

Don't Let a Catastrophe Exposure Become Your Own Catastrophe

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More often than not, a second wave of claims against insurance agents by their clients follows a natural disaster. As parties find themselves without the coverage they expected after a catastrophe, it appears to be a natural reflex for them to look to their insurance agents and brokers to fill the perceived gap. Sometimes, this second wave is just a ripple. Katrina, following on the heels of a year that saw four major storms sweep through Florida, generated a veritable tsunami.

For the most part, the types of problems that lead to E & O exposure after an individual loss (such as a house fire) are the same we see after a catastrophe, just on a greater scale because of the number of people impacted—failure to procure a certain kind of coverage, failure to place coverage at all and failure to obtain adequate limits, are all frequently exacerbated by a lack of documentation in the agent's file to aid in their defense. (Richard Cole, of Cole, Scott and Kissane, a Florida law firm heavily involved in the defense of insurance agents in post-disaster E&O claims, says that “the key to winning a case brought against an insurance agent is, nine times out of ten, proper documentation...”)

To some extent, the claims following the string of hurricanes we experienced in 2004 and 2005, and particularly after Katrina, have their own characteristics. The number, severity, and landfall of hurricanes vary from year to year, but certainly exposure exists in most eastern and Gulf coastal areas during every season. Therefore, it is useful to look at the common causes of E&O claims, along with suggestions about possible ways to prevent or minimize the losses. It will be impossible to completely eradicate claims by clients who feel they lack the insurance coverage they needed to compensate them



following a natural (or manmade) disaster, just because we operate in a very litigious society. But following certain "best practices" could certainly help to eliminate some of the problems that lead to claims in the first place, and reduce the impact of the claims that are made. Before we embark on a discussion of the actual claims patterns, however, we want to ask:

How Prepared Are YOU?

Agents live and work in the same communities as their customers, and are just as vulnerable to the effects of a hurricane or other natural disaster. Not surprisingly, a number of agents saw their offices seriously damaged, destroyed, or made inaccessible after Katrina. What was a surprise was the number of agents that completely lost all of their records, did not have them backed up, and had no plan in place to resume business as rapidly as possible. This made defense of claims that were made against them particularly difficult, especially as key employees dispersed and were hard to contact.

The key is planning for recovery. While many agents' clients have disaster recovery plans, those same plans may be deficient among the agents. Disaster recovery planning is not new. There are many vendors available that provide temporary staff, technology, communications, connectivity, space, and power recovery after the unthinkable happens, relatively inexpensively. However, many agents don't perceive an exposure because they "are not near a flood plain", "don't live near the coast", or "have never been sued by a client". The fact is an agency needs a recovery plan, including off-site data storage, to cope with post-disaster losses not just to aid in their own defense, but to keep their business running efficiently.

Wind and Flood Coverage Problems

It can't come as any shock that following a hurricane, most E & O claims arise from some problem with wind or flood coverage, especially as the standard market restricts its writings in hurricane prone areas, making it necessary to obtain coverage through special markets, wind pools and the NFIP. Let's look at some of the specific issues:

◆ **No coverage in place at the time of the storm-delayed submission or failure to submit paperwork.**

Coverage is not effective in wind pools, the Fair Plan, or NFIP until the application AND premium payment have been received by the Plan. Many of the claims we have seen involved instances in which the insured agent took an application and premium payment from their client, and then for some reason delayed sending it in, or simply failed to do so at all. In other instances, it appeared that the paperwork was mailed, but the Plan claimed to never have received it, and there was no proof of mailing in the agent's file, or follow up to see what had happened when the policy was not timely received. By the time the problem was detected, either a

moratorium was in effect (as the storm approached the area), or the storm had hit and the damage was done. Beyond making sure that clients understand exactly when their coverage is to become effective (such as when the carrier receives and accepts the risk, when premium is paid, after any applicable waiting period, etc.) having clear written (and enforced) procedures in place for processing, placing and tracking business is essential for any agency. It sounds simple, but breakdowns in communication and process are a frequent cause of E & O claims. What procedure is to be followed once a producer takes an application? Is it immediately entered into a tracking system? Is it clear who is responsible for taking the next steps to get the application (and premium) to the appropriate carrier or plan? What process is in place to follow up if the policy is not received in a timely fashion from the carrier, and transmitted to the client? Are efforts to follow up documented? Do you maintain proof of mailing when critical time-sensitive documents are transmitted? Who checks the coverage to make sure it matches what was requested, and follows up to seek corrections if there are errors?

