

## From the Chairman

by Patricia A. Hannemann, CPCU



■ **Patricia A. Hannemann, CPCU**, is chairman of the CPCU Society's Risk Management Section. Her insurance career consists of more than 20 years' experience working in agencies and companies. Currently, she is working with The Insurance Society of Baltimore in promoting and teaching various insurance classes. Hannemann served as the CPCU Society's Maryland Chapter president, and chaired both the Public Relations and Good Works Committees. The Maryland Chapter's CPCU Excellence Award was presented to her for spearheading the Good Works Committee and establishing the chapter's scholarship fund in connection with the SADD organization. Serving on the CPCU Society's Chapter Awards Task Force, she helped create and judge the current Circle of Excellence Recognition Program. Hannemann received her CPCU designation in 1987, and holds bachelor's and master's degrees in music from the Manhattan School of Music, and a master's degree in business from Johns Hopkins University.

**F**or those of you who have been waiting in breathless anticipation for the next issue of our RMQ, here it is. Hopefully we will soon be back on our regular schedule of providing you with intriguing articles, new material to accelerate your mental capacity, and topics to pique your interest. In this issue I am proud to announce a couple of new authors who will be contributing articles on a regular basis.

We are starting a new column by **Jerome Trupin, CPCU, CLU, ChFC**, who will be enlightening us about what really happened to our insurance language when ISO decided to simplify it. As many of you know, at that time, most everything we knew and loved went out the window. After years of working with this new language, we often ask ourselves, is it really simpler now? Trupin will be taking words and phrases of yore, and attempting to explain what happened.

Being called the Risk Management Section, it is time we start featuring more articles on the subject near and dear to our hearts. Therefore, **Michael J. Moody, ARM**, who writes articles for *Rough Notes*, will be a regular contributor to our RMQ on one of his favorite topics, enterprise risk management (ERM). In this issue he is providing us with a short introductory article about ERM.

The Risk Management Section Committee recently held its mid-year meeting in Phoenix, AZ. For those of you wondering if we were there when it was hot, yes, we were there when the thermometer decided to strive for the 100-degree mark. My only comment is, I don't care if it is dry—**It's still hot**. During our meeting, in nice air-conditioned rooms, we discussed where

we are to date and how far we have to go to meet the remainder of our goals. During the meeting we discussed such items as our role at the CPCU Society's Annual Meeting and Seminars in Nashville, our committee needs, potential workshops, our updated web page (thanks to Marty Frappolli) and our attempt to again attain the Gold Circle of Excellence (last year we received our first).

Special thanks to **Jerome Trupin, CPCU, CLU, ChFC**, and **Richard G. Berthelsen, J.D., CPCU**, as the Risk Management Section is presenting two seminars at the CPCU Society's Annual Meeting and Seminars in Nashville. As a section member, please make every effort to attend these sessions to show your support. The first session on Monday, September 11, from 1:30 to 3:30 p.m. is in connection with the IT Section and titled, "Predicting and Preparing for Disasters—A Case Study Approach." The second one is on Tuesday, September 12, from 8 to 10 a.m., and titled, "Employee Dishonesty and Employee Theft: Coverage Choices for an Often-Overlooked Exposure."

Finally, at the meeting in Phoenix, the committee decided one of our main goals is to provide risk management material for the non-risk manager. So our question to our membership is: how can we better serve you and exactly what type of risk management material can we supply to help you on a daily basis? Without your suggestions we go along our way without knowing if you are being properly served. Therefore, we need you to help us decide some of our future goals and let us know how we can help you. Stop by the Sections Booth in Nashville and chat with us or send me an e-mail to david.patricia@verizon.net. ■

# From the Editor

James W. Baggett Jr., CPCU, CIC



**A**s we prepare for the CPCU Society's 2006 Annual Meeting and Seminars, your Risk Management Section will be developing one seminar and co-developing another with the Information Technology Section. One of our regularly contributing authors will be presenting two other programs.

The Risk Management Section will present along with the Information Technology Section, "Predicting and Preparing for Disasters—A Case Study

Approach." **Richard G. Berthelsen, J.D., CPCU**, our section liaison with the AICPCU/IIA, will moderate; **Andrew Castaldi**, with Swiss Reinsurance Group, and **W. Paul Taliaferro, CPCU, CPA**, with Farmers Alliance Companies, will also participate. Risk Management Section committee member **Jerome Trupin, CPCU, CLU, ChFC**, will be on the panel dealing with the subject of employee dishonesty and employee theft. Also, one of our regular contributing authors, **Hamid Mirsalimi, Ph.D.**, a principal in DBH Consulting, Inc., will be presenting two programs dealing with leadership and career development.

Articles included in this edition are by **Earl D. Kersting, CPCU, ARM, ALCM, AU, AIC, AIS, AAI**; **Donald S. Malecki, CPCU**; **George L. Head, Ph.D., CPCU, ARM, ALCM, CLU**;

and **Michael J. Moody, ARM**, as well as the above-mentioned **Hamid Mirsalimi, W. Paul Taliaferro, CPCU, CPA**, and **Jerome Trupin, CPCU, CLU, ChFC**, dealing with subjects as diverse as claims litigation, disaster recovery, and new policy terminology.

