Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

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Is Your Property Adequately Insured?

By Jeffrey W. Cavignac, CPCU, RPLU, CWCA

Many people don't pay attention to property values until they have a claim, and then they can only hope that their limits are adequate. Unfortunately, in many situations, such as the wildfires that ravaged San Diego County in 2003, people found that they were inadequately insured. As a matter of fact, in general, people tend to underinsure.

Spending a little extra time making certain your property is adequately insured is worth the investment. The process will require forethought, research, and even some educated guesswork, but the result will be a more or less adequate property valuation.

How is property valued?

On most direct damage property forms, coverage is either valued on a "replacement cost" basis or an "actual cash value basis." **Replacement cost** is defined as the cost to replace the property, new today, with materials of like kind and quality. **Actual cash value** is the replacement cost less actual physical depreciation (not accelerated accounting depreciation). In some cases, actual cash value might also make a deduction for economic obsolescence, as well as actual physical depreciation.

The only difference between replacement cost and actual cash value is depreciation. If your property is brand new, and has not had any depreciation, there is no difference between the two methods.

You should also be aware that accounting or book value has no relevance to either method of valuation, and that the choice of valuation does not affect the rate. The only difference in cost between replacement and actual cash value is the cost of insuring the higher replacement cost values.

The limit of coverage you select serves as the maximum on the amount to be paid in the event of a loss. In general, the insurance company has the option of repairing or replacing your property, subject to the limit of coverage for that property.

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Building coverage

Selecting an appropriate limit of coverage for your building is relatively straightforward. It is basically the cost to rebuild a similar structure to the one that is being insured. "Building" is defined in the policy but basically means the building or structure, as well as completed additions, fixtures, including outdoor furniture, permanently installed machinery and equipment, and personal property that are used to maintain or service the building.

If not covered by other insurance, coverage is also extended to **additions under construction**, as well as **alterations and repairs** to the building, and **materials, equipment, supplies, and temporary structures** within one hundred feet of the described premise, which are being used for making additions, alterations, or repairs to the building or structure.

You should also be aware that under the standard "Insurance Services Office" (ISO) Commercial Property Form (CP 00 10) building foundations are specifically excluded, as is land. Other things, such as paved surfaces, retaining walls, underground pipes, flues or drains, are also specifically excluded (these can usually be added back by endorsement).

There are a number of ways to accurately determine the **replacement cost value** of a structure. These include professional appraisals, original cost figures that are appropriately indexed as well as square footage multipliers.

If you are a landlord, you must also address the issue of **tenant improvements**, regardless of whether you or the tenant paid for them. Either way, these are considered part of the building. Ideally, the landlord should insure them, but the lease will spell out who is responsible.

If you own the building, are not contractually obligated to insure the tenant improvements, and don't want to insure them, then tenant improvements should be specifically excluded from the definition of building. This can help avoid a coinsurance penalty if it is determined after a loss that you were underinsured. In general, we recommend that the landlord insure the tenant improvements, regardless of who is responsible contractually.

Business Personal Property – Business personal property includes things such as furniture, fixtures, machinery, equipment, stock, and leased personal property that you have a contractual responsibility to insure (in general, when you lease a copier, computers, or similar equipment, you are responsible for providing insurance).

Coverage also extends to any other personal property owned by you and used in your business. Coverage is provided for labor, materials, or services that are furnished or arranged by you on personal property of others, and finally, it extends to your "use interest" as a tenant in your "improvements and betterments."

The standard ISO Commercial Property Form covers this type of property, whether it is within a covered location or one hundred feet of that location. It also provides coverage to personal property of others that is in your care, custody, or control.

A long list of items specifically are not covered. The list includes, but is not limited to money, animals, automobiles, electronic data, the cost to restore or replace valuable documents, and property that is covered under another coverage form, in which it is more specifically described.

The Sample Business Personal Property Calculation below shows the replacement cost calculation of a thirty-six-person office with relatively nice furnishings. As you can see, the sub-total ($600,000) was multiplied by 1.20% to take into consideration other uncapitalized items as well as supplies and other miscellaneous personal property. The total limit of $720,000 equates to about $20,000 per person.

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Sample

Business Personal Property Calculation

Based on firm with 36 employees and 10,000 square feet of office space

Description of Property	Valuation
Furniture and Fixtures	$280,000
Computer Hardware	180,000
Tenant Improvements	100,000
Equipment under Lease	40,000
Sub-Total	**$600,000**
Miscellaneous Property Factor (1.20)	120,000
Total Property Value	***$720,000***

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As a rule of thumb, business personal property for an office environment should be approximately $15,000-$25,000 per employee, including computer hardware.

