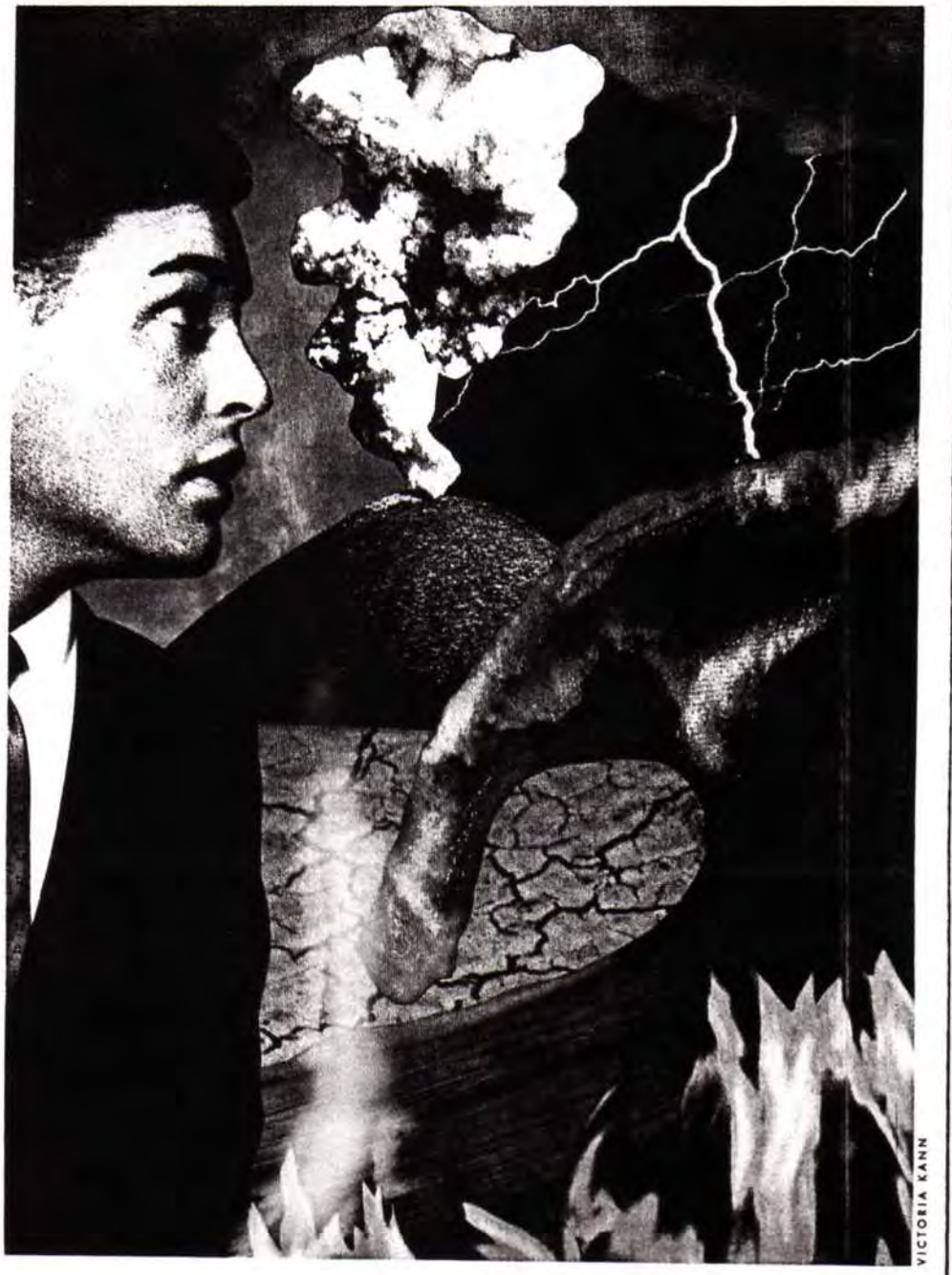
Planning for the Worst

BY JERRY HARGROVE

NATURE HAS NOT BEEN KIND TO the insurance industry. The floods that beset the Midwest this summer are one disaster in a long chain of natural calamities. The memories of Hurricane Andrew are not too distant. The damage was so colossal and the news coverage so thorough that everyone can recite the basics: more than 200,000 left homeless, entire crops wiped out, and damages totaling approximately $15.5 billion. Then, just three weeks later, a second hurricane, Iniki, devastated Hawaii. In a few hours, 10,000 homes and 70 hotels on the island of Kauai had been reduced to rubble. The bill this time: about $1.6 billion. When combined with other disasters that have plagued the United States in the last three years – Hurricane Hugo, the San Francisco earthquake, the Chicago flood and the Los Angeles riots, to name a few – the magnitude of loss is mind-boggling indeed.