The Risk Management Section has worked diligently this past year to give you timely and useful articles on topics of immediate importance, as well as to provide quality educational opportunities at this year's Annual Meeting and Seminars. We invite all section members to attend our seminars and to become more actively involved in the Risk Management Section. We on the Risk Management Section Committee look forward to meeting many of you, our section members, at the CPCU Society's 62nd Annual Meeting and Seminars! ■

## Don't Miss these 2006 Annual Meeting Seminars Developed by the Risk Management Section

### Predicting and Preparing for Disasters— A Case Study Approach

Monday, September 11 • 1:30 – 3:30 p.m.

Tough times call for smart solutions. Given a disaster scenario common to many organizations, the speakers will describe the types of predictive modeling used in managing risk and will illustrate how to perform a business impact analysis; develop prevention and mitigation strategies; draft a formal business continuity plan; train personnel to execute the plan; and test the plan and correct any deficiencies.

#### Presenters

**Richard G. Berthelsen, J.D., CPCU**  
American Institute for CPCU/Insurance Institute of America  
(moderator)

**Andrew Castaldi**  
Swiss Reinsurance Group

**W. Paul Taliaferro, CPCU, CPA**  
Farmers Alliance Companies

### Employee Dishonesty and Employee Theft: Coverage Choices for an Often- Overlooked Exposure

Tuesday, September 12 • 8 – 10 a.m.

Have you heard the one about the school board employees stealing \$11 million? How about the printing firm bookkeeper who stole \$2.3 million? Or the hotel controller who pocketed \$14 million? The list goes on and on. This seminar will highlight some of the major embezzlements of the past few years from small- and mid-size firms.

#### Presenters

**David A. Lewis, J.D., CPCU**  
GE Insurance Solutions

**Kevin M. Mattessich, J.D.**  
Cozen O'Connor's

**Jerome Trupin, CPCU, CLU, ChFC**  
Trupin Insurance Services

**Register today for the  
2006 Annual Meeting and Seminars at [www.cpcusociety.org](http://www.cpcusociety.org)!**

# Enterprise Risk Management: Just the Next Fad?

by Michael J. Moody, ARM

■ **Michael J. Moody, ARM**, is the managing director of Strategic Risk Financing, Inc. (SuRF). SuRF is an independent risk management-consulting firm that was formed in 1986 to assist clients in determining the most cost-effective approach for their risk management programs. Recently, SuRF has been actively involved with the promotion of enterprise risk management by providing current, objective information about the concept, the structures being used, and players involved in the ERM movement.

Moody has been involved in insurance and risk management for more than 20 years. He is a frequent speaker and writer on various risk financing and enterprise risk management topics, and currently has a monthly byline column on enterprise risk management in *Rough Notes* magazine. He can be reached at [mmoody1222@yahoo.com](mailto:mmoody1222@yahoo.com).

One concept that has gathered significant attention over the past four or five years is enterprise risk management (ERM). It's difficult to read any industry publication today that doesn't talk about some aspect of ERM. The problem is that while there is a lot of discussion about this topic, few people, due to the evolving nature of ERM, actually understand what it is. In that regard, I have agreed to address this topic in future issues of the *Risk Management Quarterly* newsletter.

I would like to provide some information that will set the stage for future articles. Future issues of *RMQ* will provide reprints of ERM articles that have appeared in *Rough Notes* magazine. I have been writing about ERM for the past four years in my monthly column in *Rough Notes*, and these articles will serve as the basis of upcoming newsletter articles. I will include an introduction to the reprinted article and will also add any new or updated information that may be required.

## ERM Basics

It is also difficult to know where to start an article on a topic that is as broad as enterprise risk management. This is made more difficult by the fact that ERM is still an evolving specialty. Rather than jumping into the definitions, steps, etc. of ERM, I think it is important to discuss why there is so much interest in ERM—an interest that has increased significantly over the past six months. As with any new management concept, there is, in fact, a number of reasons for this amplified interest; however, I would like to just highlight a couple of the major reasons.

Shortly after the world welcomed in the new millennium, information began to emerge about improper conduct by a number of large corporations. As time has progressed, companies like Enron, Global Crossing, Tyco, and WorldCom have become all too familiar with U.S. investors. Unfortunately, it was not until after a number of these firms went

through bankruptcy that the full scope of the problem was realized. Following these widely publicized events, many in the investing community began to question the validity of the current financial reporting standards. News sources began to talk about a “crisis in confidence” that the financial markets were sustaining. In an attempt to head off this potential train wreck, Congress passed and the president signed the Sarbanes-Oxley Act of 2002 (SOX).

SOX was a very broad and wide-sweeping legislative act that placed accountability squarely on the shoulders of the board of directors, the chief operating (CEO), and chief financial officers (CFO). There are many parts of the act that were specifically drafted to reinforce the burden of trust on these executives. However, one of the key portions of the act is Section 404, which requires that the CEO and CFO each sign and personally attest to the validity of the information provided in the company's financial statements. Over and above this requirement, the board was also responsible for knowing what major risks were facing the company and what plans were in place to handle these material risks.

