Winter 2006

Viewpoint

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Growing range of motorized toys poses coverage challenge

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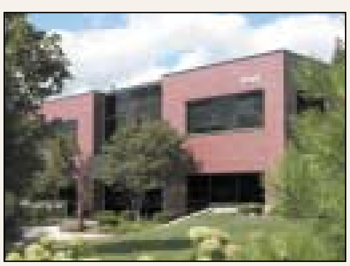

AAIS
1745 S. Naperville Road
Wheaton, IL 60187-8132

Toll free: 800/564-AAIS
E-mail: *info@AAISonline.com*
Web: *www.AAISonline.com*

Cover: *Dirt Bike* Photo by Joe Pasint

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From the editor

Are you too busy to make good decisions? If you are, beware, because bad decisions made in haste will only make matters worse.

Today's breathtaking pace of change means that companies have to make more decisions, more quickly, and amid more complexity, than ever before.

In an age when products and capital are commodities, the quality of strategic choices makes the difference between success and failure. To survive, organizations must subject their decision-making processes to the same rigorous scrutiny they devote to their production processes.

Managers must be courageous enough to look critically at themselves and identify common but unacknowledged biases and flaws in the way decisions are made.

This year's ***AAIS Annual Conference, April 9-11*** *at The Ritz-Carlton in Sarasota, Fla., is devoted to "Executive Leadership: Decision-Making in a Dynamic Environment."*

The cornerstone of our program is a half-day session by Professor J. Edward Russo of Cornell University, who will describe "decision traps" that afflict many organizations and the techniques needed to avoid them and produce "winning decisions." Each registrant will receive a complimentary copy of the book Winning Decisions: How to Get It Right the First Time, *co-authored by Russo.*

The program will be rounded out with sessions addressing key decisions facing insurers, plus a panel of company executives discussing decisions they've made to distinguish their companies.

See pages 16-17 for an overview of the event, then go to www.AAISonline.com *for more information and to register.*

I look forward to seeing you in Sarasota.

Joseph S. Harrington, CPCU

Toys or Vehicles?

Growing range of motorized toys poses coverage challenge

What a difference two miles an hour can make.

Distributors of the popular Pukka Electric Mini Bike advertise its ability to attain a maximum speed of 17 miles per hour (mph).

If the Pukka (pronounced POO-ka) reached only 15 mph, it would qualify for liability coverage under standard homeowners endorsements that provide liability coverage for certain motorized vehicles that are not designed or modified to exceed 15 mph.

With an advertised maximum speed of 17 mph, the Pukka does not qualify for coverage under such endorsements.

Unless someone had the foresight to insure the bike separately, a household might have no coverage for bodily injury or property damage (BI/PD) arising from the use of a Pukka it owned. (There would be coverage under a standard homeowners policy for BI/PD arising from use of a non-owned motorized vehicle designed for use off public roads.)

Until contacted by *Viewpoint*, the question of how to insure use of a Pukka had never come up, says Darren Jensen, managing member of Pukka USA, American Fork, Utah.

The question whether a Pukka is a toy or a vehicle apparently has, however.

While online promotions for the bike feature pictures of children riding them, at least one listing carries this warning: "We do not recommend this to be purchased as a toy. It is a vehicle and not made for kids!"

How many parents understand that?

Hazards

There are hundreds of thousands of self-propelled ride-on toy vehicles in the United States, judging from figures included in product recall announcements by the Consumer Product Safety Commission.

Many of these vehicles are considered hazardous enough to have prompted municipalities across the U.S. to enact ordinances regulating their use in public places.

An ordinance from Green River, Wyo., enacted in July 2005, states that "toy vehicles include, but are not limited to, roller skates, roller blades, motorized and non-motorized skateboards, coasters, push scooters, toy cars, and similar non-licensed riding toys designed for off-road use."

Under the ordinance, those vehicles are prohibited from public roads, except crosswalks. Ordinances in other communities prohibit or restrict the use of such vehicles on sidewalks as well.

The Green River ordinance treats motorized skateboards separately, mandating that they be operated only during daylight hours at speeds not to exceed 20 mph. Operators can be no less than eight years old, must have completed a local safety class if they are under 12, and must wear a helmet and other protective gear if they are under 18.

A 2004 ordinance from Sandusky, Ohio essentially subjects toy vehicles to all traffic laws, and prohibits any child under age 14 from operating a motorized toy vehicle or motorized skateboard.

Among other things, the Sandusky ordinance distinguishes between electric scooters with a top speed of 15 mph, which are classified as bicycles, and those that exceed 15 mph, which "shall be treated as motorcycles" for purposes of traffic regulation.

Expectations

Homeowners insureds should reasonably expect to be covered for BI/PD arising from the use of toys by young children and adolescents, observed members of an AAIS personal lines advisory committee in 2005. (The committee has 14 members, most of them from primary carriers, but also including representatives of agents, reinsurers, and AAIS staff.)

Yet, a strict reading of standard, unendorsed homeowners policies could leave insureds without coverage for a BI/PD claim arising from the use of a motorized vehicle designed for recreational purposes away from the insured premises.

Most parents would certainly expect to be covered for an injury claim arising from use of the miniature Porsche Boxster produced by Berchet and distributed by "KidsWheels." Similar to other "kiddie cars," the battery-powered Boxster is clearly designed for young children and can go only up to 2.5 mph.

Indeed, it's hard to imagine a homeowners carrier denying such a claim, unless it was unusually severe.

Still, without a motorized vehicle endorsement, one could argue that standard homeowners exclusions eliminate liability coverage for BI/PD arising from the use of certain motorized vehicles away from the insured premises. (Coverage is provided for BI that occurs at the insured premises, and for motorized vehicles used to service the premises or assist the handicapped.)

There could be no question about coverage for a kiddie car if parents knew to purchase motorized vehicle endorsements, but it is unlikely that many do.

"Who thinks to change their insurance coverage when they buy a kiddie car?," says Susan Luecke, AAIS assistant vice president for personal lines.

What's a toy?

The questions grow murkier as we consider more powerful toy vehicles.

From appearances alone, many parents might regard the Cobra Strike Pro Electric Scooter as a toy, and the Honda MiniMoto XFR-500, a miniature electric motocross motorcycle, as a vehicle.

Even if they were knowledgeable enough to seek a motorized vehicle endorsement, many parents would be surprised to learn that the scooter would not qualify for coverage under the endorsement, while the miniature motocross motorcycle would.

Many parents would be surprised to learn that a scooter might not qualify for coverage, while a miniature motocross motorcycle would.

