - The company agrees to defend the insured against any covered suit, no matter how groundless.
  - The insurance company will reimburse the insured for any reasonable expenses incurred at the insurer's request.
  - The insurance company will reimburse the insured for any travel loss of earnings and cost to obtain witnesses as deemed necessary by the insurer.

The insurance company will not reimburse the insured for any expenses not approved by them except for first aid at the scene of the accident.

PERSONAL INJURY LIABILITY

Personal injury liability coverages are for claims arising from:

- Alleged false arrest, detention or imprisonment, malicious prosecution;
- Libel, slander, defamation of character, or invasion of privacy;
- Wrongful entry or eviction or the violation of any other right of private occupancy; and
- Advertising injury.

---

* The policy places an aggregate limit of the insurance company's maximum responsibility during the policy year for damages under products and completed operations coverages, fire legal liability, personal injury, medical payments, premises and operations coverages, and independent contractors' coverages.

For example, if the policy shows:

Limit of liability - $300,000
Aggregate - $300,000

The policy will cover any single loss up to $300,000 but will cover no more than $300,000 of claims in the policy year.

The liability policy *excludes*:

- Intentional acts of the insured.
- Injury or death subject to workers' compensation.
- Damage to property in the insured's care, custody, and control.
- Claims arising out of the use of automobiles, aircraft, and watercraft, whether operating or loading and unloading. (Liability will cover parking automobiles on the insured's premises such as a hotel or restaurant. Watercraft on the insured's premises may be covered as well.)
- Claims arising out of acts of war, insurrection, or revolution.
- Claims under the dram-shop law (arising out of serving alcoholic beverages). The new commercial general liability policy, in the states where it is approved, *does* include this coverage if the insured's business, such as a bar or restaurant, does not serve alcohol.
- Claims falling under the category of malpractice or errors and omissions.
- Claims arising out of the use of nuclear materials.
- Claims alleging pollution.
- Liability assumed from others.

ACTIONS REQUIRED BY INSURED

In order for the insurance company to provide coverage, the policyholder must comply with the following requirements:

- Notify the insurer as soon as practicably possible of any claim or possible claim, giving full details known;
- Take any prudent action necessary to prevent further loss exposure;
- Forward *immediately* to insurance company, any notice of claim or suit received;
- Cooperate with the insurance company in the investigation, defense, and settlement of the claim; and
- Submit to inspection and audit by the insurance company.

COMMERCIAL GENERAL LIABILITY

We begin building a liability policy using the commercial general liability policy as a foundation. This form covers losses arising out of the ownership, maintenance, and use of the premises owned, leased or controlled by the insured. Operations connected with normal business activities are also

covered. A new location is automatically covered for 30 days. If the insured is held liable for a claim arising from a property previously owned, the policy will respond under the "grantor's liability clause."

The commercial general liability policy *excludes*:

- Assumed liability *except* for:
  - Lease of premises;
  - Easement on operations on or adjacent to a railroad;
  - Municipal ordinance;
  - Sidetrack agreement; and
  - Elevator maintenance agreement
- Vehicles and aircraft *except*:
  - Vehicles not subject to motor vehicle registration;
  - Vehicles used exclusively for maintenance of the property; and
  - Contractor's equipment
- Watercraft, except on premises
- New construction or demolition (this coverage can be added for an additional premium)
- Water damage, sprinkler leakage property damage liability (can be added for an additional premium)
- Professional liability (malpractice or errors and omissions)

Premiums are charged based on one or more of the following bases, depending on the type of business:

- Admissions (i.e., theaters);
- Receipts;
- Area;
- Frontage (i.e., land held for development);
- Per unit (i.e., dwellings);
- Per acre;
- Per pupil;
- Per contestant; and
- Per location per day (i.e., conventions).

PRODUCTS LIABILITY COVERAGE

Products liability coverage covers losses arising from the legal loss exposure from the manufacture, sale, or distribution of products. It covers products relinquished to the customer and off-premises. Exceptions to the off-premises rule are restaurants and drugstores. The standard form provides coverage in the U.S., its possessions and territories, Canada, and international waters and air space. In state that have adopted the claims-made products liability form, in situations where the use or occurrence is also allowed, coverage may be worldwide.

The products liability coverage form does *not* cover:

- Equipment rented or located for use by others (vending machines);
- Damage to the property that caused the loss, or the value of the completed operation;
- Dram shop liability — liability arising from serving alcoholic beverages;
- Assumed liability;
- The failure of the product to perform as promised (i.e., lawnmower engine won't start); and
- Withdrawal of property from the market (known as "sistership liability").

Products liability coverage is priced according to the type of product and gross annual sales. This premium is also subject to annual audit.

CONTRACTUAL LIABILITY INSURANCE

If a business has assumed liability from others via contract, covering the loss exposure will require contractual liability insurance. This coverage is automatically included in the commercial general liability policy in the states that have adopted it. There are no set rates for this type of coverage. Each written contract or hold harmless agreement must be submitted to the insurer for review and rating.

OWNER'S AND CONTRACTOR'S PROTECTIVE LIABILITY

If a business uses independent contractors, the loss exposure created will be covered by the owner's and contractor's protective liability. This coverage does not replace worker's compensation. The cost of this coverage is based on the cost of the contracts.

MALPRACTICE INSURANCE

If your client is in the medical, legal, or accounting fields, malpractice insurance is indicated. The policy covers claims made against a practitioner for failure to meet established standards of skill and care. The coverage is broad, for both negligent and intentional acts.

For non-medical professions, the form of insurance is called "errors and omissions" insurance.

DIRECTORS' AND OFFICERS' LIABILITY INSURANCE

This coverage pays on behalf of the executives of a corporation or reimburses the corporation for losses arising out of the following:

- Errors made by officers or directors;
- Neglect of duty by officers or directors;
- Breach of duty by officers or directors; and
- Misleading statements made by officers or directors.

Large deductibles of $5,000 to $100,000 are used. In addition, the insured will be required to participate in losses up to 5% above the deductible.