Subsequent to the passage of SOX, several other important players have moved to bolster their position with regard to accountability for corporate officers and directors. Heading this list was the New York Stock Exchange (NYSE), which now requires publicly-traded companies that are listed on the NYSE to have a formal plan for handling their risks.

While there are a number of ways to comply with the requirements of SOX, NYSE, et al, many experts believe that one of the most appropriate methods to respond to these requirements is to implement an ERM program. Thus ERM has received significant attention since the financial disasters of the past few years.

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# Enterprise Risk Management: Just the Next Fad?

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A recent development that has occurred over the past six months is the involvement of the rating agencies. Shortly after the first of the year, rating agency giant Standard & Poor's (S&P) announced that it would begin incorporating an assessment of insurance companies' ERM efforts as part of its overall rating analysis. Subsequent to this announcement, S&P has made public its rating criteria and confirmed that it will begin using it in its rating process. S&P has also indicated that it will begin considering ERM programs in analyzing other industry segments as well. Other rating agencies, such as Moody's, have also signaled that they will begin to utilize ERM analysis as part of the overall rating methodology. Additionally, one other potentially larger consideration is the fact that several debt providers have indicated a desire to review a company's ERM program as part of the due diligence process prior to approving new financing.

An additional reason for the current interest in ERM can be found in a recent study by the Conference Board, which provided some added insight into why companies are moving to a more holistic approach for risk management. The Conference Board research indicated that companies that have already implemented ERM have reported a significantly higher level of value added for their organizations. The top three value-added benefits noted by the Conference Board included better-informed decision making, greater management consensus, and increased management accountability. It further notes that those companies that embraced ERM are better able to improve management practices, such as strategic planning, and have a greater ability to understand and weigh risk-reward equations in their decisions.

## Summary

While there are a plethora of reasons to adopt ERM, the most telling is quite simply—it works. The banking industry provides the best example. Banks have been the most proactive when it comes

to implementing ERM programs. For a variety of reasons they were early adopters of the ERM concept, and today are quite comfortable with the results. In fact, the banking industry should be the role model for ERM. If you looked at banks prior to the mid-1980s, you would note the significant volatility experienced in their results. The reasons for the volatility were many and varied: emerging markets, developing countries, real estate speculation, and the list goes on and on. But they always ended the same way, a string of charges and massive write-offs. Many banks realized that they needed a different approach to risk management, a holistic view of their risks, and began to develop and implement ERM programs. As a result, banking, as an industry segment, has made a real comeback. In the early 1980s, the average return on equity for most banks was in the 10 percent to 12 percent range. Over the past 20 years, banks have found ways to remove much of the volatility that hampered them in the 1980s, and now you find they are able to have a return on equity in the 18 percent to 22 percent range.

For the most part, corporate America is just beginning to understand and implement ERM programs. And while the results are still heavily anecdotal, there is little doubt that ERM will become a permanent part of the business lexicon. While a business case can be made for the value-added aspects of ERM, outside pressure to embrace it are now also coming from many quarters. If you have anything to do with risk management in your current position, or you are working for an insured in a risk management capacity, you should follow the advances that are being made in ERM. We will try to address some of the basics in future issues of the RMQ. In the meantime, should you wish additional information, feel free to read past articles in *Rough Notes* ([www.roughnotes.com](http://www.roughnotes.com)) or review the ERM information at [www.ART-Solutions.info](http://www.ART-Solutions.info). ■

# Ethical Decision-Making in Organizations

by Hamid Mirsalimi, Ph.D.



■ **Hamid Mirsalimi, Ph.D.**, is a founding principal and consultant with DBH Consulting. He is also on the faculty at the Georgia School of Professional Psychology at Argosy University.

On October 25, 2005, during the CPCU Society's 61st Annual Meeting and Seminars, a panel of professionals with diverse backgrounds addressed the topic of "How Behavior and Decisions Are Impacted by Leadership, Corporate Culture, and Ethical Guidelines." Given that a number of major U.S. corporations, such as Enron and WorldCom, were experiencing scrutiny regarding their corporate decisions and behaviors, and given the troubles that had been recently highlighted about Marsh & McLennan, the panel discussion provided a timely focus on what shapes ethical decision-making in corporations in general, and in insurance organizations in particular. In addition, the impact of ethical and unethical practices on corporate clients was discussed as well.

The panel was moderated by **Demmie Hicks**, the president and CEO of DBH Consulting, Inc. Panel presenters were **James R. Pender, CPCU, CLU, ChFC**, of Oswald Companies; **Marjorie Fine Knowles, J.D., Ph.D.**, of Georgia State University, **Lori Taylor** of Coca-Cola Enterprises, Inc., **Hamid Mirsalimi, Ph.D.**, and **Maureen H. Hunter, Ph.D.**, both of DBH Consulting, Inc.

**James R. Pender, CPCU, CLU, ChFC**, chairman of the board of the Oswald Companies, shared his insights from the perspective of an insurance executive and leader in the industry. He stated that in insurance organizations a set of priorities need to be routinely established, priorities that have to do with the following three questions:

1. Are we acting in the best interest of our client?
2. Are we acting in the best interest of our partners and associates? (This includes the person in the next office, external advisors, suppliers, etc.)
3. Are we acting in the best interest of the community at large? (This includes issues such as our regional economy, our support of health, education, and arts, etc.)