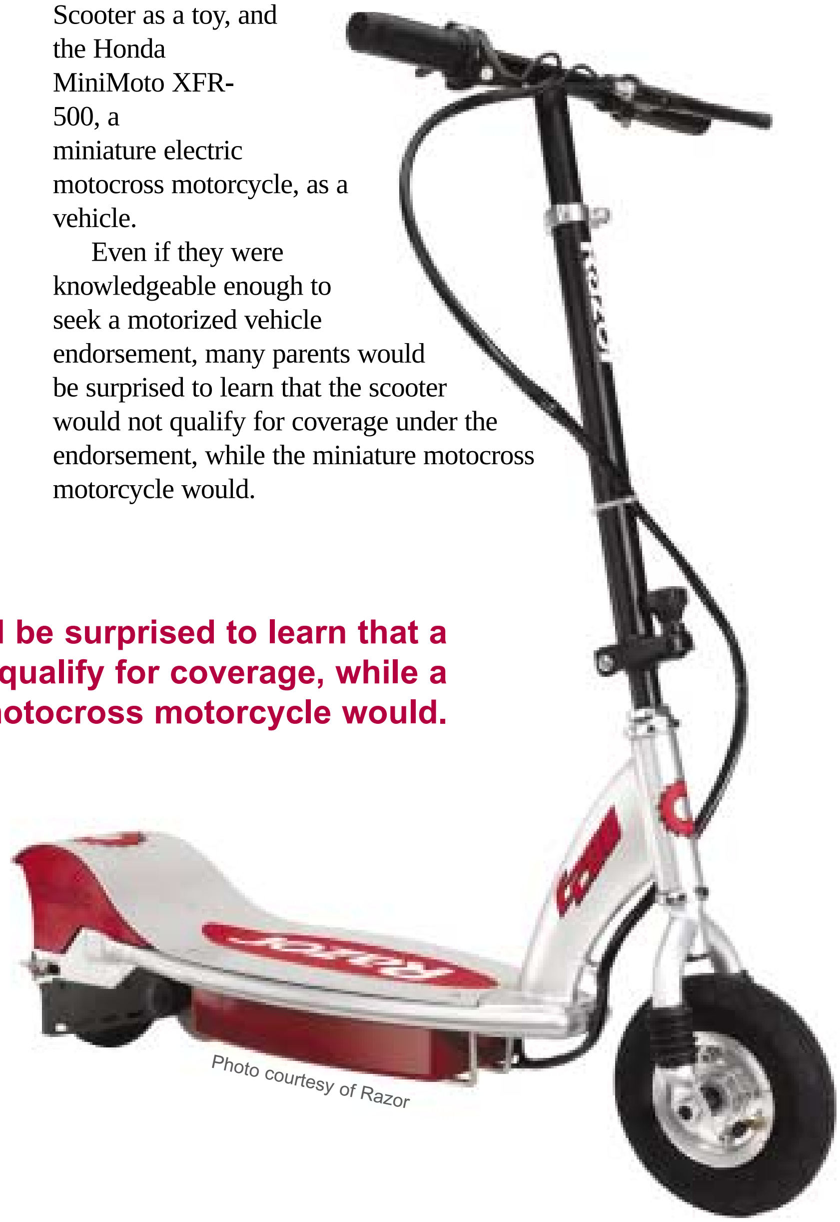

Photo courtesy of Razor

AAIS Homeowners Vehicle Coverage (existing and proposed)

All entries in the table refer to vehicles not subject to registration.

Type of vehicle	Current Homeowners base form	Motorized Vehicle Liability Coverage endorsement	Proposed "kiddie car"provision
Motorized vehicles that are used only to service insured premises or designed to assist the handicapped	Covered	Not necessary	No change
Recreational vehicles designed for use off public roads	Covered only if vehicle is not owned by the insured or claim arises from occurrence on insured premises.	Adds coverage for such vehicles when owned by the insured and used away from insured premises, but only if it does not exceed 15 mph, and is not a moped, motorized bicycle, or golf cart.	No change, except as described in box below.
Battery powered toy vehicle that travels no faster than 15 mph	"	"	Extends built-in base form coverage to such vehicles when owned by the insured and used away from insured premises.
Battery powered toy vehicle that can exceed 15 mph	"	No coverage	No coverage
Gas-powered toy vehicle that travels no faster than 15 mph	"	Adds coverage for such vehicles when owned by the insured and used away from insured premises and is not a moped, motorized bicycle, or golf cart.	"
Gas-powered toy vehicle that exceeds 15 mph	"	No coverage	"

The AAIS approach seeks to meet an expectation of insureds--that they will be insured for use of children's toys--while meeting an expectation of insurers--that homeowners policies will avoid vehicle exposures.

That's because the Cobra Strike Pro scooter promotes "the fun you'll have zipping around your neighborhood at 17 mph," while the Honda MiniMoto claims a top speed of only 15 mph.

Even if one's scooter does not actually reach the advertised speed, it is ineligible under the standard endorsement because it is designed to exceed 15 mph.

AAIS action

In response to input from its personal lines advisory committee, and to ensure that homeowners clearly have some coverage for use of children's toy vehicles, an upcoming revision to the AAIS Homeowners Program includes a new provision that expands incidental motor vehicle coverage to provide coverage for certain types of toy vehicles.

The new "kiddie car" provision establishes built-in coverage--on or off premises--for BI/PD arising out of vehicles (other than motorized bicycles, mopeds, and golf carts) that meet two conditions:

- They are operated only from electrical current supplied by a battery; and

- They are not built or modified after manufacture to exceed a speed of 15 mph on level ground.

With those stated criteria, agents and insureds can readily deduce what is not covered under the base policy:

- There is no coverage for off-premises use of vehicles owned by the insured and powered by gasoline or any other fuel. Certain vehicles that burn fuel but do not exceed 15 mph can be covered for off-premises use by adding a motorized vehicle liability coverage endorsement, which will still be available under the revised AAIS Homeowners Program.
- There will be no off-premises homeowners coverage at all for motorized vehicles designed or modified to exceed 15 mph (except for those that are not licensed or required to be licensed and are used to service insured premises or assist the handicapped).

The AAIS approach seeks to meet an expectation of insureds--that they will be covered for use of children's toys--while meeting an expectation of insurers--that homeowners policies will avoid vehicle exposures.

In doing so, AAIS utilizes one recognized insurance standard: maximum speed of 15 mph. For that or any other standard to become a commonly understood benchmark, toy manufacturers must be more mindful of insurance considerations when designing toy vehicles.

As it is, homeowners cannot assume that use of their children's toy vehicles is insured unless they learn the characteristics of those vehicles and the implications for coverage. ■

From Farm to Fork

"Traceability" provides benefits and drawbacks to farm insurers

In Europe today, you can learn the history of some meat you've purchased by entering a number off a barcode into a computer.

That will lead you to an online database of information that can identify the animal or herd the meat came from, what it was fed, its veterinary history, whether it was confined or allowed to roam, and what happened to its meat as it went through processing.

"They can trace Argentine beef sent to Romania for processing and on to some supermarket in Europe," says Jerry Mithen, vice president of manufacturing service for RQA, Inc., Darien, Ill., a firm that specializes in food safety and management of recalls.

Such capabilities are less widespread in the U.S., but growing rapidly, especially as European food retailers purchase American chains.

Also, American retailing giant Wal-Mart Stores, Inc. has ordered suppliers to utilize "radio frequency identification" tags to trace merchandise, including food bound for Sam's Club stores, from production to delivery. (See sidebar on page 7.)

In the meantime, there has been acceleration in the development of new technologies for tracing the origin and processing of food.

At press time, leading food service technology firms are preparing for an international "Food Traceability" conference, to be held in Dallas the first week in February.

Traceability arises from marketing practices and technology

The drive for comprehensive food traceability is enabled by developments in technology that are transforming all areas of life.

Until recently, the principal means for "tagging" food was the familiar barcode which, when scanned, can yield not only a price, but other information stored within the code that can be read by a scanner.

Today, some food distributors are replacing barcodes with "radio frequency identification" (RFID) tags that can also store information on a product's history, but which do not have to be individually scanned with a wand.

Among other things, RFID tags allow distributors to track the location of inventory while the inventory is in locations and vehicles with sensing equipment.

Wal-Mart Stores, Inc., the Arkansas-based retail giant, took a major step last year to promote the adoption of RFID tagging by requiring suppliers of its Dallas-Fort Worth area stores to utilize a prescribed system of RFID tracing on shipments, including food products shipped to Sam's Club stores.