Whether natural or man-made, disasters are taking an ever-greater toll on society. And as populations grow and industrialization proliferates throughout the world, it is reasonable to assume that this trend will continue, costing more and more each year in dollars, jobs and human lives. In fact, a recent study shows that, worldwide, the number of catastrophes and their victims has increased over the last few years. And yet, it is human nature for people to believe that disasters won't happen to them. Residential development contin-



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ues along the San Andreas Fault in California, for example, and less than 5 percent of homeowners nationwide have earthquake insurance, even though studies show that 39 states are at moderate to high risk for an earthquake.

This "it can't happen to me" attitude also extends to the corporate community. For example, many companies that employ risk managers direct them to spend most of their time on immediate loss-reduction efforts. Although these are essential risk management tasks, companies must not overlook the importance of protecting their assets through a comprehensive disaster preparedness plan. In essence, the plan must help risk managers assess which disasters are most likely to affect the company, institute the appropriate protections and contingency plans, and ensure that insurance will provide the coverages the company needs to continue operations.

CONSIDERING COMPANY LOCATION

Creating a contingency plan first requires risk managers to determine which disasters are most likely to occur in the areas in which their companies are located or will be located. This is because particular geographical regions are susceptible to certain types of disaster. A hurricane isn't likely to level parts of Nebraska, for example, but an ice storm could do real damage. Similarly, a volcanic eruption may not bury New Orleans anytime soon, but a tornado traveling up the Mississippi River could flood the city in a matter of hours. Determining which disasters are most likely to affect the company allows the risk manager to create a disaster plan tailored to these risks.

An effective method for determining the risks that threaten a firm is hazard analysis. Through hazard analysis, risk managers consider not only the obvious risks to their companies (such as the danger earthquakes pose to a company located in San Francisco), but also other risks that could conceivably cause a major business interruption. A hazard analysis will usually reveal a list of potential disasters, along with their direct and indirect effects.

These indirect effects might include the disaster's impact on a company's clients or its suppliers. For example, had Floridian farmers been able to save their crops from Hurricane Andrew, there still would not have been facilities to process and pack them, much less open roads through which they could be delivered. A good disaster preparedness plan takes such possibilities into account and creates strategies for dealing with them.

IF YOU DON'T HAVE A PLAN

The failure to conduct a disaster analysis can leave a company unprepared, thus creating the potential for a significant loss. An example of such a situation involved a company that relocated from Washington, D.C., to the Orlando, Florida, area. Citing lower operating costs, lower taxes and a desire to be closer to many of its customers, the company built a sprawling complex in a new office park. Plans for the grounds included a lake, which was to serve as a drainage pond as well as an aesthetic component.

However, the company's risk managers failed to consider the area's high water table. Excavation for the lake went deeper than it should have, and water poured into the completed building's first two levels – part of a parking garage. The company was forced to pay not only for the redesign and repair of its lake, but also for dozens of automobiles owned by its employees.

To prevent the loss, the company's risk managers could have researched past and recent floodplain history, and ordered an engineering study to determine the depth of the water table. They also could have asked their insurer for relevant loss data on properties in the area. Had they taken these steps, they might have decided to handle the drainage problem in a different way; they might even have decided to build in a different location.

When conducting the hazard analysis, risk managers must also ensure that

STEPS FOR FLOOD PROTECTION

According to Tom Hollowell, vice president and manager of the adjustment division of the Factory Mutual Research Corp. in Norwood, Massachusetts, flood protection falls into three categories: permanent protection, contingency protection and emergency procedures. Permanent protection refers to preventive measures that are always in place and require little or no human action to remain operational. Examples of permanent protections include flood walls and dikes. However, the cost of building these barriers must be weighed against the flood damage potential. For example, a facility within a 100-year flood zone that has high-value equipment with low-salvage potential might warrant such protection. (Flood severity is expressed by its recurrence interval. The greater the time interval, the greater the severity of the flood.)

Other, less expensive permanent protection measures include bricking up ground-level windows (only halfway if low-level flooding is expected); installing flood doors of aluminum, steel or wood, which can be suspended above doors and windows by pulleys or counterweights mounted on rails and then rolled into place before the flood strikes; installing hand-operated valves in piping to prevent backflow through floor drains or plumbing fixtures; and building low walls or curbs around vital equipment such as boilers, furnaces, computers and switchgear boxes for protection against any water that seeps into the building.

Contingent protections are measures used on a contingency basis as opposed to those that are permanently installed. The primary form of contingency protection is flood shields, which involve permanently mounting brackets on door and window frames so that shields can be quickly bolted into place. This level of protection is advisable in areas where some warning is given before a flood.