Pender argued that until these questions are asked and priorities are established, there is not much point in moving forward. He asserted that ethical living is a matter of habit; it is a question of trying to do the right thing over and over again, in the workplace, the neighborhood, the place of worship, the school, etc. He pointed out further that ethical living must take place out in the community and is not done in solitude; that ethical living must be no different when at work or at play, in our homes or away, at our place of worship, or at the "corner bar." Finally, he shared his wisdom that ethical standards are usually enhanced when we make a habit of forgiving ourselves and others. He concluded by a compelling story about an insurance executive who made the choice to personally help one of his employees who suffered during the Hurricane Katrina disaster, and the example that it set for his employees, and the contribution that it made to the culture of his company.

**Marjorie Fine Knowles, J.D., Ph.D.**, professor of law and former dean of the College of Law at Georgia State University, who has served as a member of board of directors in a number of

corporations, including chair of the TIAA-CREF Committee on Corporate Governance and Social Responsibility, discussed ethical decision-making from the perspective of board of directors of corporations. She highlighted two important responsibilities of any board:

1. To have ethical decision-making at the forefront of their decision-making practices.
2. To ensure that their views, regarding appropriate and ethical corporate behavior, are trickled down throughout the organization.

Without appropriate dissemination of information regarding the board's position on ethical behavior, the employees might live with their own beliefs about how they should conduct themselves, or make assumptions about the wishes of the board, assumptions that may be incorrect and ethically inappropriate.

**Lori Taylor**, vice president of risk management at Coca-Cola Enterprises, Inc., discussed her relationship with some of the insurance agencies with which she had been working. She explained, from the perspective of a corporate client, how observing unethical behavior of the insurance agency representatives creates a wedge of trust that is hard to overcome. She explained that when she perceived agency representatives trying to steer the insurance needs of Coca-Cola Enterprises to their favored insurance underwriters, she lost trust in them realizing that they no longer had Coca-Cola Enterprises' interests in mind. The consequence: the agencies lost the business of Coca-Cola Enterprises! Taylor's presentation was a great testament that ethical behavior and good business are profoundly intertwined.

**Hamid Mirsalimi, Ph.D.**, a clinical psychologist, and principal consultant at DBH Consulting, commented on human behavior and different ways that individuals reach ethical decisions. Citing research by Harvard psychologist

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# Ethical Decision-Making in Organizations

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Lawrence Kohlberg, who conducted research on how boys and men approach ethical dilemmas, Mirsalimi explained that, at least for men, three approaches in ethical decision-making have been identified:

1. Ethical decision-making based on fear of punishment or wish for a gain/reward.
2. Ethical decision-making based on fear of how colleagues might approve or disapprove of one's behavior.
3. Ethical decision-making based on agreed-upon societal rules and rights, and personal ethical principles.

While that research is limited in scope because it only explored ethical decision-making in boys and men, it does illustrate that individuals, at any moment in their decision-making process, may engage

in one or another of the above three approaches. Given that the last approach to ethical decision-making (i.e., ethical decision-making based on agreed-upon societal rules and rights, and personal ethical principles) is more likely to lead to ethical behavior, an awareness of our choices in any ethically challenging situation, is likely to help us make better decisions about what we ought to do.

**Maureen H. Hunter, Ph.D.**, an organizational psychologist, and principal consultant at DBH Consulting, provided insight on the profound impact of organizational culture on the individual member's ethical behavior. Hunter discussed how the culture of an organization is shaped by stories that are often talked about regarding the conduct of various influential leaders of the organization. Such stories are at the

heart of the organizational culture as they implicitly define what an organization's ethical belief system is. A story about unethical behavior for the financial gain on the part of an organization leader is likely to perpetuate the idea that the financial bottom line always supersedes ethical behavior; on the other hand, stories about ethical conduct by leaders perpetuate the notion that ethics come first, and that the organization's success is indeed tied to ethical behavior.

After presentations by individual panel members, the moderator, **Demmie Hicks**, the president and CEO of DBH Consulting, provided thematic links among the presentations, and asked important follow-up questions from each member of the panel. The session ended with a question-and-answer period between the audience and panel members. ■

## What Were Their Names?

by Jerome Trupin, CPCU, CLU, ChFC

■ **Jerome Trupin, CPCU, CLU, ChFC**, is a partner with Trupin Insurance Services. He holds a B.S. from the School of Management at Syracuse University and an M.S. from the Graduate School of Business at Columbia University. Trupin has acted as an adjunct instructor at Westchester Community College, St. John's University, Tobin Business School (formerly The College of Insurance), Marymount College, and Iona College. He's the educational coordinator for the CPCU Society's Westchester Chapter, past president of the Westchester Chapter, and past president of the North Jersey Chapter. Trupin is a licensed insurance agent/broker in New York, a licensed insurance producer in New Jersey, and a licensed insurance consultant in New York, and has been a principal and contributing author on numerous publications.

