Avoid E&O Pitfalls in Earthquake Coverage

On Aug. 29, 2005, Hurricane Katrina made landfall in the Gulf Coast region of the United States. After the wind abated and the water receded, this natural disaster had displaced thousands of residents and caused approximately $50 to 60 billion in property damage. Unfortunately, many property owners in the area had either inadequate or no insurance coverage at the time. In the aftermath of Katrina, many property owners filed lawsuits against insurance agents and insurers across the Gulf Coast region, alleging that agents failed to offer flood and excess flood coverages. This disturbing trend revealed a new reality: insurance agents face significant E&O exposure in connection with procuring insurance coverage for natural disasters. This risk is clearly present regarding earthquake coverage given that only a small percentage of consumers who need this insurance coverage actually have it. The California Earthquake Authority estimated only 12% of Californians have purchased earthquake insurance despite the relatively recent 1994 earthquake in Northridge that killed 57 people and caused $20 billion in damage. The percentage of homeowners with earthquake coverage is even lower on a nationwide basis, despite the fact that approximately 90% of Americans live in seismically active areas.

While basic homeowners, condo and rental insurance policies do not cover damages caused by an earthquake, earthquake coverage can be purchased as an endorsement or as a separate stand-alone policy. Generally, earthquake insurance pays the policyholder when an earthquake causes damage to the insured property. Geographical areas are typically graded on a scale of one to five for likelihood of quake, which is then reflected in the insurance premium. Some insurers may require a property inspection before agreeing to issue a policy. Many carriers require the property be bolted down to its foundation—a practice required by some building codes from the 1960s.

As a best practice, agents should consider offering earthquake coverage to all property insurance clients. It is important to obtain accurate information about the age, construction type and the specific location of the property. All information provided by the client, including all rejections of coverage, should be fully documented in the agency's file. Remember, if this information is later disputed, any resulting legal action may ultimately be resolved based on how a court and/or jury perceive the agent's credibility against the customer's. In this regard, the agency's file will provide the best weapon in defending a lawsuit.

Many insurers recommend that the minimum level of earthquake insurance coverage purchased should be sufficient to cover the costs of rebuilding the insured building and replacing damaged contents. As such, the amount of coverage should be based upon replacement and reconstruction costs, instead of the market value of the property and contents. At minimum, agents should send a cover letter with each renewal requesting that the client review the limits and notify the agency about any changes required to insure the full replacement cost of the structure(s). Agents who provide valuation assistance to their clients should review the amount of earthquake coverage limit at each renewal for any changes in replacement value and document these reviews in the agency's file. The agent should also send confirming correspondence of these reviews to the client. Such documentation will and has played a major role in the defense of suits brought against agents involving allegations that the earthquake coverage limits selected were inadequate to replace the insured building.

While many clients may not be located in areas prone to an earthquake, some may have suppliers and other business affiliates that are located in higher risk areas, such as California and the Gulf Coast. These customers face a significant secondary risk to their businesses in event that an earthquake interrupts operations in the high-risk areas. Accordingly, these clients may require additional insurance coverages, like business interruption coverage, to address this type of secondary exposure. Evaluate the commercial client's in-state and out-of-state operations and critical business relationships in order to fully evaluate the client's insurance needs. Make sure any business interruption coverage applies to interruptions caused by natural disaster-related disruptions to any of the client's critical suppliers, whether the remote site is owned by the client or merely a vendor. IA

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Expect the Unexpected

Preparing for the unexpected is one aspect of running a business that often gets overlooked. After Katrina, some agencies were left with boxes of unrecoverable documents that were ruined in the flood. The goal of any emergency plan is to assure the business can get back up and running with full access to all critical data and systems as soon as possible. An emergency plan should:

- Protect critical business activities.
- Provide emergency management training for staff.
- Develop an effective emergency management system that provides a backup for paper and electronic records.
- Support and protect staff.
- Have a safe location to conduct business and obtain critical equipment, such as a phone system and computer equipment.
- Assure that customers' and business partners' critical systems can continue.

Once the agency has adopted an emergency plan, review it annually. An agency's plan should be updated as new employees are hired and as changes in your operations occur.

—C.I.