There are approximately 12 insurers, including Lloyd's of London, providing this coverage on a large scale. Coverage for directors and officers is becoming extremely difficult to obtain and requires serious efforts by the insured or the insured's broker or agent to locate.

UMBRELLA LIABILITY

Once all the basic liability exposures have been identified and insured, the limit of coverage can be increased and coverage broadened with an umbrella liability policy. This is a separate policy that gives coverage above the limits of the basic policies and coverage bought. The umbrella is bought in units of $1 million. This amount is placed in addition to the limits of coverage on the basic liability coverages. Therefore if the business has a policy covering premises and operations with a limit of $300,000, with an umbrella policy of $1 million, the business would have a total limit of coverage for premises and operation of $1.3 million. To get an umbrella policy, the insured must first cover all the basic exposures to limits, as prescribed by the insurer. The following is an example of such required limits of underlying coverage:

Premises and operations:	$300,000
Products liability:	$300,000
Business autos:	$300,000
Worker's Compensation:	Mandatory limits

The insurer using the umbrella may also require the purchase of a comprehensive general liability form or a broad form liability coverage. Additionally, many insurers will not issue an umbrella over any company other than themselves.

When an otherwise uninsured claim is covered by an umbrella policy, a large deductible (self-insured retention) must be paid by the insured. Typical is a self-insured retention of $10,000 or $25,000.

Although there are various ways that umbrella coverage may be priced by insurers, a common method is to charge a percentage of the total premiums of the underlying liability coverages. Percentages may range from 25% to 50%.

CASE STUDY

Here is how to determine whether any liability coverages are missing from the ABC Manufacturing Corp.'s portfolio (see case study information on pages 2 and 3). First, the CPA would review the Loss Exposures (Legal) and compare them with the coverages carried.

Management should be informed about the gaps in coverage described below.

Gap #1 — Exposure not insurable anywhere at any cost.
Response: a. Avoid exposure; or b. Retain the risk.

Gap #2 — Exposure insurable, but client cannot afford the coverage.
Response: a. Avoid the exposure; or b. Retain the risk.

Gap #3 — Exposure insurable, insurance was overlooked.
Response: a. Obtain quote(s) for coverage needed; or b. Have coverage bound by agent or company.

Gap #4 — Coverage was previously considered, but management decided against coverage. Response: Check to see if premiums' basis was correct (Payroll, Receipts, etc.) and ask for a requote.

For each example of loss exposure listed below, the following liability insurance could be recommended:

Loss Exposure	*Liability Coverage*
1. Premises Factory, Parking Area, Offices	1. Premises and Operations
2. Sale of Products	2. Products Liability
3. Repair and Modification of Other's Products	3. Completed Operations Coverage
4. Assumption of Liability from Major Computer Manufacturer	4. Products Liability
5. Vehicles	5. Business Auto Liability Coverage
6. Engineers and Consultants	6. Professional Liability
7. Use of Independent Contractors	7. Owners' and Contractors' Protective Liability Coverage
8. Substantial Assets	8. Umbrella Liability Coverage

These are some of the questions the CPA should ask of management:

- Have any of the missing coverages been priced recently?
- Have competitive quotes been sought from more than one company?
- Are the payrolls and receipts that are used to calculate the premiums accurate?
- Is the overall limit of liability coverage adequate enough to:
  - Protect the owner's and firm's assets?
  - Meet any contracts with customers, landlords, etc.?

CHAPTER 10

BUSINESS AUTO POLICY

OBJECTIVES

After completing this chapter, you will be able to:

- Analyze a business auto policy for adequacy and appropriateness of coverage.
- Provide advice regarding the business auto policy.

Business insurance coverage has many facets, and another type of policy you'll find in your client's "shoebox" is the automobile policy. This policy covers vehicles used by the company or its employees in the course of business. This chapter will provide you with the knowledge to make sure your clients are sufficiently covered, and that the coverage takes into consideration all the vehicles used in the day-to-day running of the business.

THE STRUCTURE OF THE BUSINESS AUTO POLICY

The following is the basic structure of the business auto policy:

- *Liability*
  - — Bodily injury and property damage combined single limit
- *Medical Payments Insurance*
  - — Single limit
- *Personal Injury Protection (No-Fault) Coverage*
  - — Limit per person/per accident
- *Uninsured Motorist and Underinsured Motorist Protection*
  - — Bodily injury limit for uninsured motorist protection
  - — Bodily injury limit for underinsured motorist protection
- *Physical Damage Coverage*
  - — Fire, theft, vandalism, explosion, windstorm, hail, earthquake, flood, and sinking, burning, collision, or derailment of any conveyance transporting the vehicle
  - — All-risk coverage excluding collision and upset
  - — Collision and upset

- *Miscellaneous Optional Coverages*
  - Towing and labor coverage
  - Rental reimbursement coverage

LIABILITY INSURANCE

Liability insurance in this policy covers accidents for which the insured is legally liable arising out of the ownership, maintenance, or use of a covered vehicle. The client can determine which vehicles are to be covered under the policy by electing one or more of the options listed below when purchasing the policy. If the client has not made the choice himself when purchasing the policy, the options should be reviewed with the overall insurance review and corrections or changes made.

The options are:

- Any automobile. (This option covers autos owned, leased, hired, rented or borrowed, and autos owned by employees or members of their households when the auto is used in the named insured's business or personal affairs.);
- Owned autos only;
- Owned private passenger autos;
- Owned autos other than private passenger autos;
- Owned autos that are specifically described on the policy;
- Autos that are leased, hired, rented or borrowed, except autos leased, hired, rented or borrowed from any employee or any member of an employee's household; or
- Autos owned by employees or members of their households, but only when the auto is used in the named insured's business or personal affairs.