**H**ere are two standard fire policy conditions that were renamed when ISO issued its simplified language forms in 1986:

### **From Common Commercial Property Conditions CP 00 90 07 88**

#### **Transfer of Rights of Recovery Against Others to Us**

If any person or organization to or for whom we make payment under this coverage part has rights to recover damages from another, those rights are transferred to us to the extent of our payment. That person or organization must do everything necessary to secure our rights and must do nothing after loss to impair them. But you may waive your rights against another party in writing:

1. Prior to a loss to your Covered Property or Covered Income . . . This will not restrict your insurance.

### **From Common Policy Conditions IL 00 17 11 98**

#### **Transfer of Your Rights and Duties Under this Policy**

Your rights and duties under this policy may not be transferred without our written consent except in the case of death of an individual named insured.

*The similarity in the titles of these two provisions can be a source of confusion. What were these provisions called in days of yore? (Answer on page 10.)* ■

# Contractual Liability: To Transfer or Not To Transfer: That Is Part of the Question

by Donald S. Malecki, CPCU



■ **Donald S. Malecki, CPCU**, is a principal at Malecki Deimling Nielander & Associates L.L.C., based in Erlanger, KY. During his 45-year career, he has worked as a broker, consultant, archivist-historian, teacher, underwriter, and insurance company claims consultant; and as publisher of *Malecki on Insurance*, a highly regarded monthly newsletter. Malecki is the author of 10 books, including three textbooks used in the CPCU curriculum. He is past president of the CPCU Society's Cincinnati Chapter; a member of the American Institute for CPCU examination committee; an active member of the Society of Risk Management Consultants; on the Consulting, Litigation, & Expert Witness Section Committee of the CPCU Society; and a past member of the Commercial Lines Industry Liaison Panel of the Insurance Services Office, Inc.

**C**ontractual risk transfer has many aspects to it that are not often understood. For example, contractual risk transfer is commonly thought to involve three parties:

1. The indemnitee who is seeking to transfer the financial consequences of its negligence.
2. The indemnitor who accepts the contractual risk transfer from the indemnitee.
3. A third-party who is injured because of the indemnitee's negligence.

In actuality, however, injury or damage sustained by a third party is not necessary with all contractual risk transfers. In many cases, two parties are only necessary. Contractual assumption under a lease agreement, for example, can involve solely the landlord (indemnitee) and the tenant (indemnitor). The landlord who requires the tenant to hold harmless and indemnify the landlord for its negligent damage to the tenant's property is an example of a two-party exposure. The effect is the same as a one-sided waiver of subrogation in favor of the landlord.

Other types of agreements involving two parties are easements or license agreements, agreements required by municipalities, except in conjunction with construction work, railroad sidetrack, and elevator maintenance agreements. Another important point is that few laws restrict the degree of the fault (i.e., sole or partial) that may be the subject of these agreements.

When it comes to construction work, the situation is somewhat different, in part because contracts involving this kind of work are, for the most part, regulated. Nonetheless, opponents of contractual risk transfers would have people believe that most states have statutes holding void and unenforceable sole and partial hold-harmless agreements. This is only

partially true. If one were to read each of the statutes addressing this matter or court decisions where statutes do not exist, he or she would learn that most states grant exceptions to such assumptions, so long as insurance is in place to cover them.

To be more precise, 22 states have statutes holding void and unenforceable sole or partial contractual transfers, unless insurance is in place. Another 13 states hold either through statute or case law that contractual risk transfers involving sole or partial fault are not permitted, unless the contractual terms are clear and unequivocal. The clear minority of another 13 states holds void and unenforceable sole negligence, regardless of whether insurance is available or not.

With those kinds of figures in mind, one might think that sole or partial fault assumptions are prevalent, particularly in the construction industry. To contrary, however, a growing number of indemnitees are beginning to learn, after a claim occurs, unfortunately, that their contractual requirements are less than adequate. To put it bluntly, what damages and litigation costs can be assumed by the indemnitor (and paid by its insurer) are being retained by the indemnitee instead!

A case in point is *Francesse, Inc. v DOS Concrete Services, Inc.*, 713 N.E.2d 984 (App. Ct. Mass. 1999), where an employee of the subcontractor, sued the construction manager. The court found the employee to be 40 percent at fault, with the remaining 60 percent of fault attributed to the construction manager. Apparently, the construction manager did not realize that it had a mutual or reciprocal agreement in place, because it tried to obtain indemnity for its part of the fault. The court, however, rejected the construction manager's claim for indemnity, because the subcontractor agreed to indemnify the construction

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# Contractual Liability: To Transfer or Not To Transfer: That Is Part of the Question

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manager from any liability for injury or damage attributable solely to the negligence of the subcontractor.

## Diagnosing the Issue

The question is why it is that indemnitees think they should be indemnified when, in fact, their contracts say otherwise. One reason is that it is not unusual for the lawyers who prepare these contractual liability agreements to be unfamiliar with the extent to which the financial consequences of liability can be transferred. What some lawyers often do instead of reinventing the wheel and drafting contractual transfers from scratch to fit the particular needs of indemnitees is to use an existing indemnification agreement.

