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THE INSURANCE NEWSLETTER

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Cyber Risk and Privacy Liability

Information technology (IT) has developed and changed at a staggering rate over the past quarter century. Computers have evolved and become ubiquitous; new ways to use, manage, manipulate, transmit and store information have evolved. Think about cell phones, PDAs, wireless internet, satellite navigation and GPS...the list goes on.

Inevitably, such technological development also brings risk. A couple of decades after IT first presented itself as a potential concern, the risk and insurance picture is now starting to become clear. Interestingly, the insurance industry's go slow approach in developing insurance products to address these new exposures seems to have been prudent...the most serious risks that businesses now face from IT are not those most people worried about just a few years ago.

What's the Risk?

In early days computer hackers, as often as not kids with powerful computers and too much time, made sport out of breaking into computer systems, launching viruses, and generally making mischief. They still do, but it was not until enterprising criminals found that stolen data has value and there was money to be made from cyber crime that risk from IT became a serious concern.

The black hats are not amateurs anymore. Organized crime and highly skilled professional criminals, often based in third world countries, find cyber crime to be an ideal venture: low risk, high reward, often committed from a distance, and with small chance of capture. They are able to mount sustained and highly

sophisticated attempts to breach systems, obtain personal and confidential business information, and convert it to money through a variety of illicit means. And besides these criminal elements who are always searching for vulnerabilities, random hackers, rogue employees, or anyone else who stumbles across potentially valuable information can easily sell it on a global electronic black market.

What kind of information are the bad guys looking for? Top targets would be financial information (credit card, bank, or other account numbers) or any kind of personally identifiable information (SSN's, drivers license numbers) can be converted into cash through fraud and identity theft. All businesses are potentially exposed: at minimum you maintain this information on your employees, and any business that makes or accepts payments or transfers funds electronically is also at risk.

Its not just liability risk you face. Potential liability to any third party who sustains a loss through your negligence still exists, but there are now also a whole host of state and federal privacy laws that come into play. On the federal level, HIPAA, Sarbanes Oxley, and FACTA (the Fair and Accurate Transaction Act of 2003) all apply, and as of this writing 41 states have enacted some form of privacy laws. These laws specify your obligations in the event of a breach. The direct costs you must bear for compliance can be quite high.

Insurance Coverage Issues

Don't look to your current policies to find coverage for these losses. Standard policy forms were developed long before these exposures arose. They were,

and still are, written and designed to cover *tangible* loss or damage, that is, damage to property you can pick up, touch, handle. IT and privacy exposures are for loss, damage or misuse of nontangible *information*. Standard policy forms have been repeatedly revised to make clear that for most such exposures they provide no coverage.

In the past few years as the risks and exposures have become clear, the insurance industry has responded with new products to address privacy risks. The broad description “Cyber Insurance” still applies, but the more accurate and useful term coming into wider use is Privacy Liability insurance. Privacy Liability policies can cover direct out of pocket costs you incur as a result of a breach, which under most state laws involve notification and credit monitoring costs. They can also respond to liability lawsuits, both individual and class action, that arise out of a privacy breach. The best policies may also offer crisis response coverage, which will help guide you through the necessary steps to comply with all applicable laws and properly respond to a breach.

There are good reasons to consider this type of insurance. Privacy breaches are on the rise. If you have an IT department or manager, ask him if you are secure. He’ll say yes, and mean it, but what he’s really saying is that you are only as secure as he knows how to make you. The black hats are becoming increasingly more sophisticated; network threats and vulnerabilities are getting worse. Costs imposed on you for a breach of federal and state privacy laws are growing, and plaintiffs attorneys are becoming ever more active. In early days the potential risk was thought to be small for non-technology related businesses. Today, it’s common for businesses and organizations that are far from high tech to obtain, process, use and store personally identifiable information. As social concerns have grown, breach of privacy and identity theft has become a real and significant risk.