Liability Exclusions

The business auto policy does *not* cover:

- Liability assumed under contract;
- Bodily injury, disease, or death of an employee subject to workers' compensation laws;
- Damage to property owned or transported by the insured or in the insured's care, custody, or control;
- Bodily injury or property damage resulting from the loading of property before it has been put in or on the covered auto or from the unloading of property after it has been taken off or out of the covered auto;
- Bodily injury or property damage caused by the dumping, discharge, or escape of irritants, pollutants, or contaminants, unless the dumping, discharge, or escape is sudden and accidental; and

- Liability for which the auto is otherwise covered under any nuclear energy liability policy.

NO-FAULT COVERAGE

When a state passes a no-fault law, it requires that the insurers in that state provide coverage for injuries arising from auto accidents regardless of negligence. Coupled with this is often a modification of tort liability requiring that in order for an injured person to sue the one responsible for the accident, one of the following must occur:

- Medical expenses must exceed some prescribed amount (often $500);
- There must be an injury that caused death or dismemberment;
- There must be an injury that caused permanent and serious disfigurement, loss of sight or hearing; or
- There must be an injury that caused a fracture.

Who Is Covered

No-fault insurance covers:

- The named insured and resident relatives anywhere in the continental U.S.;
- Any passenger in the covered auto within the state, unless extended by endorsement to the business auto policy;
- Pedestrians struck by the insured auto; and
- Bicyclists struck by the insured auto.

Medical Expenses

Medical expense coverage often includes:

- Medical, hospital, surgical, nursing, dental, ambulance, x-ray, prescription drug, and prosthetic services;
- Psychiatric, physical, and occupational therapy and rehabilitation;
- Any nonmedical remedial care and treatment rendered in accordance with a religious method of healing recognized by the laws of the state; and
- Any other professional health services.

Work Loss

The coverage often allows benefits for lost wages resulting from injuries covered under the policy. The coverage usually allows a percentage (80% in many states) of the gross average weekly wage up to a maximum monthly benefit.

Other Expenses

In addition to medical and work loss benefits, the no-fault coverage usually allows benefits for other expenses, including travel to and from the doctor, as well as domestic assistance and care.

COMPREHENSIVE COVERAGE

Exclusions

Exclusions (in addition to collision or upset) are:

1. Wear and tear, freezing, mechanical or electrical breakdown, or failure or road damage to tires (except vandalism or theft);
2. Loss to custom furnishings or equipment on trucks or vans;
3. Loss caused by war, radioactive contamination, or nuclear weapons;
4. Camper bodies or trailers (unless specifically declared on the policy);
5. Loss to CB radios, two-way radios, scanning receivers, or telephone equipment unless declared on the policy; and
6. Loss to equipment for the reproduction of sound (including tapes and records).

Exclusions 5 and 6 do not apply if the items are permanently installed in the covered auto.

COLLISION

Deductibles

The example below details a typical collision insurance scenario.

EXAMPLE 10-1

The vehicle insured is a 1996 Audi. Its comprehensive coverage has a $100 deductible and full coverage glass.

Collision insurance is usually purchased with a larger deductible, such as $200 or $250.

A safe source of premium savings is found in the selection of deductibles for physical damage coverages. Often, increasing the deductible on comprehensive coverage from $50 to $250 (an affordable level of risk assumption) can save 50% on the premium for that coverage. Increasing the deductible on collision coverage from $200 to $500 may result in a savings of 15%-20% on that coverage.

Miscellaneous Optional Coverage

Other options that can be added to the business auto policy are towing and labor and rental reimbursement coverage.

Towing and Labor. Towing and labor coverage allows an amount of coverage to pay the expenses incurred by the necessity of calling a tow vehicle for road assistance. This coverage pays actual tow bills and labor charges even if the vehicle is not actually towed (tow truck provides a "jump-start" and leaves).

The limit of coverage available is $25–$50 per disablement. This coverage does not pay for the cost of parts such as new batteries or belts.

Rental Reimbursement Coverage. Comprehensive coverage automatically includes rental reimbursement coverage only if the vehicle is stolen. If stolen, comprehensive coverage allows, after a 48-hour waiting period, $10 per day up to 30 days.

As an additional option, the insured may purchase rental reimbursement coverage. This coverage pays rental charges when the vehicle is disabled as a result of any accident covered under the physical damage portion of the policy. Limits of coverage are typically $15 per day up to 30 days. This coverage does not pay insurance costs, fuel, or mileage.

REVIEW OF AUTO POLICY

When a client's business has several vehicles, the business auto policy should be reviewed at least every three months to check for correctness of:

- Limits of coverage on each vehicle;
- The schedule of covered vehicles (firms with many vehicles tend to change them periodically;
- Physical damage coverages. Be sure that vehicles of high value and vehicles that are financed carry the correct physical damage coverages. Often, an insured replaces an old vehicle that had no collision or comprehensive coverages with a new vehicle that requires those coverages. If a simple change of vehicle endorsement is issued by the insurer, the new vehicle will not have the coverage needed; and
- Deductibles. All deductibles should be reviewed for cost effectiveness. If 10 vehicles are insured for collision with a $200 deductible and it costs $500 per year more than if they carried a $500 deductible, changes are in order.

CASE STUDY

We'll review the business auto policy enumerated below for accuracy and adequacy of coverage.

Coverage	1996 Audi	1994 Chevy Van	1986 Ford Pick-Up
Liability	$1,000,000 each accident	$1,000,000 each accident	$1,000,000 each accident
No-Fault	$150,000 per person/per accident	$150,000 per person/per accident	$150,000 per person/per accident
Uninsured Motorist	$500,000	$500,000	$500,000
Underinsured Motorist	$500,000	$500,000	$500,000
Medical Payments	$10,000	$10,000	$10,000
Collision	$500 Deductible	$500 Deductible	No Coverage
Comprehensive	$200 Deductible, full coverage - glass	$200 Deductible, full coverage - glass	$200 Deductible, full coverage - glass
Towing	$50 per disablement	$50 per disablement	$50 per disablement
Rental Reimbursement	$25 per day	$25 per day	$25 per day

For each step noted below, here are the substeps the accountant must remember to perform.