By themselves, barcodes and RFID tags can store only a limited amount of information for retrieval, often intelligible only to specialists.

But when connected to Web-based databases, the possibility is created for storing virtually unlimited amounts of information, complete with background explanations where needed to make the information intelligible to the average consumer.

The next frontier in food tracing technology involves using biological information, such as DNA and retinal scans, to establish identifying information that cannot be lost or altered.

Not all advances in food traceability are technology-driven, however.

Even without technology, new patterns of food processing and marketing are creating a stronger trail from the consumer back to the producer, with potential implications for farm liability insurers. These practices include:

- Recent campaigns by restaurants that promote the fact they only sell meat and produce grown by local farmers.
- "Vertical integration" of farms and food processors into combined "grower/packer/shipper" operations where a single entity would be liable for several stages of the food chain.
- Brand-specific marketing of food, particularly fresh produce, where growers increasingly opt to have individual pieces of produce identified as coming from a specified grower.

Scheduled conference sessions will address topics such as the use of DNA in tracing food products, biometric identification of livestock, "automated whole-chain traceability," and others.

Experts foresee a day, not far off, when it will be possible to document the "food chain" thoroughly, even for bulk products, such as grain, that are commingled as they move to markets, and ingredients of processed foods, such as frozen foods.

Ambivalence

Traceability is not entirely new.

Since at least the 1930s there have been U.S. laws mandating record keeping in the food supply chain. Dairy products, in particular, have been carefully monitored and inspected from production to sale.

Until recently, however, it was difficult to trace the cause of a food-borne ailment all the way back to a farm or ranch. Modern traceability techniques promise to change that, and farm insurers are ambivalent about it.

"By identifying products, I'm apt to believe we are looking at more exposure," says Dean Hosfelt, vice president of American Reliable Ins. Co., Omaha, Neb., a writer of farm and ranch coverage.

"Tracing could prevent serious injuries from happening," says Kelli Kukulka, a vice president and agriculture specialist in the Chicago office of American Re-Insurance.

"However, if tracing doesn't work to prevent a loss, and you have a claim, there's a trail," she adds. "With strict liability, this could benefit or create a problem for an insured."

"The ability to trace food-borne illnesses back to the source will result in more claims being pushed further downstream," adds Tammi Griffin, director of Aon's agribusiness and food system group in Kansas City, Mo.

"Many of these farmers may not carry the insurance that is necessary to respond to these claims," Griffin says. "We see contracts changing on the processing and manufacturing side that may force farmers to carry more and possibly specialized coverage."

"I think there is tremendous benefit [from traceability] to the insurance industry," he says. "Every [insurance] company we've talked to has said, 'This is great.'"

According to Mithen, it is inevitable that all food will one day be able to be traced back through the processing chain to the original producer.

Given that, he says that insurers of any type of food operation are well-advised to encourage use of tracing techniques that thoroughly document the use of safe and prescribed agricultural practices.

He predicts that such documentation will become the best defense for insurers and insureds facing liability claims from food.

"They can trace Argentine beef sent to Romania for processing and on to some supermarket in Europe."

— *Jerry Mithen, vice president of manufacturing service, RQA, Inc., Darien, Ill.*

Alarmed that traceability might increase their members' products liability, state livestock associations have been campaigning to preserve a traditional exemption for livestock from implied warranty laws.

For example, a 2003 resolution of the Kansas Livestock Association reads as follows:

> ". . . Whereas animal trace-back technology can increase the liability exposure for owners of animals whose food and by-products threaten or cause damages to consumers, and
>
> "Whereas liability in these circumstances can often be classified as 'strict liability,' even though an animal owner may not be at fault . . .
>
> ". . . the Kansas Livestock Association supports state and federal legislation to limit animal owner's liability exposure that may arise under a private or public animal identification program."

Possibilities

While some insurers worry that traceability will increase liability exposures, Mithen says others are enthusiastic about it.

"Traceability demonstrates that you have done what was necessary and proper to prevent injury," he says. A demonstration of "due diligence," required all along the food chain in Europe, can help avoid or limit liability claims in the U.S.

Traceability may also reduce exposure for general liability insurers by classifying certain occurrences as professional liability claims.

"Professional liability comes into play, especially when you have farm managers," says Chris Leliaert, a vice president and agriculture expert in the Chicago office of Towers Perrin, the international reinsurance firm.

According to Leliaert, even traditional farm owner-operators are now required to get state licenses to apply pesticides, herbicides, and fungicides. What was once considered a part of farm operations is increasingly seen as a distinct professional activity.

This increases the possibility that, with sufficient documentation, a farm general liability insurer may not be liable for a claim arising from misapplication of farm chemicals.

Recalls

Mithen at RQA acknowledges, however, that increased use of traceability will lead to more frequent recalls of products. He believes insurers and agents need to do a better job explaining recall coverage.

"Companies I have spoken to think that their products liability insurance [automatically] covers recalls," he says. "Insurance companies and brokers don't do a good job explaining it to them."

When an insured adds a standard product recall endorsement, that usually covers only about 20% of the real cost of a recall, says Dan Cahill, a colleague of Mithen's in RQA's Phoenix office.

"Often the recall [itself] is the smallest portion [of the cost]," Cahill says, adding that related costs for loss of stock, loss of income, public relations, and logistical changes usually far exceed the cost of pulling a product off the shelves.

As an example of the growing cost of product recalls, Cahill says public authorities are increasingly demanding documentation that a recalled food item has been destroyed.

Criteria

Traceability is also a critical component in the recent growth of "contaminated product insurance," a first-party property coverage.

To support that line, tracing techniques are used to document that certain foods meet criteria demanded by groups of consumers. These criteria include, among others--

- That the food is truly "organic,"
- That the food is free of genetically-engineered organisms;
- That environmentally sound agricultural techniques have been used;
- That animals have been treated humanely; and
- That the food has been imported according to principles of fair trade.

Continued on page 22

by Paul Henault, vice president,
The Hartford Steam Boiler
Inspection and Insurance Company,
Hartford, Conn.

GUEST ESSAY

High-Tech, High Risk

Modern Equipment Demands Better Insurance Coverage

This is the fourth in Viewpoint's series of guest essays submitted by organizations that are associate members of AAIS. For information on associate membership, contact Rick Maka, director of marketing, at rickm@AAISonline.com *or by calling 800/564-AAIS.*

It was an hour before closing when the lights flickered inside a wireless telephone store. A utility power spike surged through the lines, shorting out equipment as smoke poured from electrical outlets. Printers, scanners and computers were damaged, but it was the loss of electronic cash registers, several credit card readers and a computer server used to program new cell phones that shut the store down.

A power outage might have been an inconvenience in years past. Today a power surge can damage sensitive equipment and cost even more in business interruption losses and extra expense. Like the phone store, many businesses depend on data connections and links to inventory and accounting systems. That loss totaled $10,225, including more than $600 in lost income, but it was covered by equipment breakdown insurance.

"In the Basement, On the Roof"

When it comes to equipment, nothing is simple any more. Whether it's Silicon Valley, or a shop on Main Street, we all depend more than ever on new technology. It used to be that commercial clients worried about equipment "in the basement and on the roof." That meant the boiler downstairs; maybe a large rooftop air conditioning unit. Now, computers and other electrical equipment are everywhere, in every type of business and location.

It follows that electrical and electronic equipment is the No. 1 category of commercial loss - 10 or more years ago, boilers, air conditioning and refrigeration were the types of equipment most likely to break down. Mechanical breakdowns of boilers and other equipment still account for many expensive losses, but power surges and other electrical line disturbances have become the top cause of equipment claims.