There are currently nine insurance companies actively writing this coverage, with many others dipping a toe in. Underwriters ask a lot of questions about what kind of information you have, and how you protect it, so the application is a long one and involves some work. Policies, all non standard of course, are getting broader and are providing meaningful coverage. The

good news is that costs are not extreme. As a general rule businesses with revenues up to \$50 million might expect to spend no more than ten thousand dollars for a policy, and those with revenues up to \$100 million might see premiums as low as fifteen thousand dollars annually.

Give us a call if you would like more information. It’s timely to think about this type of protection.

2009 Insurance Market Forecast

Unfortunately, we can now predict with absolute certainty that the soft market conditions of the past few years will come to an end. Underwriters will become more conservative, policy terms will become more restrictive, premiums will rise....

The devil is in the details, of course. We can make this prediction with almost absolute certainty because we know that every soft market in insurance since these things have been tracked has been followed by a hard market. Markets go up, markets go down. The things we can’t predict: When will the market turn? How fast? How hard? And how will it affect you?

Commercial insurance rates were generally still dropping through the third quarter of 2008, although most recently only by single digit percentages, lower than we have seen over the past couple of years. We all read the newspapers and hear the news; the news in this economy is not so good. Insurance companies were already making noises about the market bottoming out before housing prices collapsed and our current economic problems hit us. Common sense suggests that these problems will manifest themselves in changes in the insurance market.

How? It’s a complicated picture, hard to forecast. Some factors that come into play:

- Last summer’s hurricane Ike ranks as the seventh largest single catastrophe loss in history in inflation adjusted dollars; add in other named storms, one of the worst tornado years in history and what seem to have become routine California wildfires. Through three quarters of 2008, the industry reports \$22 billion in catastrophe

claims, already ranking 2008 as fourth most severe in ten years. Underwriters have priced for these types of catastrophes, and have adequate reserves; these events alone would probably not turn the market.

- Reported underwriting profits for most insurance companies have been slipping, reflecting several years of premium reductions. Insurance companies are still charging more in premium than they are paying out in claims and expenses, and as of the third quarter, the industry is still generally profitable, but just barely. Mitigating this somewhat is the fact that the biggest hit to underwriting results has come from a very small segment of the industry, those companies writing mortgage and financial guaranty insurance. Take out their results, and property and liability insurers are still generally OK.
- Investment returns are down. Historically, the major source of insurance company income is from investments of reserve funds. Generally, more than 3/4 of property and casualty insurance company investments are in fixed income instruments. We all know what is going on with interest rates and the stock market. All else equal, lower total investment gain suggests greater emphasis on producing underwriting profits, which as noted above are slipping. And a markdown of assets to reflect losses could have a severe negative impact on the surplus and reserves insurers are required to maintain, potentially a big problem.
- AIG is a question mark. Reports suggest that the AIG insurance companies are all sound and adequately capitalized; rating agencies are watching them like hawks, but as of this writing have so far held off on any rating downgrades. All of AIG's reported difficulties seem to have arisen from non insurance operations, but if the fallout requires AIG to sell off their insurance divisions piecemeal, or leads nervous policyholders to abandon ship, there will certainly be an impact on the insurance market.

None of the factors listed by themselves would seem to be enough to trigger a market turn. Put them all together, throw in a very healthy dose of economic uncertainty, and the whole picture suggests a turn will come sooner, rather than later. Historically,

the industry's best underwriting performances are rooted in periods when interests rates were low and/or equity market performance poor, like now. Good underwriting performance for insurance companies means a firm insurance market for buyers.

For most of 2008 insurance company bigwigs were busily announcing the soft market is over, and no doubt they all wish it were so. Historically there is a time lag ranging from a few months to a couple of years before the pronouncements from on high actually translate to higher insurance rates on the street. Our crystal ball has a big crack in it, but at this point all indications suggest that 2009 will most likely mark a market bottom. All the usual caveats apply: not all lines of insurance are the same, your loss experience matters, unusual or high risk operations have their own rules, etc. All things considered, commercial insurance rates are probably not likely to drop much more in the near future, but in most lines of insurance and for most insurance buyers there are unlikely to be any significant rate increases either.