STEPS IN THE REVIEW OF A BUSINESS AUTO POLICY

1. **Review the policy for accuracy:**

   Verify that:

   - Correct vehicles are shown on the policy;
   - Serial numbers are correct;
   - Values of vehicles are up-to-date (or cost new); and
   - Additional loss payees are correctly noted (banks financing vehicles or leasing companies, etc.).

2. **Review the policy for adequacy of coverage:**

   Verify that:

   - Limits of liability are adequate;
   - No-fault benefits are included;
   - Uninsured and underinsured motorist coverages are adequate; and
   - Collision and comprehensive coverages are adequate.

Liability. Coverage is set for $1,000,000. This is the maximum available on an auto policy from the majority of insurance companies. If this limit is not adequate enough to protect the assets of the client, the addition of an umbrella liability policy will be required.

Note: In most cases, the cost to increase auto liability from a lower limit such as $500,000 to $1,000,000 is just a few dollars per vehicle.

No-Fault. Coverage is set at $150,000 per person/per accident. No-fault limits required as minimums will vary by state. Some states require higher limits as minimum (including some states that require unlimited no-fault benefits).

In states with lower-limit requirements (such as $50,000 per person/per accident), higher limits should be considered and priced.

Other factors to consider include:

- Workers' compensation benefits will insure covered employees operating the employer's vehicles in the course of their operation;
- Some states limit out-of-state coverage for no-fault benefits to the named insured and may exclude guest occupants of the vehicle; and
- Additional coverage should be added as needed.

Uninsured and Underinsured Motorists Coverage. Coverage is $500,000 each. Statistics show that those drivers most likely to inflict damages upon others are also most likely to either be uninsured or to carry minimum limits of liability insurance.

Adequate limits of these coverages should always be covered. A good rule to follow is:

- Carry the maximum limit allowed by the insurance company; or
- Carry limits equal to the liability coverage carried on the policy.

Medical Payments Coverage. Coverage is $10,000. Although replaced in importance by no-fault coverages, medical payments coverages should be carried as a supplement to no-fault coverage.

Since the price for medical payments coverage is usually as low as $2.00 per vehicle for $5,000 of coverage and $4.00 per vehicle for $10,000 of coverage, this is a good buy.

Collision Coverage. Coverage is $500 deductible and no coverage for the pick up. First of all, consider the value of the vehicle:

- The 1986 Ford Pick Up — low in value.
- 1996 Audi and 1994 Chevy Van — certain coverage may be required by the bank financing the purchase and/or by the leasing company.

Next, consider the amount of the deductible. The lower the deductible, the higher the cost of coverage. Although discounts vary from state to state and company to company, some standard discounts are shown below.

COLLISION COVERAGE

Standard Deductible = $200

Deductible	Discount
$ 500	15%
1,000	25%
2,500	30%
5,000	40%

Comprehensive Coverage. Coverage is $200 per vehicle. Give the same consideration to the purchase of collision insurance as to the purchase of comprehensive coverage.

Since comprehensive coverage is much less expensive than collision coverage, it may be elected even if collision coverage is not.

Towing/Rental Reimbursement. Coverage is $50 for *towing* and $25 for *rental*. These will not in any way affect the solvency of the business. They are nice additions and offer convenience.

Costs for these additions are minor — towing coverage usually costs $4.00 per vehicle; rental reimbursement usually costs $5.00 per vehicle.

The following are some of the questions the CPA should ask of the insurer:

- What savings can be realized by using larger deductibles?
- Have all discounts been secured (including experience discounts)?

CHAPTER 11

PACKAGE POLICIES

OBJECTIVES

- Analyze a package for adequacy and appropriateness of coverage.
- Provide advice regarding package policies.

A typical approach to business insurance is to purchase a package policy that combines several coverages with the exception of workers' compensation, disability benefits law coverages and business auto coverages. (Some insurers include auto coverage.) This chapter will show you the benefits of this kind of insurance, as well as enable you to provide clients with advice as to the adequacy of a particular package for their needs.

The benefits include streamlining and, usually, a discount.

Fulfilling a client's insurance needs will usually be accomplished by the use of some form of multi-peril package policy. The more complex the business, the more complex the package policy must be.

BUSINESSOWNERS' POLICY

The basic businessowners' policy covers building and contents on a named perils basis. Coverage for burglary and robbery have to be added for an additional premium. Perils insured are: fire and lightning, extended coverage perils, vandalism and malicious mischief, and sprinkler leakage. The businessowners' policy is similar to the special multiperil policy in format. Businessowners' policies have the following special features:

- Building and Contents coverages are *for replacement* cost;
- There is *no coinsurance* on the policy;
- Building coverage automatically increases 2% each quarter to protect against the effects of inflation;
- *Business interruption* (loss of earnings) and *extra expense coverages* are included automatically;

  There is no dollar limit to this coverage, and there is no coinsurance applicable. The insured may collect up to 12 months of actual losses so long as the insured exercises due diligence and dispatch in rebuilding or repairing.
- Property off premises and in transit is covered for $1,000 or $2,000.

- *Liability coverage* is automatically included for a minimum limit of $300,000 and includes coverage for:
  - Premises and operations
  - Personal injury
  - Owners' and contractors' protective liability
  - Contractual liability
  - Host liquor legal liability
  - Advertising liability
  - Fire legal liability
  - Care, custody, and control coverage for property damage
  - Products liability
  - Completed operations liability.

The policy is written as either a *basic form* or *special form*. Different insurers will use different terms such as "Deluxe" or "Supreme" or "Excel" and so forth to define them. Premium calculation is based on whether the insurance is "basic" or "special," and on other factors.