Today's Equipment Needs Protection

Equipment breakdown insurance is also changing to keep pace with new equipment risks and the need for new types of coverage. Once known as boiler and machinery insurance, and mostly limited to larger manufacturers and municipalities, equipment breakdown coverage is an increasingly important part of most commercial insurance programs. After all, your clients may not even have a boiler, but it's likely they rely on a range of equipment for sales, production, communications and other essential functions.

Here are some typical losses that were covered by equipment breakdown insurance.

- **Office Building** — a power surge was transmitted through an office communications network, destroying 200 computers. Total paid loss: $100,000.
- **Law Firm** — electrical arcing knocked out power for a week. Attorneys and staff had to relocate until repairs were completed. Total paid loss: $176,000, including $114,644 in business interruption and $60,356 in extra expense.
- **Retail Store** — a voltage spike damaged the store's telephone system, printers and computer circuitry. Total paid loss: $46,640.
- **Service Station** — a short circuit caused a surge that damaged 14 credit card readers on gasoline pumps. An employee had to bill credit cards by hand. Total paid loss: $27,881.

"Business interruption coverage is an important option, since high-tech means high risk, not only for equipment damage, but business interruption losses and extra expense."

Filling the Coverage Gaps

Equipment breakdown coverage protects against the unique causes of equipment breakdown, just as property coverage protects property damaged by fire or windstorm. Virtually any type of business equipment is covered and equipment breakdown insurance can be designed to fit with any commercial property program. Equipment breakdown coverage will pay for the cost of repair or replacement, spoilage and expenses incurred to protect property, or to speed up the restoration of normal operations.

Business interruption coverage is an important option, since high-tech means high risk, not only for equipment damage, but business interruption losses and extra expense. Business income exposures that were once low to moderate for many businesses have increased as clients become ever more dependent on equipment. Surveys show that up to half of all equipment breakdown claims have business income expenses.

New Products, Expanded Coverage

Equipment breakdown insurance continues to evolve with new products and coverage. Since business interruption risks are higher, more coverage is available for income losses due to breakdowns. The list of covered equipment is greatly expanded to include many types of electrical and electronic devices. Some equipment breakdown policies offer extensive coverage for personal computers, voice mail and other computer equipment, and for the recovery or restoration of data lost because of a breakdown.

An important feature of some equipment breakdown policies is contingent business income coverage. It recognizes the interdependence of today's economy by paying for business interruption losses and expenses that result from a covered equipment breakdown at the separate location of a key supplier or customer. Some policies also include off-premises coverage for an insured's own equipment that breaks down when used away from the insured's building or property.

It's Easier When It's Automatic

Perhaps the most significant change is that equipment breakdown insurance is becoming a standard coverage. Once offered primarily as a stand alone policy, dozens of insurers are embedding the coverage into their property-casualty packages, now including farmowners policies. By adding equipment breakdown automatically, the risk is spread among many policyholders to broaden the coverage, keep prices affordable and eliminate extra paperwork. Research shows that agents prefer to package equipment breakdown coverage.

Insurance for the Way the World Does Business

Equipment breakdown insurance has changed drastically over the years. It has adapted in response to technology and the marketplace. What new exposures lie ahead? Who can know for sure? Perhaps totally wireless offices, or buildings that generate all their own electrical power. Past experience shows there will be equipment we can't yet envision and risks we don't foresee. As an industry, we must continue to improve coverage and services to reflect the ways that our clients do business.

Paul Henault has been with HSB for 25 years, specializing in underwriting, marketing and reinsurance. He is currently responsible for new client company acquisition and is HSB's Industry Affairs officer. Paul is the product manager for HSB's farm initiative which focuses on the equipment breakdown needs for property casualty companies specializing in the agricultural industry. He has a BA in Economics from Boston College and an MBA in Finance from the University of Hartford. ■

Terrorism Clarifications

AAIS questions lead to clarifications of federal coverage in certain lins

Questions raised by AAIS staff have prompted clarifications of the coverage provided by the federal terrorism reinsurance program.

AAIS staff members participated in a Jan. 17 conference call meeting of a terrorism working group of the National Association of Insurance Commissioners (NAIC), and provided questions beforehand.

Partly in response to those questions, officials of the U.S. Treasury Dept., which administers the program, clarified several features of the revised U.S. Terrorism Risk Insurance Program (TRIP).

Farm insurance

Farm insurance whose premium is reported under "farm multi-peril" on insurer annual statements is no longer covered under the revised federal program. However, Treasury officials said that if premium for a farm policy is reported under a line still covered by TRIP (such as "fire," "allied lines," or "general liability") that policy would still be covered under the program.

Therefore, insurers writing monoline farm policies need to know how the premium for those lines is reported, and offer federal terrorism coverage when required. Endorsements and disclosures for following the law are already available under AAIS farm and agribusiness programs.

Incidental professional liability

Treasury officials said that TRIP provides no coverage for any type of professional liability, including incidental professional liability built into or endorsed onto a policy for a line covered under TRIP. This clarification may allow insurers to "carve out" (exclude) coverage for professional liability exposures from endorsements that provide TRIP coverage.

Auto coverage under commercial umbrellas

While the revised TRIP no longer covers commercial auto as a line, Treasury officials confirmed that commercial umbrella coverage that extends to auto exposures will still fall under the program if the premium is reported as general or excess liability. No changes are required under the AAIS Commercial Umbrella Program to accommodate this clarification.

Following the meeting, AAIS issued bulletins to its commercial lines and farm affiliates clarifying the application of TRIP to certain coverages available under AAIS programs, including:

- Crime insurance available under AAIS output programs;
- Commercial auto coverage endorsed into AAIS-based Artisans, Businessowners, or Commercial Liability policies, and covered under the AAIS Farm Umbrella and Commercial Umbrella/Excess Liability programs; and
- Incidental professional liability coverage available under the AAIS Businessowners and Commercial Liability programs; and
- Insurance for farm exposures whose premium is reported under annual statement categories other than "farm multi-peril." ■

How do you earn trust?

More than 200 of America's best property casualty insurers place their trust in us, including many AAIS members. They expect us to deliver industry-leading products from equipment breakdown to identity theft and employment practices liability competitively and seamlessly. They expect us to provide innovative engineering-based risk management and timely claims service. They expect us to understand their goals and work with them to open new markets and improve revenue and profitability. They expect us to execute everything we do – products, services, systems, support, flawlessly. They expect us to understand their business as though it were our own. And we do. *That* is how we've earned their trust. We'd very much like the opportunity to earn yours.

For more information about The Hartford Steam Boiler Inspection and Insurance Company please call us at **1-800-472-1866** or visit **www.hsb.com**

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Windstorms and Windfalls

It's possible to profit from demand surge and file a business income claim. Is it fair?

Richard Lewis thinks insurers want to have it both ways.

Lewis is an attorney with Anderson, Kill & Olick, P.C., New York City, a firm representing energy companies in disputes with carriers over business income claims arising from the 2005 hurricanes in the Gulf of Mexico.

According to Lewis, insurance companies are contesting business income claims submitted by companies whose Gulf facilities suffered damage during the storms.

His firm claims that its energy clients were told that, because of price hikes and huge profits following hurricane-induced disruptions of supply, those companies actually profited from the storms and could not claim a loss.

"[The insurers] are trying to consider the wider effects of a disaster" in weighing these claims, says Lewis. "That is not something allowed other policyholders."