It is not unusual, for example, to find the indemnification agreement of the American Institute of Architects, found in its General Conditions A 201, to be incorporated into contracts of others. This contract is a mutual or reciprocal one. What this means is that the indemnitee is willing to hold harmless, indemnify, and defend the indemnitor for any resulting injury or damage caused by the indemnitee, so long as the indemnitor promises to do the same for the indemnitee when injury or damage results from the indemnitor's acts or omission.

While "borrowing" that kind of wording saves lawyers time in drafting their own contractual wording, it does little justice to the indemnitees who are looking to transfer the financial consequences of their sole or partial fault to indemnitors.

Not to be overlooked also is the fact that even though an indemnitee has the bargaining power to force an indemnitor into such transfers does not necessarily mean that an indemnitee will wield its power to do so. Some indemnitees are of the opinion that the obligations of the parties should be mutual or reciprocal in nature.



What these indemnitees fail to realize, sometimes, is that while the indemnitors' promises with these mutual or reciprocal agreements may be viewed as being honorable, many cases grow out of injuries by employees of indemnitors who are not commonly involved in these promises between indemnitees and indemnitors. When these kinds of cases arise, indemnitees begin to have second thoughts about mutual or reciprocal agreements—at a time when it often is too late to anything about it.

Indemnitors will accept these mutual or reciprocal agreements with open arms, since what is being promised is nothing more than what the respective parties' obligations are at common law, i.e., in the absence of an expressed contract. In fact, there is a lot of activity, particularly among subcontractors' groups, to "push" for nothing more than the use of these mutual or reciprocal agreements. There is nothing wrong with accepting (or deciding to impose) mutual or reciprocal agreements, so long as the parties understand what they entail.

## Risk Management Measures

It is difficult in the corporate world for risk managers to have working relationships with corporate counsel and the purchasing departments, both of whom often wield a lot of power as to what contracts are to specify. This is unfortunate, because lawyers know the law but seldom know the intricacies of insurance. Risk managers, on the other

hand, know insurance coverage, but seldom know the law. Together, they can conquer a lot of contractual risk problems that can potentially arise.

Risk managers of entities in the position of being indemnitees need to determine their philosophy over the kinds of contractual risk contracts they wish to impose. Much will depend on where they operate and the nature of the agreements. In making this decision, they need to understand all of the ramifications of their choices. Mutual or reciprocal agreements, for example, are fair contracts for both parties, until indemnitees are confronted with third-party-over actions involving suits brought by employees of indemnitors.

When it comes to construction work, it is necessary for risk managers to consult with legal counsel to determine what a state will permit in terms of contractual risk transfer. Risk managers also need to review the contracts drafted by legal counsel to determine what degree of liability (if any) is being transferred.

Risk managers also must be careful to determine whether proper insurance is in place by the indemnitor to cover the attempted contractual risk transfer. This is an especially important task, given that insurers have two endorsements that can serve to limit contractual liability coverage, and certificates of insurance are not helpful in confirming whether any of these limiting endorsements apply. ■



# Catastrophe Modeling Can Be Hazardous Too!

by Paul Taliaferro, CPCU, CPA

■ **Paul Taliaferro, CPCU, CPA**, is treasurer and chief financial officer of the Farmers Alliance Companies. At Farmers Alliance he heads up the financial reporting and actuarial divisions along with various other duties. Taliaferro received his B.B.A. in accounting from Texas A&M University and his master's of science in accounting from the University of North Texas. He is both a Certified Public Accountant and a Chartered Property Casualty Underwriter. He has taught for a number of years in both the accounting, economic, and insurance fields as an adjunct professor and continuing education instructor. He serves on the local boards of the United Way and YMCA, and frequently volunteers as a youth coach. Taliaferro and his wife, Cindy, have a school-age daughter and son.

**I**nsurers' reliance on catastrophe modeling has increased significantly over the past 24 months along with the frequency and severity of these events. The heightened use of these analytical tools has put a spotlight on models, and uncovered a number of shortcomings. As with any statistical analysis, the use of a model and the interpretation of the results should be done with care. Multiple models may give totally different results that could lead to a wide variety of conclusions. In addition, different outcomes can be derived depending on the type and quality of the data used in a model.

The data requested and used in models may lack logical underpinning. If a model is targeting a once in 100- or 250-year event, the user of the model may falsely assume an infrequent occurrence. Recent frequency should dispel that logic. Over the course of 250 years, an event may on average be expected to occur two or three times. The problem with today, versus a decade ago, is we may have seen that event occur two or three times just in the past few years. We cannot assume, from that

point on, that it will not happen again for an extended period of time. Smoothing occurrence rates over time eliminates, or unduly mitigates, bunching or clustering of catastrophes. This smoothing practice may fail to consider permanent changes in the climate that in turn affect occurrence frequency. Shorter frequencies have to be utilized, since a too long-term view may result in an under-priced product.

The lack of realistic severity may be an even bigger problem than higher than expected frequency. Inflation, risk concentration, and event magnitude can combine to make an "average" catastrophe a super one. You need only reference New York City, Long Island, and the decision Allstate recently made to avoid a megacatastrophe in that area. Replacement cost has become a key component when considering maximum probable loss in an area.