PACKAGE POLICIES

BUSINESS OWNERS' POLICY

Liability

Replacement Cost

Business Interruption and Extra Expense

SPECIAL BUSINESSOWNERS'		BASIC BUSINESSOWNERS'
"All Risks"		Fire and Lightning
		Extended Coverage
		Vandalism
		Sprinkler Leakage

SPECIAL MULTIPERIL

MANUFACTURERS	BASIC
OUTPUT	Premises and Operations
	Extended Coverage
	Fire

Not Combined:

1. Directors' and Officers' Liability
2. Workers' Compensation
3. Disability Benefits
4. Professional Liability
5. Business Auto

RATING PROCEDURE

The following is an example of the rating procedure used to calculate the premium for an apartment house:

Data

Form selected:	Special
Construction:	Masonry
Fire protection class:	4 (within 500 feet of a fire hydrant, within 3 miles of a full-time fire station)
Type of business:	Apartments with no mercantile occupancy
Amount of coverage:	$1,000,000 on building
Insurer's rate from manual:	$4.50/$1,000
Premium:	$4,500
Discount allowed by insurer:	15%
Final premium:	$3,825 annually

This premium will include all the coverages listed on page 110.

CHAPTER 12

LIFE INSURANCE

OBJECTIVES

After completing this chapter, you will be able to:

- Analyze life insurance for adequacy and appropriateness of coverage.
- Provide advice regarding life insurance.

Life insurance is a very important aspect of business. It provides for business continuation through key person coverage, and the use of life insurance as a funding vehicle in a buy-sell agreement. This chapter will enable you to make sure your clients have the correct kind of coverage to protect their business.

YEARLY RENEWABLE TERM INSURANCE (NATURAL PREMIUM PLAN)

The yearly renewable term insurance policy renews each year at a higher premium reflecting an older age and higher rate of mortality for that age group. Renewal is allowed up to age 70 by most insurers.

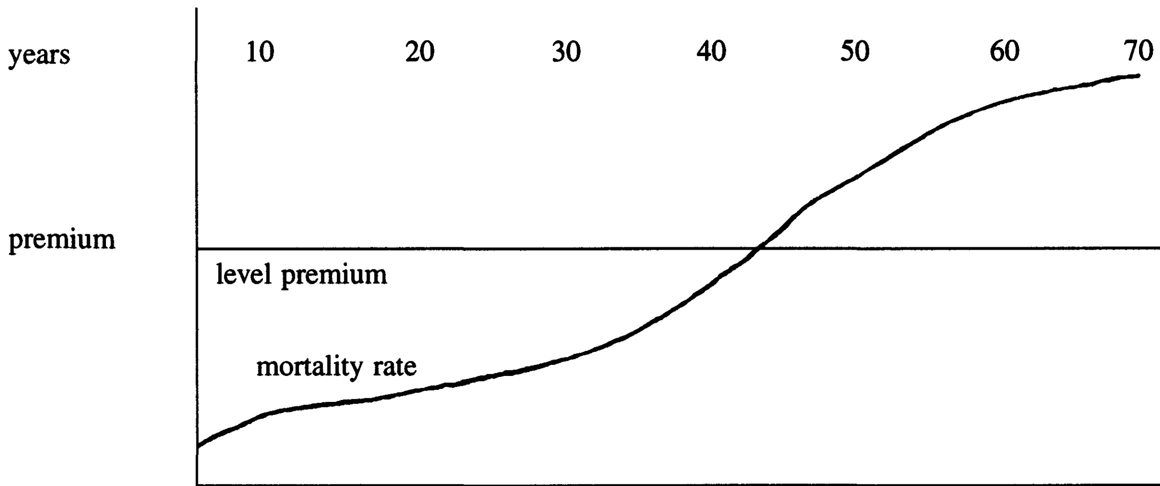
EXAMPLE 12–1

For a male, age 20, the death rate for a group of 100,000 males is 179 and the corresponding rate per $1,000 of life insurance is $1.79. The insurance company then loads expense factors on top of this rate to cover processing, commissions, and profit.

A final rate per $1,000 of life insurance for a male, age 20, would be approximately $2.14. An annual premium for a yearly renewable term policy would be, for example, $214 for $100,000 of coverage for the first year. As the insured's age increases and the death rate goes up, the premium for each year of coverage would increase accordingly.

LEVEL PREMIUM TERM INSURANCE

Level premium term insurance charges higher premiums than are dictated by the mortality table during the early years to maintain artificially lower premiums in later years of the policy.

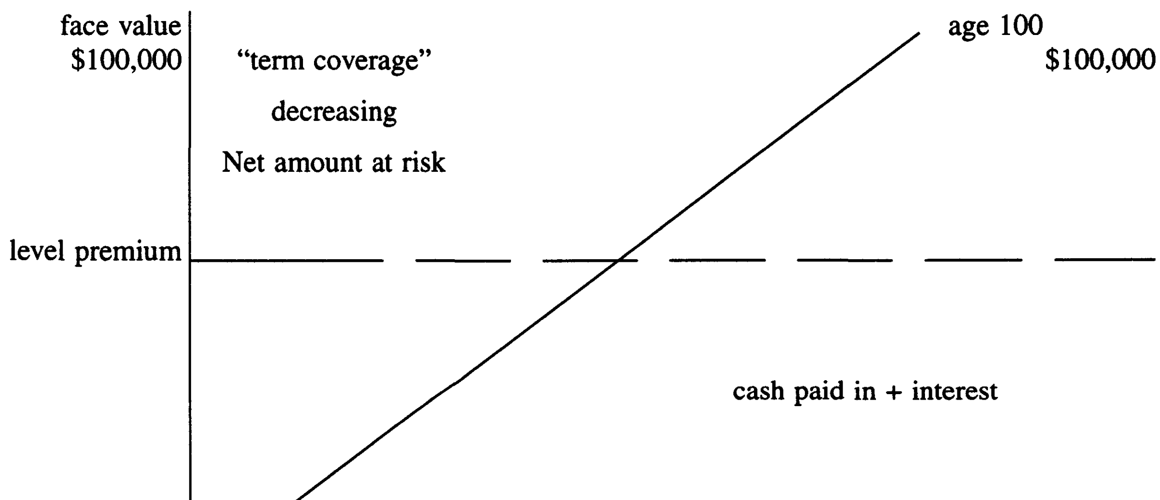


WHOLE LIFE INSURANCE

Whole life provides life insurance coverage until death, or until age 100. At age 100, the total amount of cash reserve built up in the policy, plus interest and accumulated dividends, will equal the face amount of the policy. Premiums paid in the early years of the policy exceed the actual cost of life insurance coverage. Early premiums, coupled with interest, equal the exact amount needed to make up for the deficit in premiums in later years. A portion of premiums is used to cover the insured with term coverage, and part is put into a cash reserve. As the cash reserve builds, the term coverage decreases, until the cash plus interest equal the face amount of the policy.