If you do not have written office procedures in place, there are vendors that provide off-the-shelf templates that provide an excellent foundation which can be customized to fit an agency's unique requirements. Once the procedures are established, it is important that all employees within an agency clearly understand them and that full compliance is required. Many successful agencies have quality-control measures in place to track compliance with the processed to assure that everything is running smoothly.

◆ **Evidence of Insurance provided at close of escrow before premium paid and submitted.**

Banks or other lenders typically require that insurance is procured to protect their collateral, and want assurance that required coverage is or

will be placed before they will proceed with closing on real estate transactions. In a number of instances, agents provided binders or other evidence of flood or wind coverage at the time of closing, before the premium was paid. However, while this practice is appropriate when a standard homeowner's policy is involved (because coverage can be bound by the agent without payment of the premium), no coverage placed with the wind pool or flood plan is effective until the premium is actually paid and submitted to the Plan. Further, the agent has no authority to bind the Plan to coverage. Thus, when the storm(s) struck just a short while later, there was no coverage in effect and the Plan(s) would not honor the unauthorized binder. The banks and property owners claimed that the binders led them to believe that coverage was actually in place, and that they did not understand that coverage was contingent on premium payment. Had they understood this, they claimed, they would have immediately tendered payment so coverage became effective. The error made is understandable, and also preventable. The agent can provide the coverage quote and other evidence of coverage that will be in place once the premium is paid, with clear notice that the coverage will not in fact become effective until that happens and the application and payment are received by the



plan. If there is a waiting period that may apply, this should also be noted. Of course, when the agent receives the premium, they should promptly submit it with the request for coverage to the plan, keep a record of the transmittal, and track on diary until policies have been issued and received

◆ **No contents coverage on wind or flood policy.** In some instances, the agent in question simply misunderstood that when a carrier moved to exclude wind coverage from the homeowners' policies they wrote in hurricane-prone zones that the restriction also applied to contents coverage. While they diligently replaced dwelling coverage in the applicable wind pool, contents coverage was not included, and when Katrina struck, the involved customers were consequently without wind coverage for their contents. More often than not, though, there was no record in the agent's file of a specific request for contents coverage, or no indication this had been offered and declined. When the client found themselves without contents coverage after the hurricane(s), they looked to their agent, raising a variety of allegations: that a specific request was not acted on; that the agent should have pointed out the need for the coverage; that the agent should have understood the client wanted/needed the same coverage they had on their homeowners policy, etc. These claims are difficult, as while the reality may be that the clients only procured the insurance their lender required (the dwelling coverage), they rarely will admit that is the case. Likewise, the nature of the relationship an agent has with his or her client may not place them in a position of having any duty to advise the client of the coverage they should have. However, having no documentation at all to counter the claims by the client can impair the ability to defend the agent, especially given the propensity of juries to "side" with the party they perceive to be a victim when there is an uncovered loss. Therefore, legal duty questions aside, it may be advisable for agents to document offers of coverage, automatically provide quotes for contents coverage when dwelling coverage is requested, quote wind and flood coverage, and then maintain documentation when the client declines the coverage offered. In addition to greatly enhancing the chances of a successful defense of an E & O claim, this practice could also increase agency revenues as customers accept the additional coverage offered.

◆ **No flood coverage at all.** This is very similar to the situation involving the lack of contents coverage. As has been highly publicized, many parties have claimed that they did not have flood coverage because their agent allegedly told them "they did not need it," either because the homeowner's coverage they had in place covered "hurricane damage," or because it was not "required." (Lenders require flood coverage to be in place typically only when property is in Flood Zone A). As in the case of contents coverage, the agent may not have a legal duty to offer the coverage to their client. However, if a written offer was made to every client in areas potentially subject to flooding, with the rejection of the coverage documented, it is very likely that many of the suits that arose would have been easily defended. Most parties in Mississippi and Louisiana are no doubt acutely aware of the need for flood coverage in certain areas even those that rarely saw flooding in the past. What about in other areas, such as the Northeast, that has not seen a serious hurricane strike for a long time. Would now be an excellent time to remind your clients of the potential exposure and provide quotes for the coverage?

◆ **No coverage for other structures or pool cages.** Citizens (in Florida), state wind pools, the Fair Plan and the NFIP have specific rules regarding how coverage applies to separate structures, docks, or as we most commonly saw, pool enclosures. In some instances, coverage must be separately applied for to be Insured, or specifically requested at the same time of application. It is extremely important to stay on top of each Plan's requirements and procedures, make sure that you ask the client the appropriate questions when taking an application, and document all conversations and transactions to avoid problems.