With that last statement, Lewis was referring to provisions added to standard business income forms in recent years. Those provisions seek to exclude compensation for additional profits an insured could have earned if a disaster had occurred but not interrupted its operations.

For example, the latest AAIS Businessowners forms include the following restriction:

> We do not pay for any increase in net income that might have been earned by your business as a result of conditions created by the effect of the covered peril.

Thus, under standard policies, business income (BI) coverage is intended to reimburse an organization for earnings and continuing expenses it would have under normal circumstances (plus extra expenses needed to limit losses and resume operations).

The new provisions are designed to clarify that BI coverage is not intended to guarantee a windfall to an insured due to a surge in demand for its service following a general disaster.

The case of the energy companies turns the scenario on its head, however.

In that case, a windfall has been reaped, in the opinion of the insurers. The energy companies did collect huge profits during a period when oil supplies were acutely constrained by physical losses to refining and distribution facilities.

Questions

Lewis and his firm decline to identify the energy companies or insurance carriers involved in the negotiations, so we don't have policies to review, and we don't know key details that would be critical to addressing the claims.

Who, exactly, is the insured? A global company or a regional subsidiary?

"I think insurers are taking the view that not only the affected part, but the entire performance of all operations be examined when considering business income claims," Lewis says.

"Does GM have to suffer a loss if Saturn goes down?," he asks rhetorically.

That's a key consideration for large organizations, which often insure all branches and subsidiaries under a single master policy, according to Linda Robinson, senior research analyst for the International Risk Management Institute (IRMI).

In such cases, it is possible that reliance solely on policy language would require that a parent organization demonstrate a loss of income to itself before being able to collect on a BI claim.

The AAIS Commercial Output Program, a property program designed for large, multi-location insureds, allows income coverage to be scheduled separately for each insured location, says Robert Guevara, AAIS vice president of inland marine. That feature is rarely used, however.

According to Guevara, it is often easier to write income coverage on a blanket basis, even if the building and personal property coverage is scheduled by location. That's because an organization would have to develop separate income statements for each insured location to write scheduled income coverage effectively.

Did the insured entity suffer a quantifiable loss of income for a defined period?

Experts consulted for this article agreed that, under standard forms and common understandings, an insured typically has to demonstrate an actual loss during a defined period of time to make a valid business income claim.

"Obviously, the insured must have an 'actual loss sustained' if the policy so stipulates," says Tom Mallin, president and CEO of the Property Loss Research Bureau, Downers Grove, Ill. "Such a requirement is almost universal."

"If the insured cannot demonstrate that it sustained a loss of expected insured business income, there will be no recovery under a form requiring actual loss of income."

outside the restoration period" when considering a business income claim, Robinson says.

Scenarios

While this discussion was prompted by the experience of large oil companies, the questions raised are not limited to large organizations. Inquires for this article considered three hypothetical scenarios:

- An HVAC contractor that suffers a brief interruption due to windstorm damage to equipment and inventory, but earns increased profits after restoration due to heightened demand.
- A restaurant that is closed for some time due to windstorm damage, then reaps a windfall upon reopening because competing restaurants have been completely destroyed.
- A distributor of bottled water that must shut down a facility due to windstorm damage, but is able to truck in water from other locations, generating increased profits due to increased demand.

In the absence of other facts, Robinson sees nothing in our hypothetical cases regarding the HVAC contractor and the restaurant that would preclude them from claiming a business income loss under standard forms.

"The pace of litigation in this area has increased dramatically. Now that we're litigating this more, the language complicates things."

— *Richard Lewis, Anderson, Kill & Olick, P.C., New York City*

Were the increased profits reaped during the period of restoration or afterward?

Whether a windfall can reduce or cancel out a BI claim payment usually depends on when it was reaped, says Robinson at IRMI.

"If the windfall is reaped during the indemnity period, then I think typical policy language allows it to be netted out [from the claim payment]," she says.

None of the experts were aware of any provisions in existence today that would allow a carrier to cancel out an income loss with a subsequent windfall profit, even if it was related to the same event.

"I don't recall anything in policies to allow insurers to look

The hypothetical bottled water distributor is a different story.

According to Robinson, if the increased profits for trucked-in water were earned while the damaged facility was being restored, common policy language could be interpreted to "net out" the profits and extra expenses.

If the increased profits were greater than the income loss there might be no business income recovery.

Continued on page 22

Executive Leadership

Decision-Making in a Dynamic Environment

AAIS

AAIS Annual Conference

APRIL 9-11, 2006

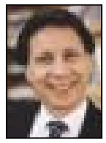
THE RITZ-CARLTON • SARASOTA, FLORIDA

Being an executive today means having to make more decisions, more quickly, amid more complexity.

At the 2006 AAIS Annual Conference you can hear presentations on key issues facing insurance executives.

Decision Traps and Winning Decisions

Professor J. Edward Russo, Cornell University



Jay Russo

"Jay" Russo will lead a half-day interactive session where CEOs can learn to identify "decision traps" in their own processes and to structure those processes to produce "winning decisions." Each registrant will receive a copy of Jay's book, *Winning Decisions: Getting it Right the First Time*, co-authored by Paul Schoemaker of the Wharton School.

Decision Analytics in Commercial Underwriting

John Lucker, principal, & Jim Marino, director, Deloitte Consulting LLP

John Lucker

Jim Marino

Deloitte Consulting LLP is leading the effort to develop "predictive analytics" for underwriting businessowners, general liability, and other commercial lines. John Lucker and Jim Marino will discuss how data mining and predictive modeling can improve underwriting results in commercial lines.

Technology Decisions: Shaping Your Future

Matthew Josefowicz, manager, global insurance group, Celent LLC

Few organizations track the evolution of information technology as closely as Celent LLC, and Matt Josefowicz will draw on Celent's extensive research to describe different scenarios executives face regarding technology.

Matt Josefowicz

A Time for Public Decisions

Ernst Csiszar/president, Property Casualty Insurers Association of America

Ernst Csiszar

At a time when there are so many public policy decisions facing the P/C industry there are few people better suited to address them than Ernst "Ernie" Csiszar, a former professor, insurance company CEO, state regulator, NAIC president, and, now, president of a major trade association.

Decision Time: Positioning Your Company in Today's Market

A panel of company executives

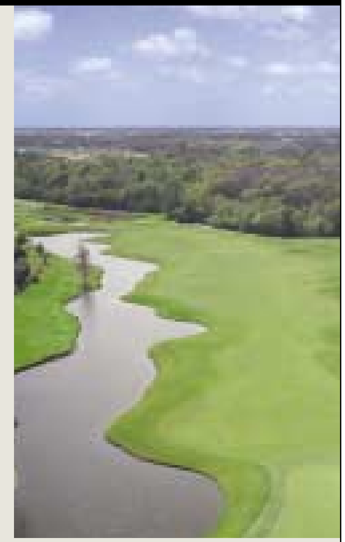
We're inviting seasoned executives to discuss how their companies are positioning themselves to compete and succeed in the coming years. Our panelists will discuss strategic choices their organizations have made regarding technology, distribution, underwriting, customer service, claims, and more.

SOCIAL EVENTS

AAIS Golf Outing

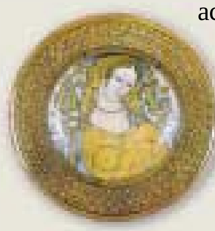
Legacy Golf Club at Lakewood Ranch, Bradenton

The AAIS Golf Outing, on Monday afternoon, takes place at the Legacy Golf Club, rated "One of America's Top Courses" by ZAGAT Survey 2003 and voted the #1 Public Golf Course by Florida Golf News.