What to do? Talk to us early. This is no time to put off dealing with your renewals until the last minute. Remember, insurance rates are not the only symptom of a tighter insurance market. Underwriters will be scrutinizing all their accounts more closely, and they will be getting stingy with coverage enhancements and broader policy terms that we were able to get easily for you in a softer market. We don't want to be dealing with these issues at the last minute before renewal, and neither do you.

Maintaining Protective Safeguards

If you ever filled out an application for a Director and Officers or Employment Practices Liability policy, you know that these policies are what are known as *warranty* policies. Underwriters rely on your accurate information in the application, and include a provision in the policy that if the information turns out to be inaccurate or wrong, they can cancel the policy and void coverage, even after a loss has occurred and a claim reported.

While you are still obligated to provide accurate information, most standard property and liability poli-

cies are not warranty policies. There is one important exception, though, found in property policies, that you need to keep in mind.

It is very common for property insurance policies covering sprinklered buildings to include a Protective Safeguards endorsement. This is a short (a page and a half) endorsement, but with powerful effect. Essentially, you are warranting that you have a sprinkler system in your building, it works, and you will keep it turned on and in operating order.

Property insurance companies grant some pretty significant premium credits for sprinklered buildings. They want to hold you to your word that the sprinkler system is actually in place to provide the protection they are relying on, and this is how they do it. If you know of an impairment or suspension in the system and don't notify the insurance company, or if you fail to maintain the system in complete working order, and a fire occurs, the insurance company has grounds to deny coverage.

Winter is here. Standard wording of these endorsements states that if part of the system has to be shut off due to "breakage, leakage, freezing conditions or opening of the sprinkler heads", you don't have to notify the insurance company as long as you can restore full protection within 48 hours. Notice, however, there was no mention of "maintenance" in there. If you have to shut off even part of your system for maintenance, repairs, or any other reason, call us immediately.

The standard endorsement can also apply to other protective safeguards, including central station fire alarms, security services, private service contracts, or any other protective system. You might find these in your policy even if you don't have a sprinklered building. Keep an eye out for it, and call us if you have any questions.

After 43 years, three new buildings, two additional offices, and immeasurable challenges & rewarding experiences – Douglas Kapnick Retires

Culminating a 43 year career in the insurance industry, Douglas Kapnick retired from Kapnick Insurance Group, the company his father Elmer founded in 1946, this past September. Although his immediate plans include spending more time with his wife, Mary, fly fishing, and continuing his community and charity work – which he expects will keep him busier than ever – "I will miss the excitement of work, the challenges and the friendships I have made within the insurance business" Kapnick said.

Douglas joined Kapnick and Company in 1965 after graduating with honors from the University of Michigan with a BBA degree. He focused his efforts on expanding the commercial department – growing the book of business and bringing in new customers from outside the Adrian area. He became vice president in 1970. In 1976 he purchased the firm from his father and was elected president. Under Douglas' leadership the company has grown to become one of the largest, most highly respected, independently owned insurance agencies in the region. Through his efforts the company gained recognition as an innovative, well managed company with a reputation for providing quality service and creative risk management solutions to its clients.

Douglas' sons Jim and Mike bought the business from their father in January, 2007 bringing the company into the third generation of family ownership. They credit Douglas with having the foresight and business acumen to expand the company and keep it successful. "It is really a testament to his judgment and leadership ability," Jim Kapnick said. "He knows how to empower people to do great things." Musing on the fact that Elmer ran the company for 30 years before he purchased it, and he ran the company for another 30 before turning the reigns over to his sons, Kapnick said with a laugh, "That means they've got 30 years of their own to put in!" and added, "I like the idea of this company staying in the family."

In addition to running a successful business, Douglas is well known and respected for his community support and involvement. He has, and continues to be, involved with numerous community organizations, including both local colleges, and has presided over the boards of many of these groups. In 2004 Douglas was honored with a Lifetime Achievement Award from Citizens and Hanover Insurance Company, one of only three individuals ever to receive the award.