You can borrow against a whole life policy, after a certain amount of time has passed.

WHOLE LIFE INSURANCE

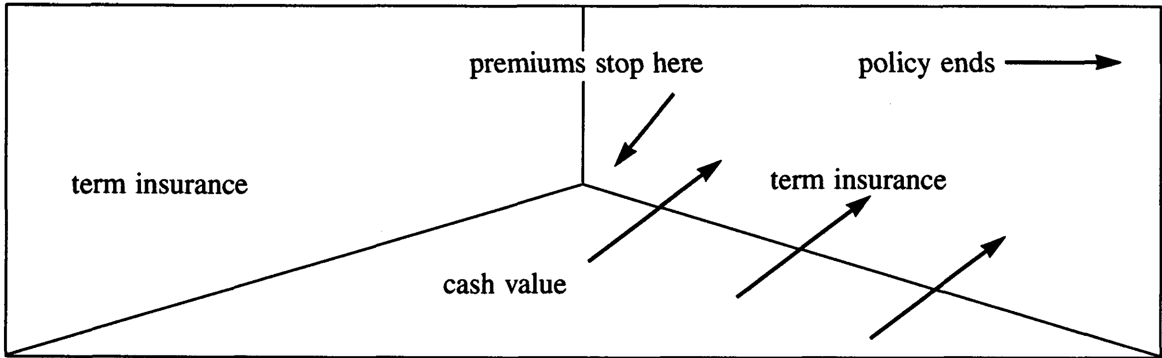


LIMITED PAY PLAN LIFE INSURANCE

The limited pay plan policies offered by insurers is a special combination of "whole life" and "term" products.

Limited Pay Plans

Face amount



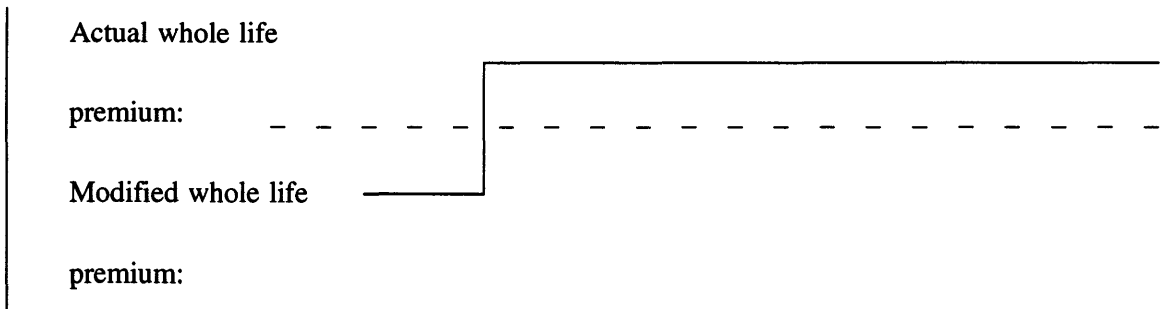
MODIFIED LIFE POLICIES

The two types of modified life policies are:

1. Modified Life, and
2. Graded Premium Life.

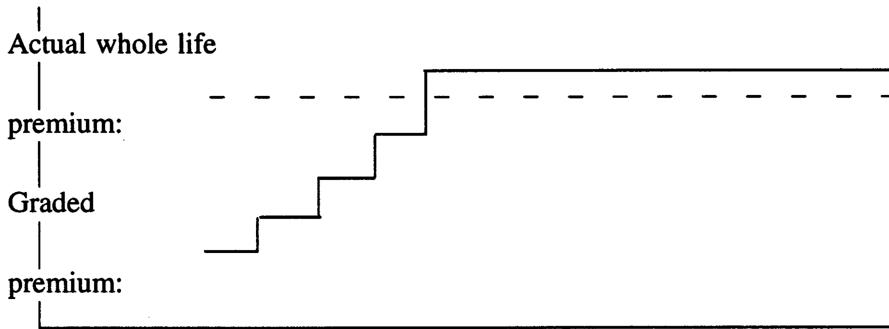
Modified Life. In modified life products, the premium is lower than normal for the first five years and then higher for the remainder of the policy term to make up the deficit in premium.

Modified Life Policy



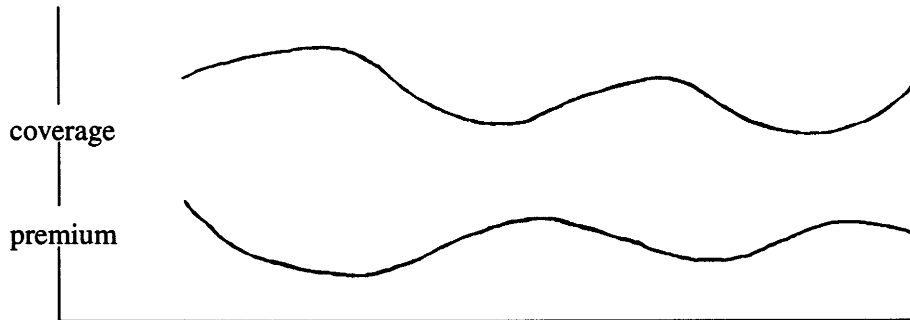
Graded Premium Life. A graded premium life policy allows premiums to increase each year for the first five years and then remain constant for the remainder of the policy period at a higher than normal level to make up for the deficit in the early years.