Legacy Golf Club

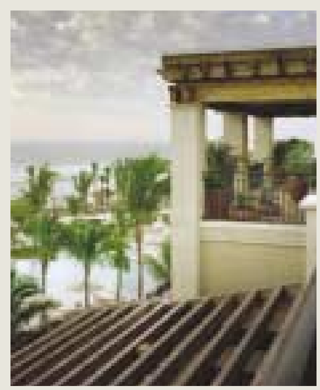
Tour of Ringling Museums



Tuesday's spouse/guest event is a tour of the John and Mable Ringling Museum of Art, located on the 66-acre estate of John Ringling, business tycoon and partner in the Ringling Bros. and Barnum & Bailey Circus. The site feartures *Cà d'Zan*, Ringling's Venetian-style waterfront mansion, the Circus Museum, and Mable Ringling's Rose Garden.

Dinner & Dancing on the Sunset Terrace

Our closing social on Tuesday evening takes place on the Sunset Terrace at The Ritz-Carlton Members Beach Club. This luxurious facility overlooks the white sand beaches of Lido Key with breathtaking views of the Gulf of Mexico.



To register:

- For copies of the conference and hotel registration forms, go to *www.AAISonline.com* or call Joe Harrington at 800-564-2247

Faster Filings

Automated filing process changing the work of compliance professionals

Regulators apparently have delivered on their promise of greater “speed to market,” and the System for Electronic Rate and Form Filing (SERFF) appears to have fulfilled the mission established by its proponents.

Filing specialists at AAIS and other organizations report that they have seen a dramatic increase in the speed with which rate and form filings are processed and approved since SERFF became fully functional. (AAIS became the first national advisory organization to submit filings through SERFF in 2004.)

“We’ve seen a real increase in the speed of approvals since we’ve been submitting through SERFF,” says Larris Larsen, AAIS assistant vice president for compliance. “Approvals that once took 60-90 days now take 2-3 days. The difference is huge.”

“We had one state approve a filing in 20 minutes,” adds Laura Lemke, senior filings and compliance specialist.

Others in the industry offer similar observations.

“Turn-around time has improved greatly,” says Rebecca Ritchey, research and development specialist for Preferred Mutual Ins. Co., New Berlin, N.Y. Some “95% of our filings are approved in half the time they were before.”

Automation

Larsen and others cite automation as the biggest reason for more rapid approvals, because of the efficiency automation creates and for the way in which it structures the process.

For example, AAIS uses the “Tracker” application developed by InSystems Corporation, Markham, Ont., to submit filings.

Tracker incorporates filing criteria of individual states into the SERFF platform developed under sponsorship of the National Association of Insurance Commissioners (NAIC).

Tracker and SERFF facilitate faster filings by requiring users to fill in all essential forms and fields, says Larsen.

“There’s very little back and forth on basic fulfillment anymore,” he says. “You have to fill it all out, or it won’t ‘Send’.”

“The nature of SERFF’s design dictates that states follow mostly uniform procedures,” says Justin Brady, manager of government and industry services for FM Global, Johnston, R.I. Brady adds, however, that standardization has led to an increase in the number of filing criteria in some states.

Nonetheless, Larsen says that most states have kept their commitments to eliminate discretionary “desk drawer” rules that individual analysts once imposed.


Larris Larsen

“The automation process has caused states to streamline their internal procedures,” Larsen says. “Automation limits states to enforcing standards that are actually on the state filing checklists.”

Mary Jo Shields, senior analyst for regulatory compliance with Jewelers Mutual Ins. Co., Neenah, Wis., recalls that, years ago, a company might not be aware of changes in a state’s filing procedures until a filing was submitted and had to be modified.

“A filer can be much more confident today that filings submitted are complete and that the approval process will not be delayed for procedural reasons,” she says.

“All filings, whether done through SERFF or traditional paper, have benefited from ‘speed to market’ reforms to the filing process,” says Joseph Bieniek, a filings specialist with CCH Insurance Services, Nagog, Mass., a part of Wolters Kluwer Financial Services.

"Congressional pressure on the NAIC resulted in the NAIC standing behind SERFF and its standardized filing requirements," Bieniek adds.

Changing work

Like professionals in other fields where automation has been introduced, insurance filings and compliance professionals are seeing the nature of their work transformed.

"The filer today is more productive than a few years ago," says Bieniek. "Most companies we do business with have told us they still have the same number of filers as in the past, but are producing more filings."

That's certainly true at AAIS where, according to Larsen, "We're doing far more filings with the same number of people."

At AAIS today, most of the filing submission activity can be handled by one member of the AAIS filings team, leaving Lemke and others time to pursue other initiatives on behalf of AAIS member companies.

One filings specialist is completing a project that will provide users of *AAISdirect* with easy access to consolidated information on AAIS form filing numbers, their effective dates, and their corresponding state filing numbers.

For the meantime, Lemke is creating a database that will provide *AAISdirect* users with direct access to the most current information on company action needed to adopt a form.

(Currently, bulletins announcing approvals describe the company action needed at that time to adopt a form. If a company waits to adopt a form, it has had to determine if there has been a change in the action needed to do so. That information will be available automatically to users of *AAISdirect*.)

Companies, too

Company filings specialists find that there are new expectations being place on them.

"Preferred Mutual is asking us to do more market studies," says Ritchey. "It's asking us to find information on how the market is changing and the industry is changing."

In a 2004 article, Penny Kilberry, assistant vice president for regulatory compliance for Monitor Liability Managers, Rolling Meadows, Ill., identified six emerging or growing areas of responsibility for compliance professionals, in addition to product submission and approval:

- Internal audits for market conduct;
- Coordination of market conduct examinations;
- Handling of customer complaints;
- Communication of compliance information to noncompliance staff; and
- Adherence to federal directives.

"As the emphasis of the compliance function has shifted in response to the changing regulatory environment, its importance to the successful operation of the company has grown," wrote Kilberry, now national secretary for the Association of Insurance Compiance Professionals (AICP).

"Top management of most companies has become increasingly aware of the impact of compliance operations on the bottom line," she continued.

Complexity

It would be wrong, however, to conclude that filing work has been "simplified," and that compliance professionals are essentially looking for new roles.

With new capabilities for executing filings come increased demands for more information in them.

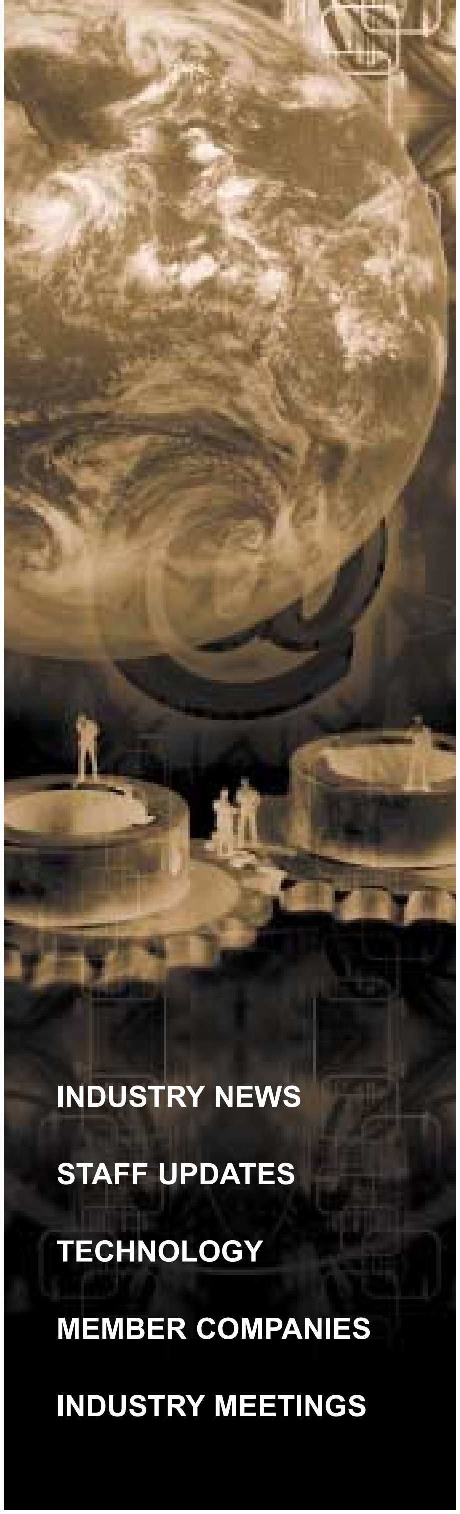
"Filers have more effective resources available, [but] demands on the filer have increased as well," says Bieniek. "Insurance departments and legislatures have increased the requirements for supporting documentation for many filings."

