

APPENDIX B

Risk Management and Insurance

LEARNING OBJECTIVES

1. Define the types of risk and explain the various techniques used to manage risk.
2. Discuss the basic insurance concepts of indemnity, insurability of risk, and affordable coverage.
3. Identify the different types of property and casualty insurance.
4. Explain the different types of public and employee-sponsored insurance available to individuals.
5. Identify and explain the different types of life insurance.

INSIDE BUSINESS

Malden Mills Battles Back from the Brink

Tragedy can strike a business at any time and without warning, as the managers, employees, and customers of Malden Mills know all too well. Based in Lawrence, Massachusetts, an old mill town thirty miles north of Boston, Malden Mills produces Polartec, Polarfleece, and other specialized fabrics used in apparel and home furnishings. Its customers include such top-flight firms as J. Crew, Eddie Bauer, L.L. Bean, Patagonia, and La-Z-Boy.

Founded by Henry Feuerstein in 1906, Malden Mills had bounced back from a variety of challenges over the years, including a Chapter 11 bankruptcy in 1981. By 1995 the company had grown to \$400 million in sales under the leadership of CEO Aaron Feuerstein, grandson of the founder. As other mills shut down or moved away from Lawrence, plunging it into an economic depression, Malden Mills emerged as one of the area's largest employers. But nothing in the company's past prepared the CEO for the crisis that erupted on December 11, 1995.

That night, with the holiday season in full swing, Feuerstein was being feted at a surprise party in honor of his seventieth birthday. The celebration ended abruptly when he received the horrifying news that a boiler had exploded in the company's factory complex, triggering a fiery blaze that injured 24 employees and gutted three buildings. Feuerstein and his management team rushed to the site, only to find that 750,000 square feet of manufacturing and office space had been destroyed.

In the aftermath of the fire, Feuerstein decided to rebuild Malden Mills on the same site. He knew that insurance would ultimately cover the business losses, but he was more concerned about the immediate needs of his 2,400 employees. Just two days after the fire, every employee received a Christmas bonus. Three days after the fire, the CEO met with more than 1,000 employees and pledged to continue paying the entire work force for the next month. At a cost of \$1.5 million per week, Feuerstein kept his employees on the payroll for 30 days, then continued to pay them for another 30 days—and yet another 30 days. In all, Malden Mills employees were paid for a total of 90 days, even though many could not return to work.

Apparel companies, union officials, the company's bank, and many individuals showed their support by sending donations to help Malden Mills employees. Customers remained patient while the company

planned and constructed a new, more modern factory complex with state-of-the-art computerized equipment, using a \$150 million line of credit and the insurance proceeds. Amazingly, in 1997 the company's levels of production were well above its pre-fire standards. However, the cost of servicing the company's bank debt coupled with the force of competition from low-cost Asian competitors led Malden Mills to again file Chapter 11 bankruptcy in 2001. Still infused with the "can-do" spirit, the company's employees and senior leaders worked hard to restructure the company, while many vendors and customers remained loyal and supportive. Finally, in 2003, Malden Mills emerged from Chapter 11 as an evolved, more efficient company well positioned for future growth, with six new Board members, new executive management, new product innovation, and a \$19.1 million dollar contract with the U.S. military for the Polartec brand.

RETURN TO INSIDE BUSINESS

What happened to Malden Mills could happen to almost any business. In addition to injuring two dozen employees, the 1995 fire destroyed millions of dollars worth of buildings, equipment, and textile products. Fortunately, some of the company's manufacturing could continue at its facility in Maine, and its warehouse was full of fabric, so the business was not entirely shut down. Also, CEO Aaron Feuerstein had transferred some of the risk by buying fire insurance. As a result, he could count on the insurance proceeds to cover the cost of rebuilding the factory complex. The new buildings were constructed to prevent the spread of fire, using advanced monitoring and smoke detection systems, zoned sprinkler equipment, and a system for dousing fires with high-pressure steam.

In the end, what really saved Malden Mills was not the insurance money—which the company collected in full only after months of negotiations with its insurer—but the spirit and dedication of its owner, managers, employees, customers, and community. From the local Chamber of Commerce to the most distant fabric customer, many people had a hand in bringing the mill back from the brink. About 95 percent of Malden Mills' customers have stayed with the company over time, just as about 95 percent of its employees have remained with the company—two enviable records.