Models have an embedded disadvantage related to severity. Inflation is only certain when viewed in the past tense, and projecting future cost hikes comprises nothing more than a guess. Assumptions about future inflation can be positioned to direct a model to any conclusion. Models also have difficulty predicting "demand surge" or the sudden lack of sufficient labor and materials. As a consequence, models need to be ultra-conservative and consider the near worst occurrence in assigning probabilities. In like fashion, more weight needs to be given to the down side. If long-term climatic forecasts turn out to be accurate, the severity question could be more of a survival question for an insurance company.

The assumption is that the user has good data on each of its risks. However, when reviewing results, the assumption should be that the data has some inaccuracies. If the data is not complete or accurate, the conclusion drawn could be flawed. Data can still be accurate yet be inappropriate. An example is the inadvertent use of a mailing address versus a property location. Property value is also a common area for inaccuracy. Replacement cost can

be one of the main drivers in determining largest probable loss. The valuation of property has to be done well. A very useful tool when reviewing results is the ability to drill down from high-level reports to policy-level data. The more granularity you have, the more useful the analysis. Another possible source of an inaccuracy could be the absence of a key characteristic such as building type, quality, or local code differences. Ultimately, the predictive value of the model is only as good as the data loaded into it.

A final safeguard is the use of multiple models or scenario analysis. It may be economically impractical to use more than one model. However, if a user does have access to more than one model, the outcomes can be compared and differences can be reconciled. A more practical crosscheck would be the use of multiple scenarios. Scenario analysis has the advantage of viewing results from different inputs plus increasing the familiarity with the data and model.

As the practice of enterprise risk management becomes more prevalent, insurance companies are becoming more self-aware of their own risk portfolios. The days of blindly accepting the results of Cat models have passed, and management now must be convinced of the validity of the data and the results. Modeling vendors are beginning to respond to the increased scrutiny and are making appropriate changes. At a minimum, modelers have the 2005 hurricane season to draw on for experience. Despite the prospect of perfect hindsight, total reliance on models can no longer be considered prudent. Additional analysis, review, and common sense need to be employed to avoid under- or over-pricing coverage. In the end, it will be the tested results that prove out. ■

# Sue Yourself and Your Clients!

by Earl D. Kersting, CPCU, ARM, ALCM, AU, AIC, AIS, AAI

■ **Earl D. Kersting, CPCU, ARM, ALCM, AU, AIC, AIS, AAI**, is assistant risk manager of The Kroger Co., Delta Division, in Memphis, Tennessee. He is a past president of the CPCU Society's Memphis Chapter, and a member of the Risk Management Section.

**I**n today's litigious environment, it's high time that you sue yourself, your employer, and your customers!

That's a bold statement, and a statement that needs explanation before you get the wrong idea.

In today's environment, litigation is filed over actions that any self-respecting attorney would not have touched a decade ago. Claimants sue because the coffee that they themselves spilled, while in a moving vehicle no less, was hot. Claimants sue because the vehicle in which they were driving did not protect them from injury when they ran off the road while operating intoxicated. Claimants sue because the shopping cart that got away from them on the grocery store parking lot struck their own vehicle. Claimants sue because they slipped and fell in the spill caused by their child. Yes, these are actual cases, and yes, you and your colleagues could add many more to the list. Litigation is a fact of life in today's world, despite your or your clients' industry.

So how do you reduce the likelihood of you or your clients being successfully sued? Take the position of a plaintiff and attempt to sue yourself and your clients (figuratively, of course).

If your client is a retailer, what can you find in or on its property that could cause you to trip, slip, or fall? How can you injure yourself with its products? Are its displays so high that they can topple, or so low that they can be tripped over? On what dark corner of its parking lot are you likely to be attacked or have your car stolen or vandalized (or at least can claim

it occurred) without being observed? Which employees are poorly trained and will falsely apprehend or detain you if you act suspiciously, or will fail to use "Caution Wet Floor" signs once they have notice of a spill? By what methods could you sue that client, and what advice or assistance can you offer it to eliminate or reduce those causes?

If your client is a manufacturer, how could you claim injury due to its products?

How clear are its product warnings and usage instructions? How state of the art are its product design and safeguarding? Will its packaging protect its product so that it reaches the end user in the same condition in which it left the manufacturing facility? Can your client document notification to purchasers regarding recalls and necessary improvements and upgrades? How could you sue this client, and what can be done to eliminate or diminish those causes?

What about your own operation? If you're an agent or producer, how easily could you sue yourself? If you, as a client, claimed you were underinsured and not properly advised regarding coverage limits or exclusions, what documentation supports a defense to the allegation? If you, as a client, claimed you were not notified regarding a lapse or cancellation of coverage, what proof can be offered to the contrary? How would you defend against claims regarding the actions (or inactions) of your employees and subordinates, or against claims of improper or insufficient hiring or supervision of those employees? How could you be sued, and what are you doing to eliminate or mitigate those actions?

We pride ourselves as risk management experts. We're educated and experienced in risk identification, prevention, elimination, and transfer. Your joining this section and reading this publication is evidence that you care about maintaining your skills and knowledge. Your clients, on the

other hand, are good at what they do, be that retailing, wholesaling, manufacturing, finance, information-based commerce, or whatever their specialty. Risk management is not their first consideration, and litigation may not cross their minds until they are served the complaint. By then, they and you must dedicate valuable time and financial resources to a defense, often a very long and expensive process. By taking a proactive stance, and assuming the role of a potential plaintiff, you can invest fewer resources now, and protect the greater resources later—something your clients and you can both appreciate.