Computer Hardware – Setting realistic values on your computer hardware is relatively straightforward. What would it cost to replace your entire network today taking into consideration the cost of installation (computer installers and consultants can be expensive), cabling and all the peripheral devices (scanners, printers, plotters) that hook into your network?

Tenant Improvements – If you own your building, tenant improvements should be included as part of the building coverage. This is because the building rate is typically less than the business personal property rate. As a tenant, improvements and betterments are specifically covered under your business personal property form.

Note, however, that if improvements or betterments are not repaired or replaced, you will only be paid a portion of your original cost, based on how much time is left on your lease.

For example, imagine you spent $100,000 on improvements and betterments, and three years into a five-year lease your premises were destroyed. Assuming you did not choose to replace those improvements, you would collect 40% of their value (two years remain on your lease divided by the total five year term). If you have substantial improvements and betterments, it is recommended that you insure these under a building form and not a business personal property form. This will give you true replacement cost coverage.

Computer Software – Computer software coverage basically indemnifies you for the cost to repair or replace your computer programs, as well as the data stored on those programs if they are damaged or destroyed by a covered peril.

Under most circumstances, you do not own your programs. Rather, you have a license to use them. If the programs themselves are damaged or destroyed, you can usually obtain a replacement program from your computer vendor for a fairly modest cost. Of course, you will need to have evidence that you were a licensed user, which hopefully would not have been destroyed when your computer programs were destroyed.

The real challenge with computer software is your data. Most businesses could not survive without their computer data, which is why risk management is critical. Daily backups ***taken off-site*** are strongly recommended. "On site" backups are better than no backups at all, but if your facility is destroyed, your backups are usually destroyed as well. Subsequent to the September 11th tragedy, many business owners were not allowed access to their premises because their buildings were damaged and deemed unsafe by public authorities. In this case, their "on site" backups were not destroyed, but were worthless nonetheless.

Backups should be tested to make certain that they work. Although you can buy insurance for the cost to replace your data, to whatever extent you can't replace it, you have no coverage. In addition, the heartache of trying to recreate it, even with coverage, is a losing proposition. This is clearly a situation where you are better off managing your risk and not relying on insurance.

Valuable Documents – In the "old days" before computers, "valuable papers" was an important coverage. It basically provided coverage for the cost to reproduce any documents that were damaged or destroyed. While some businesses still have this exposure, the computer has significantly reduced it. If you do have this exposure, you need to consider exactly what would be entailed in reconstructing these documents, and the costs associated with doing it.

Business Interruption Insurance – In the event of direct damage to your premises, you might suffer a business income loss. Business income insurance, known alternatively as business interruption or time element coverage, basically covers you for your reduction in net income, plus your continuing operating expenses, including payroll (you generally have the option of excluding payroll if you would like). It also includes expenses that are incurred to reduce the loss of business income, but only to the extent that the income loss is actually reduced by these expenditures.

This is "income statement" protection, which is designed to put the insured in the same economic position that they would have been had there been no loss. This is also one of the toughest coverages to set appropriate valuations on.

You'll need to determine how long it would take you to get back in business. During this time frame, what would happen to your revenue stream, and what would happen to your expenses? The preferred method to arrive at an appropriate valuation is to complete a business income worksheet. Although this can be quite detailed, it is worth the effort.

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Fortunately, many of our professional services clients (architects, engineers, accountants, attorneys, etc.) have business interruption incorporated into their commercial package policy, written on an "actual loss sustained" basis. There is no limit; coverage is merely restricted to the actual loss incurred during the period of restoration (the period of time that it took to get back into business). For most other businesses, however, it is necessary to complete the appropriate business income worksheet.

Contractors Equipment

Contractors equipment is generally written on an actual cash value basis. In other words, if your five-year-old backhoe is stolen, your insurance company is going to replace it with another five-year-old backhoe. It works essentially like your automobile insurance. The key here is to make certain that your equipment schedule reflects the valuation that you will be compensated on in the event of a loss.

Many people list the cost new of their equipment and never change it. They're charged premium on the cost new, but in the event of a loss, they will receive compensation based on the depreciated value. Because of this, it is necessary to evaluate your equipment schedule each year to make certain it accurately reflects the valuation clause in your policy.

For some types of equipment, we are able to provide replacement cost coverage. This generally pertains to our surveyors and engineers, who have expensive electronic tools that they use to do their work. In this case as well, limits need to be evaluated to make certain they reflect replacement cost.