"Increased marketplace competition is another factor causing insurers to develop rating or form revisions, thereby necessitating more filings."

Brady at FM Global adds that "more state insurance departments and legislatures are demanding more statistics in greater detail. It is a challenge for insurers to respond promptly."

Also, filings professionals are still learning how to maintain the human touch in a regulatory process transformed by automation, says Lemke at AAIS.

"Building rapport with individual analysts is a little more difficult now, because we don't talk to them as much as we used to," she says. ■

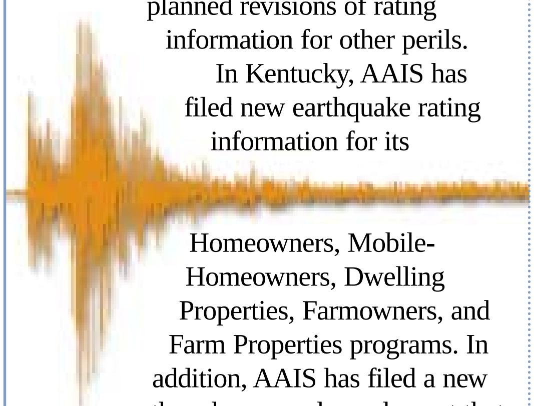


>>AAIS NEWS

Kentucky filing initiates countrywide revision of earthquake rating information

AAIS has taken the first step in what will be a comprehensive countrywide revision and update of its earthquake rating information. The earthquake rating revision, in turn, is the first of similar planned revisions of rating information for other perils.

In Kentucky, AAIS has filed new earthquake rating information for its



Homeowners, Mobile-Homeowners, Dwelling Properties, Farmowners, and Farm Properties programs. In addition, AAIS has filed a new earthquake manual supplement that can be used with each of those lines. In coming months, similar supplements will be filed for personal and commercial lines in other states.

The earthquake revision includes two new features:

- The rating information incorporates catastrophe modeling data supplied by one of the world's leading catastrophe modeling firms.
- The supplement assigns ZIP Codes to earthquake rating zones based on zones identified by the U.S. Geological Service.

AAIS program users will be able to look up the earthquake rating zone for each ZIP Code; conversely, users can see all the ZIP Code areas assigned to each rating zone. Users of *AAISdirect* will have a direct link from their line-specific manuals to the earthquake supplement.

New rating worksheets added to *Inland Marine Guide*

Five new rating worksheets have been added to the AAIS *Inland Marine Guide*, one each for:

- Bailee Customers Floater - Dry Cleaners Processing Location;
- Bailee Customers Floater - Dry Cleaners Storage Location;
- Fine Arts Floater;
- Fine Arts Dealers; and
- Warehouse Operators Legal Liability.

Files for paper versions of these worksheets have been distributed to all users of the *Guide*, a premier industry resource for forms, rating procedures, underwriting guidelines, and other information for the nonfiled classes of inland marine insurance.

Electronic versions of these worksheets will be developed and made available on *AAISdirect* at a later date.

For information on affiliating with AAIS for use of the *Inland Marine Guide*, contact Rick Maka, director of marketing, at *rickm@AAISonline.com* or by calling 800/564-AAIS.

Revised BOP manual

with factor rating filed countrywide

AAIS has initiated a countrywide filing of a revised Businessowners manual.

The new manual introduces loss cost base amounts, relativity factors, and factor rating procedures. Those features can be used as an alternative to tables of computed loss costs, which are still provided.

The factor rating information was developed to simplify the process of loading Businessowners rating information into policy rating systems. When used with the factor rating premium determination rule provided, the loss cost base amounts and relativity factors will produce loss costs identical to those in the tables of computed loss costs.

For information on affiliating with AAIS for use of its Businessowners Program, contact Rick Maka, director of marketing, at *rickm@AAISonline.com* or by calling 800/564-AAIS.

Fuel oil endorsement approved in New Jersey

An AAIS personal lines exclusion endorsement and rating information related to coverage for fuel oil leaks and spills have been approved in New Jersey, effective March 1, 2006.

Filed in response to a New Jersey Supreme Court ruling restricting the application of standard pollution exclusions, the new Homeowners and Mobile-Homeowners endorsement allows insurers to exclude liability coverage for fuel oil leaks and spills.

The exclusion allows for a "buyback" of coverage for bodily injury and property damage arising out of leaks and spills at specified locations; rating information is now approved for the buyback coverage.

AAIS Farmowners Program covered in November *PF&M*

Property/casualty professionals can read an analysis of the AAIS Farmowners Program in the November 2005 issue of *PF&M*, the policy form and manual analysis service of The Rough Notes Company, Inc.

The new section provides an overview of the AAIS Farmowners Program, plus more detailed descriptions of the FO-6 Farm Property Coverage Form and program endorsements.

Florida approves endorsements for hurricane deductibles

Florida has approved new AAIS endorsements that allow insurers to offer separate hurricane deductibles for commercial residential property on an annual or per occurrence basis.

The endorsements, which took effect Jan. 1, 2006, are available under the AAIS Artisans, Businessowners, and Commercial Properties programs. They can be used on policies insuring residential apartment buildings, condominium associations, cooperative associations, and the common elements of a homeowners' association.

A new residential risks hurricane deductible endorsement has also been approved for the AAIS Agricultural Output Program, effective Jan. 1, 2006.

The endorsements were developed to comply with a new Florida requirement

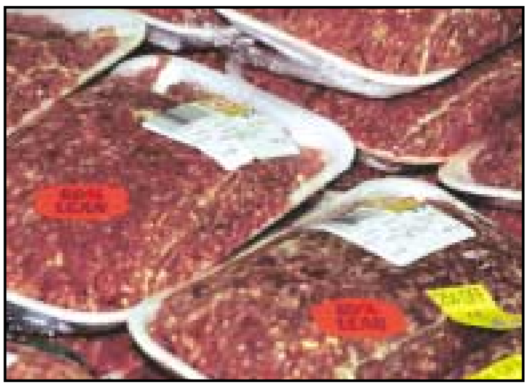
that insurers offer commercial insureds a choice between an annual or per occurrence hurricane deductible.

From Farm to Fork *Continued from page 9*

Food produced to such specifications carries a premium price in certain markets. Therefore, it can lose value if a premium attribute is lost along the way, even though the food is not physically damaged.

According to Mithen, the reduced value food is considered to be "contaminated," and major carriers are writing more contaminated products insurance to cover the loss in value.