The third type of flood preparedness is emergency protection. Companies should consider these measures only in areas where very early flood warnings can be expected or where flooding is possible but unlikely. Emergency protection measures include sandbagging building entries; relocating stock, particularly high-value or operationally important items; covering large, stationary machines with water-displacing, rust-preventive compound or large plastic sheets; and filling empty storage tanks to prevent them from turning into floating battering rams.

they do not overlook certain risks that may seem to be inconsequential. One such risk is environmental damage. For example, a Northern Virginia developer who purchased a tract of land on which to build town houses didn't take the time to find out how the land had previously been used. Had he done so, he would have found that his intended building location was once the site of a paint factory.

Not knowing this, the developer went ahead with his plans and erected and sold the first dozen town houses on his site. During excavation for the second set of homes, however, a barrel of hazardous material surfaced. Home owners contacted the Environmental Protection Agency, who then conducted an investigation. Because the land's previous owner was deceased and none of his relatives was accountable, the developer was held liable for more than $3 million in cleanup costs. To prevent similar situations, corporate risk managers should ask the real estate broker or financial institution involved in the purchase of a new property to conduct a land-use survey. This survey should reveal all prior land uses, thereby eliminating the possibility of any unpleasant surprises later on.

Many firms also overlook another potentially dangerous hazard – earthquake zones. According to the U.S. Geological Survey, by the year 2000, the chance that a major earthquake will occur along the New Madrid Fault, which covers a five-state area of northern Tennessee, eastern Arkansas and the southern portions of Missouri, Kentucky and Illinois, is between 40 and 63 percent. By the year 2035, the risk climbs to around 90 percent. That means that business locations in this area all stand an excellent chance of devastation when the quake occurs. Many companies are ill-equipped to deal with the effects of such a calamity. However, if these firms conduct a hazard analysis, they will realize the danger an earthquake poses and prepare accordingly.

Creating Contingency Plans

Once risk managers create a list of potential disasters that could affect their firms, the next step is to determine the minimum requirements that must be met so the company can create contingency plans for the resumption of business operations. To accomplish this, the risk manager should ask departmental heads to specify what they need to keep their departments operational, including crucial employees, files and other forms of information.

Increasingly, companies are taking advantage of new technological developments that allow them to preserve vital data. Many organizations, such as law firms, accounting offices and banks, rely heavily on historical data. These companies should therefore establish secondary data sites where information can be stored, replicated and/or retrieved. In some instances, an offsite warehouse may be adequate. In other cases, however, companies may wish to use hot sites, which are sophisticated interim offices containing computers and PBX services that can be used as backup facilities.

Either way, risk managers may want to coordinate data communications so that if one site is damaged, another can swing into action. Just as phones can be programmed to roll calls to another line, the same can be done with data. Of course, a more immediate concern is data backup: employees should be instructed to back up their data on a daily basis.

Companies that remain operational in the immediate aftermath of a disaster often create unexpected marketing opportunities for themselves. For example, a grocery chain that devises a plan to reopen its stores quickly after a disaster may create tremendous goodwill in the community by serving as a message center and meeting place. An early opening could also create an opportunity to gain market share.

Certainly, formulating a disaster plan that protects the company's physical property is vitally important. However, preserving other highly valuable assets, including employee safety and morale, should also be part of any disaster preparedness effort. For example, helping employees return to work as soon as possible after a disaster benefits everyone concerned. The plan should contain the home phone numbers and addresses of all employees. Also, designing a blueprint for families to use in creating their own disaster preparedness plans is a good way for companies to show they care while at the same time protecting their workers.

Even the best disaster preparedness plan is doomed if there is no insurance. And while most large companies do have various forms of coverage, they often don't have enough business interruption protection; many companies rely too heavily on the coverage built into their standard policies.

FIRES AND FLOODS

Planning for disasters also requires instituting preventive measures. One disaster that risk managers frequently do plan for is fire. Fire mitigation methods include installing indoor sprinkler systems, complying with building fire codes and creating an employee evacuation plan. Although these measures are certainly crucial for fire safety, other important steps are often overlooked. For example, many companies don't take into consideration some important information that is now known about how fires spread – central air conditioning ductwork is the chief path by which most catastrophic fires travel. To that end, building codes typically require that every rated partition have a damper that shuts down when a fire alarm activates. Risk managers should take an active role in reviewing the ductwork for the inclusion of dampers and be present when they are tested.

Careful consideration of building materials is also important for fire protection. Although modern materials are stronger and lighter in weight than many of those used in the past, they are not necessarily more flame-retardant – just the opposite, in fact. Interior walls, once several inches thick and made from brick or wood and plaster, now typically consist of newspaper-filled wallboard nailed to a wooden framework. In addition to the obvious fire risks posed by these highly flammable materials, the space sandwiched between the Sheetrock provides another avenue for fire to travel.