Graded Premium Policy



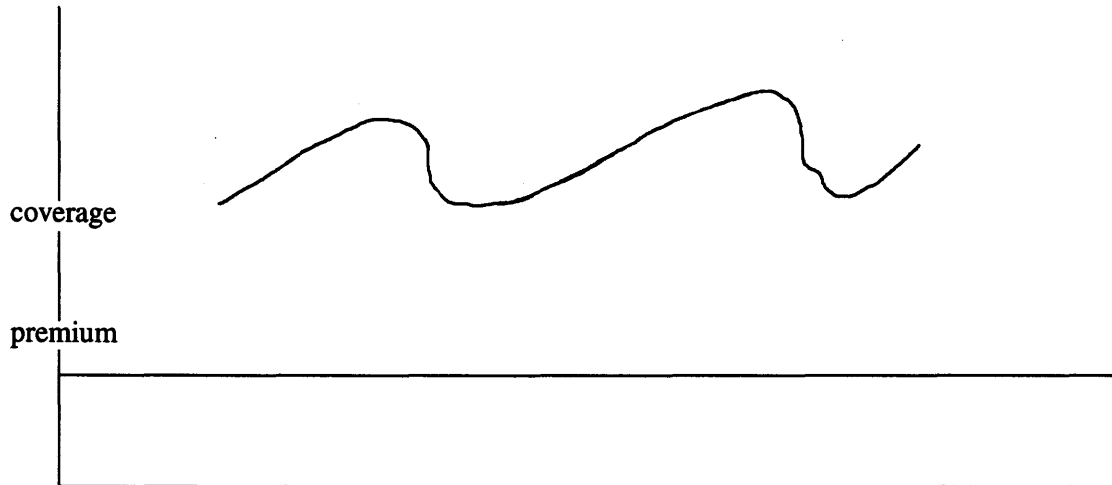
VARIABLE PREMIUM PLAN (DUTCH DESIGN)

In the variable premium system, as the dividends are produced, the premiums reduce and the face increases simultaneously. The larger the dividend, the greater the effect on premiums and coverage.



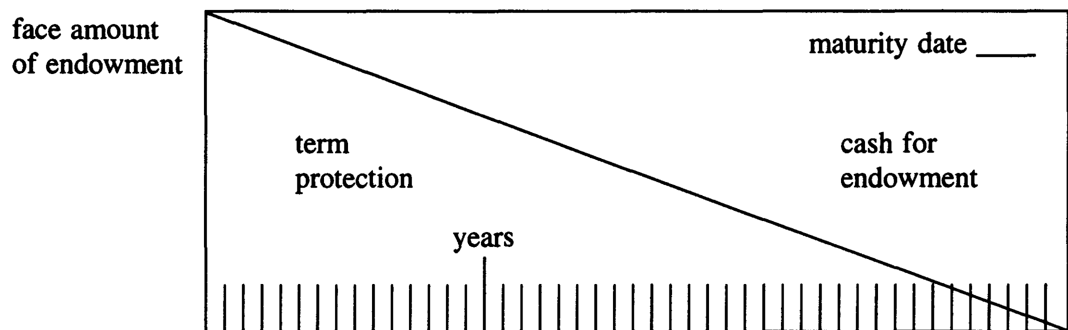
FIXED PREMIUM PLAN

In the fixed premium system, the premium is not affected by dividends, but the coverage amount is. Therefore, the fluctuation in coverage is more dynamic than in the "Dutch Design" system.



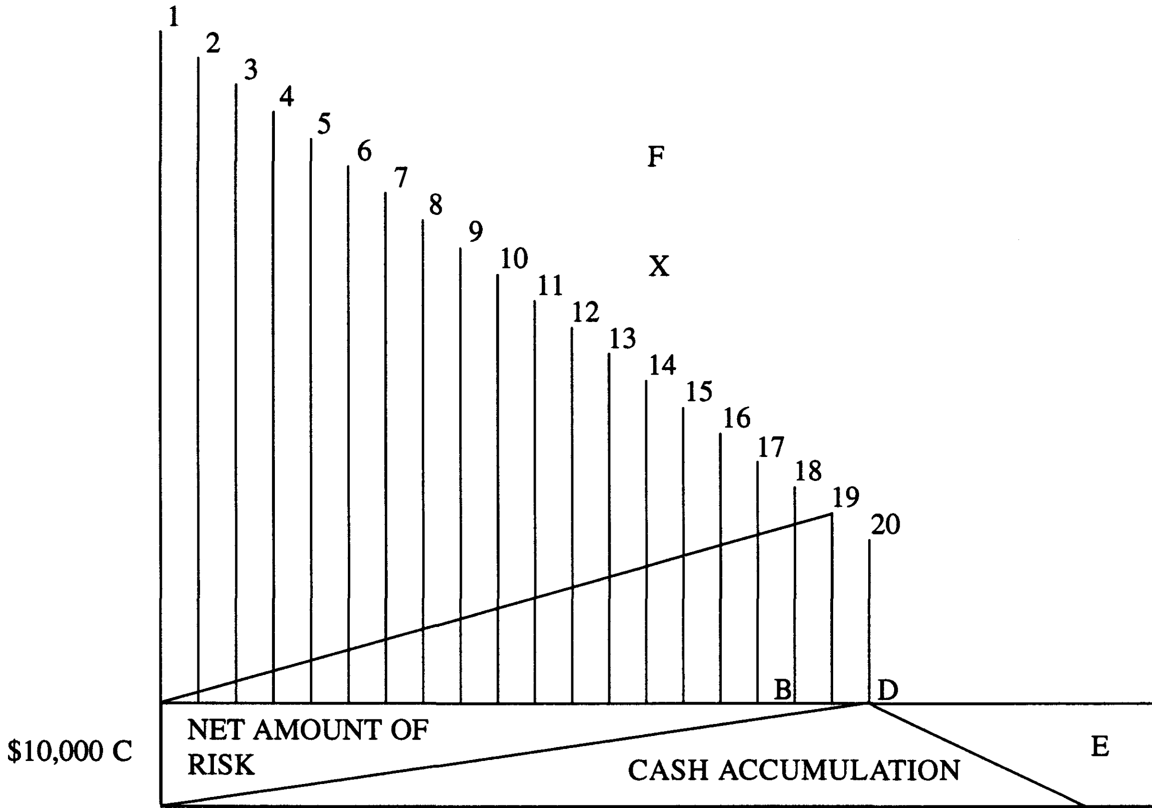
ECONOMICAL CONCEPT OF ENDOWMENTS

The economical concept of endowments creates a combination of endowment and decreasing term insurance:



FAMILY INCOME POLICY

Here is an illustration of how the family income policy works.