More about Valuation

Blanket Limits – If you have multiple locations, a blanket limit of coverage should be considered. With blanket coverage, a single limit of liability will apply for all types of property at all locations covered by the policy. If, for example, you had four locations, all with $2 million of business personal property, you could select a blanket limit of $8 million. In the event of a catastrophe at any one location, you would have up to $8 million for that specific location.

Blanket limits can also be helpful in situations where inventory is moved between two or more locations. While the total value at risk might remain relatively constant, there could be significant fluctuations between each location. Note that blanket limits can be specific to one line of coverage (such as building) or might include multiple lines of coverage.

Coinsurance and Agreed Value Provisions – Most property policies are written with a coinsurance clause. A coinsurance clause requires you to insure your property to some specified percentage of its full value (typically 80%, 90%, or 100%). If, at the time of loss, it is determined that the limit purchased is less than the limit required by the coinsurance clause, the loss recovery will be limited to that same percentage of loss as the ratio of the insurance amount carried to the insurance amount required. In other words, you will be penalized for being underinsured.

An agreed value provision voids the coinsurance clause. This usually requires a signed statement of property values, and sometimes, a recent property appraisal. Regardless, an agreed value provision should be considered if available.

Manufacturers Selling Price Endorsement – The Manufacturers Selling Price endorsement values your stock at its selling price. Without this endorsement, your finished stock would be valued at your cost. This is the only way for businesses to insure for the lost profit of finished goods. Note that your business income coverage will pick up the loss of profits on raw materials and work in process, but specifically excludes loss of profit on finished goods.

Functional Replacement Cost – In certain circumstances, it might be in your best interest to use a functional replacement cost endorsement. This amends the valuation provision from replacement cost to a loss adjustment based on "functional" replacement cost. This might be the cost to replace the damaged property with property that performs essentially the same functions, though it might be less expensive than the original. An example would be a brick warehouse, which if it were destroyed, would be replaced with a concrete tilt-up building. The concrete tilt-up structure performs the same function as the brick building, but is much less expensive to replace.

Valued Coverage – Certain types of property, such as fine arts, jewelry, and similar items are often insured on a valued basis. In other words, a value is agreed upon with the insurance company, and if the item is damaged or destroyed, the insurance

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company pays off on the agreed value. Any property that conceivably could create adjustment problems in the event of a total loss should be considered for this coverage.

Setting appropriate property values is not an easy thing to do. However, it is a critical aspect of your risk management program. The question to ask on each line of coverage is: *"In the event of a total loss, how much money would I need to replace what I lost?"* The cost of property insurance is relatively modest compared to some other lines of coverage, but the cost of being underinsured can be huge.

Disclaimer: *This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.*

Medical Provider Networks (MPNs) What Are They?

By Stuart Nakutin, AIC, WCCA, WCCP, CDMC, Director of Claims and Loss Control

An MPN is an entity or group of health care providers set up by your workers compensation insurance company and approved by the Division of Workers Compensation (DWC) Administrative Director to treat workers injured on the job. Each MPN must include a mix of doctors specializing in work-related injuries and doctors with expertise in general areas of medicine. MPNs are required to meet access to care standards for common occupational injuries and work-related illnesses.

The regulations require MPNs to follow all medical treatment guidelines established by the DWC, and must allow employees a choice of provider(s) in the network after their first visit. MPNs also must offer an opportunity for injured employees to get second and third opinions if they disagree with the diagnosis or the treatment offered.

Benefits of MPNs

1. By directing injured employees to an insurance company-approved MPN, medical control shifts from 30 days to the "life of the claim" if employees pre-designate the MPN as their doctor to handle work related injuries (some exceptions can apply).
2. MPNs can possibly save 15-30% in medical costs.
3. MPNs have agreed to comply with Early Return to Work (ERTW) guidelines.
4. Some insurance companies offer a premium discount if you use their approved networks.

The goal is to provide injured workers with quality medical care. A MPN is designed to allow for better management of medical care by ensuring that treatment is appropriate, prompt, and provided by quality practitioners.

We ask our clients to take full advantage of the MPNs their insurance companies provide. The following steps are intended to ensure employees are aware of their rights under the new regulations. Many of these notifications are required by state statute.

What Must You Do to Comply?

- Provide a copy of the MPN Employee Notice letter and list of facilities to your employees
- If you offer health insurance to your employees and you have not previously advised them of their right to "pre-designate" a physician, you must do so by providing the "Physician Pre-designation Form"

What Must You Do after an Injury Occurs?

- In the event of an emergency, direct your injured employee to the nearest medical provider or hospital (emergency situations do not require treatment from a provider in the MPN)
- After the employee is stabilized, he or she should be re-directed into the MPN

If you have any questions, please contact me.