Food traceability technology supplemented by expert inspections is essential for loss control and reduction of moral hazard in the line, Mithen says.



"[Insurance] companies don't necessarily have the trained eye for detecting traces [of impurities]" needed to verify that a product has retained its premium attributes, he says. "It's not good enough that a facility look clean to an untrained eye."

Litigation

Whether insurers are apprehensive or enthusiastic about advances in traceability, they share one observation: Food producers are subject to unprecedented scrutiny from the public and plaintiff's attorneys, and tracing techniques can help them pick their targets.

"There are people out there looking for class action lawsuits," says Mithen. "That wasn't the case 25 years ago."

"The ability to trace food-borne illnesses back to the source will result in more claims being pushed further downstream."

— *Tammi Griffin, director of Aon's agribusiness and food system group in Kansas City, Mo.*

It marks a profound shift in cultural attitudes toward farming, says Leliaert.

"Farmers used to be considered the good guys who took care of the land and produced our food," Leliaert says. "There was a day when you would never sue a farmer. Today, you wouldn't hesitate to do so." ■

Windstorms and Windfalls *Continued from page 15*

Principle

Whatever the specifics of individual claims, a larger question has been raised concerning the principle of indemnity: Is it appropriate to pay "losses" for a sequence of events that ultimately results in substantial gains for an insured?

Again, Lewis might turn the question around, and ask if it is appropriate to deny a substantiated BI claim--a loss of income at an insured location due to damage by a covered peril--because an organization managed to conduct other business successfully.

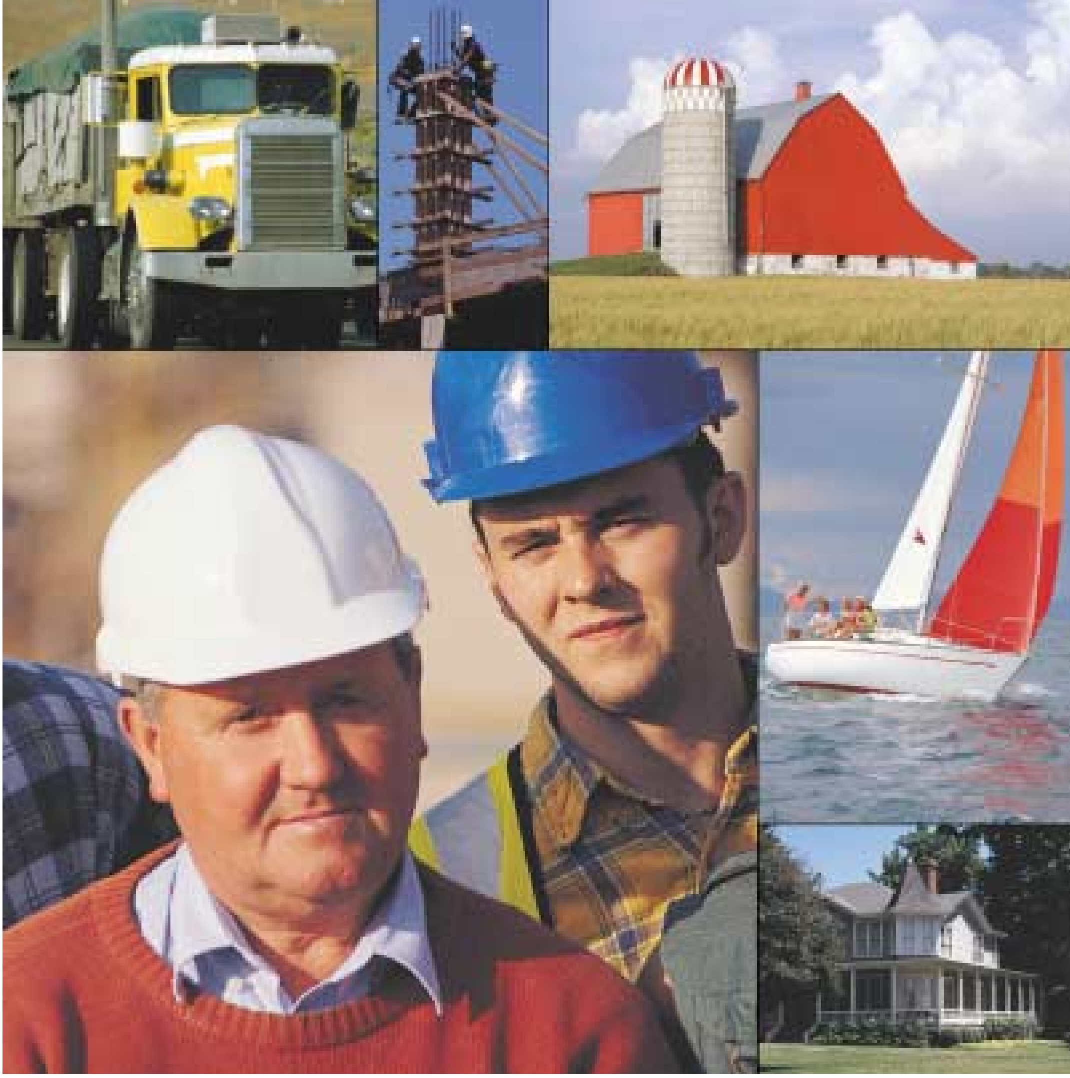
The resolution of income claims has been, by nature, more dependent on negotiation and less prescribed by policy provisions than other types of property insurance.

What is an "expected" level of earnings? What extra expenses are "necessary"? What is a "reasonable" period of restoration, especially when a community is in the midst of upheaval?

But the environment is changing, according to Lewis. "The pace of litigation in this area has increased dramatically," he says.

Flexibility and ambiguity in income coverage provisions serve the purposes of negotiation, he adds, but "now that we're litigating this more, the language complicates things."

If that's true, insurers and advisory organizations may have to address how income claims followed by windfall profits resulting from the same event can be reconciled with the principle of indemnity. ■



PERSONAL
- Boatowners
- Homeowners/Mobile HO
- Personal Monolines
- Personal Umbrella

COMMERCIAL
- Artisans
- Businessowners
- Commercial Monolines
- Commercial Umbrella

FARM & AG
- Farmowners
- Farm Monolines
- Farm Umbrella
- Agricultural Output

INLAND MARINE/ OUTPUT
- *Inland Marine Guide (nonfiled)*
- Commercial Inland Marine *(filed)*
- Commercial Output
- Commercial Output - XL
- Developers Output

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More than 600 property/casualty insurers throughout the U.S. use AAIS policy forms, rules, and rating information for their products.

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For product samples and a cost quote, contact Rick Maka, marketing director, at *rickm@AAISonline.com* or by calling 800/564-AAIS.

American Association of Insurance Services
www.AAISonline.com

AAISdirect has a new look

Users of *AAISdirect* now see a new, more attractive home page when they sign on. This redesign is the first step in a long-term initiative to enhance the content and functionality of the service.

AAISdirect is the online library of AAIS forms, manuals, bulletins, and other information. Among other things, the new design allows users to initiate searches directly from the home page, while retaining the existing tabs familiar to current users. The new design also displays the user's navigation chain (e.g., Homeowners > Bulletins > Massachusetts), and allows users to initiate new searches from their results page.

For information on licensing use of *AAISdirect*, contact Rick Maka, director of marketing, at *rickm@AAISonline.com* or by calling 800/564-AAIS. ■

AAIS Welcomes New Affiliates

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GENERALI US BRANCH

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Ohio Mutual Insurance Group

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