The risk that accompanies the use of modern building materials and practices was well illustrated by a disastrous fire that took place a few years ago in Philadelphia. There, a fire began on the bottom floor of an eight-story office building that was under construction. Using the ventilation system as its main artery, the fire engulfed all eight floors in a matter of minutes, utterly destroying the structure. Ironically, the building was owned by an insurance company.

Of course, no building is fireproof, except perhaps a concrete pillbox without furniture. But careful attention to disaster prevention and preparedness can greatly lower risk. Risk managers should familiarize themselves with all applicable local, state and federal building codes. They should also direct architects and engineers to meet or exceed requirements for fire and safety codes by employing the most fire-resistant materials and designs available. Disregarding building specifications by using a three-ply door when a five-ply is called for, or using a cheaper door reinforcement than the one recommended, may cut costs during construction. However, those costs will return exponentially should a disaster occur.

Inferior building specifications can also be problematic in disasters other than fire. For example, last year in Florida, engineers who studied the damage caused by Hurricane Andrew concluded that enforcement of stricter building codes – and indeed, in some instances, simple adherence to existing codes – would have saved thousands of structures from total ruin. Several insurers have sued certain Florida builders for shoddy workmanship, misapplication of building materials and other code violations. Building codes, meanwhile, are being revised to require plywood to be used where particleboard was once acceptable, and for the use of hammers and nails in place of staples.

Besides fire protection, companies

can also take several steps to mitigate flood damage. Often arising from the overflow of inland or tidal waters or from excessive rains or erosion, flooding is also caused by other disasters such as hurricanes. In the aftermath of the widespread flooding in the Midwest earlier this year, it is sobering to note that, according to the Federal Emergency Management Agency, 90 percent of all disasters are flood-related. Therefore, companies should include flood prevention measures in their disaster plans. (See sidebar.)

Insurance Coverages

Even the best disaster preparedness plan is doomed if there is no insurance. And while most large companies do have various forms of coverage, they often don't have enough business interruption protection; many companies rely too heavily on the coverage built into their standard policies.

Risk managers must therefore augment their standard commercial coverage with policies that cover their specialized exposures. There is a tendency for companies to take the easiest route and go with off-the-shelf insurance packages. Often, however, those coverages aren't broad enough to cover every need. For example, a number of stores in Los Angeles' South Central area had little or no crime insurance when the riots occurred. Some of the stores had no business insurance at all, even though a standard business owners' policy sells in the area for as little as $750 in annual premium.

Flood insurance represents a special problem because property policies typically do not cover floods. Most businesses obtain flood coverage through the National Flood Insurance Program (NFIP), which was created in 1968 to provide flood insurance in high-risk areas. However, anyone can purchase NFIP flood insurance, including businesses and homeowners. The NFIP also reports that it will issue policies to companies or individuals regardless of how many times their property has been flooded, provided that the local community is participating in the NFIP.

Risk managers should assess their company's unique needs and ask their agents to recommend specific coverages. Once that is done, it is up to the risk manager to inform the company of the agent's recommendations and implement them if possible. Should the company decide not to purchase the specialized coverage, risk managers should protect themselves and their insurers by notifying the insurers in writing and sending a copy to the company decision-maker. Of course, in some instances, federal disaster relief programs come to the aid of those with little or no insurance. Should a company qualify for such assistance, its risk manager should know which of its assets would be covered, and where to go for assistance.

Once these items are completed, risk managers have taken a major step toward protecting their companies to the fullest extent possible. However, the risk manager should not overlook another important aspect of disaster preparedness: cooperation between the company and the insurance agent. Normally, insurers and their agents try to be as helpful as possible after a disaster. However, there are certain things risk managers can do to expedite the claims process. First, when filing a claim, the risk manager must provide all the information that the insurer requires. Secondly, risk managers should keep the name and phone numbers of their insurers at home as well as at the office, and have all policy numbers readily available. It is also helpful to give the agent or insurer the risk manager's home phone number and address. Depending on the nature of the disaster, a claims adjuster may find it easier to reach the risk manager at home than at the office.

When preparing for disasters, it is always important to realize that a disaster can strike at any time, no matter how well-prepared a company may be. Whether it is a tornado, flood, hailstorm or fire – sometime in the life of a company, a disaster is likely to strike. Taking the time to plan now can save lives and millions of dollars. When it comes to disaster preparedness, knowledge is power. Risk managers must use that power to do all they can to protect their businesses and, ultimately, the lives on which they depend. RM