A = amount needed to pay the family income in case of the death of the principal.

B = interest accumulation reducing the amount of term insurance needed.

C = face amount of the policy and death benefit.

D = year 20, policy paid in full — premiums stop.

E = paid up permanent life protection on life of principal.

F = if insured dies at year X, family receives income payments for 20-X years.

BUY-SELL AGREEMENT: LIFE INSURANCE AS FUNDING VEHICLE

Here is an illustration showing how a buy-sell agreement funded with life insurance would work.

Business Value $1,000,000

Partner A	***Partner B***
50% Owner	50% Owner
$ 500,000	$ 500,000
Partner A buys Life Policy of $500,000 on life of *B*. *A* is beneficiary.	Partner B buys Life Policy of $500,000 on life of *A*. *B* is beneficiary.

Result:

- If *Partner B* dies, policy pays $500,000 to *Partner A*.
- Buy-sell agreement obligates *A* to use the money to buy *B*'s interest in the business from the heirs.
- Heirs receive $500,000 from *A*.
- *A* now owns 100% of the business.

APPENDIX A

RISK DEFINITIONS & THE NEW YORK STATE LAW REGARDING INSURABLE INTEREST

Hazard	A condition that creates or increases risk.
Insurable Interest	An interest of the insured in the insured property such that any damage or destruction of the property would have a direct negative financial impact on the insured.
Insurance	A social device whereby a large group of individuals, through a system of equitable contributions, may reduce or eliminate certain quantitatively measurable risks of economic loss common to all members of the group.
Moral Hazard	The hazard arising from dishonesty of individuals.
Morale Hazard	A condition of general disregard for one's own environment.
Peril	The actual negative occurrence to be insured against.
Physical Hazard	Any condition of the environment that creates or increases risk.
Pure Risk	The chance of loss with no possibility of gain.
Risk	The chance of loss or the probability of any outcome different from the one expected.
Risk Management	The practice of the insurance industry in an attempt to measure and reserve for future losses.
Speculative Risk	A risk that may result in a loss or a gain as in gambling or business.

Insurable Interest Law from New York State

No contract or policy of insurance on property made or issued in this state, or made or issued upon any property in this state, shall be enforceable except for the benefit of some person having an insurable interest in the property insured. The term "insurable interest," as used in this section, shall be deemed to include any lawful and substantial economic interest in the safety or preservation of property from loss, destruction or pecuniary damage.

APPENDIX B

PREMIUM COLLECTION PROCEDURES

INTRODUCTION

This section provides insight into premium collection procedures.

AGENCY BILL

By far, the most common situation in business insurance is agency bill. This means that the policy is purchased, the contract issued, and the client billed by his or her agent. Although the client may not differentiate between the agent and the insurance company, the agent functions as a "retailer" and the insurance company as a "wholesaler."

Once the policy is issued, the agent is billed on a net basis for the policy premium. That is, the agent must pay the insurance company less the commission due based on the contract with the insurance company. For example:

Policy premium	= $10,000
Agent's commission	= 15%
Agent must pay	$8,500

With the collection of the full premium of $10,000, the agent has received his earned commission of 15%.

The insurance company allows 30–45 days on the average for net payment regardless of whether or not the agent has collected the gross amount from the client. Unless other arrangements have been made, the client must pay the premium in full at inception or within 30 days of inception or renewal of the policy.

As the policy period progresses, the insurance company earns the premium by the day. If a policy is in force for 60 days, for instance, the insurance company is entitled to 2/12 of the annual premium and so on.

RENEWAL PREMIUMS

It has been deemed that regarding policy renewals, silence by the insured is acceptance of the contract. If a client receives a renewal policy and does not return it for cancellation, the insurer begins to accrue earned premiums from the renewal date. If the policy is not paid, the insurer will cancel for nonpayment of premium and charge a premium based on the number of days the policy was in force from the renewal date.

When an insurer cancels a policy for any reason, the policy is cancelled pro rata. This means that the insurer is entitled only to the exact pro rated amount of premium for the time the policy was in force. If the client cancels the policy, the earned premium will be calculated on a short-rate basis. In effect, this allows the insurer to charge a penalty of 10% of the unearned premium (refund or credit expected). Pro-rata and short-rate procedures are governed by statute law.

DIRECT BILL

Current trends are toward a direct bill by insurer system. In this system, the client is billed directly by the insurance company. The agent receives copies of the bills sent to the client, but is not responsible for billing or collecting premiums. Pro-rata and short-rate rules apply to direct billed policies as well.

PAYMENT OF AUDITS

When there is an additional premium due as a result of an audit, the premium is considered fully earned by the insurer as it was for the year past. Audit premiums are due immediately or within 30 days of billing at the latest. Audit premiums should reflect the payroll or receipts figures supplied by the insured to the insurance company for the expired policy period. As the premiums are due quickly, any review of the figures must be done immediately upon receipt of the audit. If the client will request a review of the audit by the CPA, the client should be instructed to notify the CPA as soon as possible of the receipt of an audit.

Audits may be expected for the following types of insurance:

- Premises and operations liability;
- Owners' and contractors' protective liability;
- Products liability;
- Completed operations insurance;
- Liquor legal liability insurance;
- Workers' compensation insurance;
- Disability benefits law coverage;
- Reporting form property coverages; and
- Marina operators' legal liability coverages.

www.aicpa.org

090448