Inadequate Limits

Insurance limits that are insufficient to cover the clients' damage has long been one of the top causes of E & O claims, whether following on the heels of a catastrophe or not, but are magnified following a disaster because of the spike in construction costs that typically follows an event involving damage to many parties. There are a number of problems that commonly arise.

◆ **Inadequate dwelling or contents limits overall.** For the most part, we would like to say that it is the client's obligation to assure that the coverage they purchase is adequate to meet their needs. When the client specifies the limits to be obtained, there is *generally* no responsibility on the part of the agent to confirm that the amount procured is inadequate. It is when the agent supplies the limits or assists in their calculation that problems can arise. Then, the agent will likely be held to a standard of using reasonable care to assure that the limits selected are "correct." When they turn out to be insufficient, they are subject to attack by the client. Here are some of the more common problems we have seen in the limits arena:

- Agents estimate the square footage used to calculate replacement cost without verifying the correct amount
- Agents calculate replacement cost using a replacement cost estimating system, and do not adequately account for upgrades in the client's property, or use the short form calculator instead of the more detailed format.
- We have had clients say they asked for higher limits, and instead of turning the request into the carrier, the agent has told them that the amount generated by the "cost estimating" system is the maximum the carrier in question would offer, without referring the request to the carrier.
- Agents set limit based on purchase price, or ask for a real estate appraisal. The problem with this approach is that the cost to rebuild is not the same as appraised value, and the purchase price can be higher or lower than that cost. (This

could also lead to limits that are too high, in that appraisals typically include the value of the land on which the property sits).

- Owners advise the agent that they have engaged in property renovations, but this information is not forwarded to the carrier, and the limits are not reviewed for the adjustment that may be necessary because of upgrades made.
- In other instances, the agent maintains higher limits were suggested, but were declined by the customer, yet there is no written documentation in the agent's file of either the offer or the rejection.

◆ **The limits on the wind or flood policy are lower than those on the Homeowners policy.** We understand that the limits on the policies obtained are often the amounts the client requests, or are the minimum amount the client is required to carry by their lender. We also realize that while the homeowners' limits may be automatically increased by the carrier over time, this is not the case with the wind or flood policy. We are not suggesting that there is necessarily a legal duty on the part of the agent to assure the limits are consistent, but a "prevention" best practice would be to have clear documentation regarding how the limits were established, sending a letter to the client that they should let you know if they desire higher limits at any time, asking whether an adjustment is desired on the wind or flood policy when adjustments are made to the HO limit, and documenting the response

The main point to keep in mind when it comes to assisting a client with the establishment of limits is that if they end up being inadequate, you will be the first party they turn to for recovery of the difference. Attention to detail, accuracy and documentation are all critical, as well as employing the assistance of the carrier are all practices that will help minimize the impact of the E & O claims that will inevitably follow.

Coverage bound outside of carrier guidelines

Because carriers tend to limit their exposure in catastrophe prone areas, it is very important that agents with binding authority be very familiar with their carriers' guidelines and appetite to assure there is no violation of requirements. A fair number of the claims we have received over time are those by the carriers seeking recovery from the agent for the losses they sustained when the agent bound them to a risk that was ineligible for coverage and they were consequently required to respond to a claim.

Commercial Claims: The vast majority of claims we see after a catastrophe are generated by personal lines accounts. However, we do see some activity in the commercial arena. The more common problems leading to claims:

- No business interruption coverage
- No coverage for off premises power failure
- Lack of flood coverage at a particular location
- Application of a coinsurance penalty because limits were inadequate
- Inadequate limits because a policy has been changed from a blanket limit to a specified location limit, and the specific location limit is inadequate.

Do you employ the use of a written exposure checklist to aid you with identifying the coverage a commercial risk may require? Do you put all quotes and proposals in writing, and document any time the coverage is rejected by the client? Are all of the binders you issue authorized by the carrier, and if they are issued by an intermediary broker or the carrier, are they consistent with the coverage requested? Do you review applicable forms, and compare the policies issued with the coverage requested? These are all practices that may help minimize any E & O claim you may face.

This is a very broad overview of the claims made against insurance agents after the hurricanes of 2004 and 2005. As the 2007 season is upon us, now is a good time to review your procedures to see what you can do now to help you avoid the next "second wave."

ABOUT THE AUTHOR

Sally Combs is Technical Director for Fireman's Fund Insurance Company, where she oversees the Agents' E&O book on a company-wide basis. Fireman's Fund Insurance Company is the second largest writer of this coverage in the United States, and has seen considerable post-disaster E&O claim activity over the years.



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