It's high time that you "sue" yourself, your employer, and your customers, before someone else does! ■

## What Were Their Names?

*Answer to question on page 6*

**"Transfer of Rights of Recovery Against Others To Us" was called "Subrogation."**

**"Transfer of Your Rights and Duties Under this Policy" was called "Assignment."**

Two words were replaced by 18; none of the 18 has four syllables the way subrogation does, but are the new versions really easier to understand?

Extra credit question: Give a better example of an oxymoron for "Insurance Policy Simplification."

# But What If . . . ?

by George L. Head, Ph.D., CPCU, CSP, CLU, ARM, ALCM



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**M**uch as we might like risk management—particularly the ethical aspects of managing risk—to be an exact science, much of it rests on judgment. Making good judgments rests, in turn, on knowing as many of the true facts of a situation as possible. Altering even slightly the facts of a situation, introducing a few “What if . . .” possibilities, can greatly change one’s judgment about what is the ethically correct thing to do in that situation.

## One Basic Scenario

Consider a hypothetical situation in which Justin Case (one of my favorite fictional characters in this uncertain world) is the risk manager for one of the ten largest interstate trucking companies in the United States. Justin has been negotiating with one of the trucking company’s insurers for nine months about renewal of its experience-rated motor fleet and cargo damage insurance, which is excess over the substantial per accident and annual aggregate retentions that Justin has negotiated through his company’s long-time insurance broker, dealing with this same insurer for each of the past five years.

As Justin is driving to the broker’s office to meet with this transportation insurer’s head underwriter, confident they will

come to a final agreement on the price and other terms of this coverage for yet another year, Justin gets a call on his cell phone. It is from a senior vice president of his company, who is almost always very calm, but now is very excited. He feels he must tell Justin that he has just heard a report of a horrendous highway accident near one of the company’s midwest terminals, an accident that may involve six or seven of the company’s fully loaded trucks as they were leaving the depot. If the report is true, the accident could be the worst in the company’s history, with losses well in excess of its transportation insurance retentions. Trying to stay calm, Justin asks this senior vice president to get more information as soon as possible about this reported accident, and to leave a message on Justin’s office phone within the next hour.

Pondering the significance of all this, Justin drives on to his meeting at the broker’s office, only three miles and 15 minutes away. He wonders what, if anything, he should say about the reported accident. One option is to say nothing—after all, Justin does not know yet for sure that there was an accident. Besides, Justin knows, the experience period used for setting the coming year’s premium for this coverage ended two months ago—the actuaries already have a set body of loss data. Another option is to tell the broker and the underwriter everything, that he has it from a reliable source that the company has just suffered its worst roadway accident ever and is lucky to have such fine insurance. Justin realizes the broker and the underwriter will soon learn about the accident and when it happened, and will think Justin was a fool—or worse—for not telling them in person what he had been told.

## Some Alternative Situations

At this point, as a fellow risk management professional, you may have your own opinion about what Justin should say at that meeting—even if he should go at all. The broker and the underwriter are both

his friends; they would understand if he phoned each of them (or even the broker’s office) and called off “sick” or with a “family emergency.” But at this point, dear reader, let me ask whether your ethical advice to Justin (whatever that advice may be right now) would change if we altered the circumstances somewhat. Considering each of these possible changes separately, not cumulatively, **what if . . .**

1. Justin’s employer, the trucking company, were on the verge of bankruptcy?
2. In the opposite case, this insurer was on the verge of bankruptcy?
3. The senior vice president was wrong—in fact, there was no accident?
4. The broker was Justin’s son, and this was by far the son’s largest account?
5. The insurer was a captive, equally owned by Justin’s employer and two other major trucking companies?
6. Justin was about to leave his present company and move to a guaranteed top risk management position, at a much higher salary, with a rival major trucking company?

Would any of these alternative scenarios change your first judgment about what Justin should say at the upcoming meeting with the underwriter and the broker? Perhaps not—perhaps you believe, as I once did, that the rules of ethics are the same for everyone, like the rules of a professional sport, and that the almost unique personal relationships among the individuals involved should make no difference. Or, just perhaps, one of the above “what ifs”—or perhaps an alternative scenario that comes just to your mind will lead you to understand that deciding what is “the right thing to do” in a given situation can be a highly personal, sometimes rather emotional, matter. ■

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### **Risk Management Quarterly**

is published by and for the members of the Risk Management Section of the CPCU Society.  
<http://riskmanagement.cpcusociety.org>

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Statements of fact and opinion are the responsibility of the authors alone and do not imply an opinion on the part of officers, individual members, or staff of the CPCU Society.

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## Risk Management Quarterly

# RMQ

Volume 23

Number 2

August 2006

CPCU Society  
720 Providence Road  
Malvern, PA 19355  
[www.cpcusociety.org](http://www.cpcusociety.org)

PRSR STD  
U.S. POSTAGE  
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