Questions

1. In this situation, did Malden Mills incur the cost of a potential loss becoming an actual loss or the cost of reducing or eliminating the risk of potential loss?
2. Whenever Malden Mills introduces a new textile product, it faces the risk of failure and other losses. How can it transfer some of this risk to an insurance company?

APPENDIX REVIEW

Summary

1. Define the types of risk and explain the various techniques used to manage risk.

Risk is the possibility that a loss or injury will occur. Risks can generally be classified either as speculative, which is the risk that accompanies the possibility of earning a profit, or pure, which is the risk that involves only the possibility of loss. Though it is impossible to avoid all risk, various techniques, including risk avoidance, risk reduction, risk assumption, and shifting risk can be used to manage it. Risk avoidance encourages common sense procedures to reduce or eliminate obvious high-risk situations. Risk reduction for businesses focuses on safety programs, alarms, and control systems based on effective decision making. Risk assumption means that businesses take on the responsibility for the loss or injury that may result from risk. Shifting risks involves transferring risk to an insurance company.

2. Discuss the basic insurance concepts of indemnity, insurability of risk, and affordable coverage.

The purpose of insurance is to provide protection against loss. The greater the risk and the amount to be paid, the higher the premium. The principle of indemnity means that in the event of a loss, the insured firm or individual cannot collect an amount greater than the actual dollar amount of the loss from the insurer. Insurability means that insurers will accept responsibility for risks that meet certain conditions. These conditions are generally that losses must not be under control of the insured, that the insured hazard be geographically widespread, that the probability of a loss be predictable, that the losses be measurable, and that the policyholder have an insurable interest. Affordable coverage means that the price of the premiums must be high enough to cover expected payouts but low enough to encourage customers to buy policies to offset possible losses.

3. Identify the different types of property and casualty insurance.

Property and casualty insurance is used to manage certain types of risks. Fire insurance covers losses due to fire. Standard policies protect against partial or complete loss of a building and/or its contents. In order to reduce its premium, a firm may insure a property for less than its replacement value, but a coinsurance clause requires the policyholder to buy coverage equal to a specified percentage of replacement costs. Extended coverage may also be purchased to cover special conditions. Burglary, robbery, and theft insurance covers the illegal taking of property through forcible entry (burglary), the unlawful taking of property from an individual by force or threat of violence (robbery), or the wrongful taking of property that belongs to another (theft or larceny). A firm may also purchase a fidelity bond, which protects a firm from theft, forgery, or embezzlement by its employees. Motor vehicle insurance is classified as either liability or physical damage insurance. Automobile liability insurance covers losses resulting from injuries or damage caused by the insured vehicle whereas automobile physical damage insurance covers damage only to the insured vehicle. No-fault auto insurance requires that those suffering injury or loss be reimbursed by their own companies. Business liability insurance includes public liability insurance to protect the firm from losses due to injuries suffered by others as a result of negligence on the part of the business owner. Product liability insurance protects the firm from losses due to injuries suffered by others as a result of using the firm's products. Marine transportation insurance is available for goods shipped over water or land. Business interruption insurance protects a business whose operations are interrupted because of a natural disaster.

4. Explain the difference types of public and employer-sponsored insurance available to individuals.

Public insurance includes Social Security and workers' compensation insurance, Social Security is actually four programs: retirement benefits paid to eligible individuals when they reach age 65; survivor benefits paid to a worker's spouse or dependent children if the worker dies before retirement; disability benefits paid to workers who are severely disabled and unable to work; and the Medicare program, which provides hospital and medical coverage. Workers' compensation insurance covers medical expenses and provides salary continuation for employees injured at work. Employer-sponsored insurance includes healthcare, which may include major medical assistance or a health maintenance organization plan.

5. Identify and explain the different types of life insurance.

Life insurance pays a stated amount of money upon the death of the insured individual to one or more beneficiaries. Term life insurance provides protection for a stated amount of time. Premiums increase as the individual gets older. Whole life insurance provides both protection and savings. Premiums remain constant as long as the policy is in force. Endowment life insurance guarantees the payment of a stated amount after a specified number of years. The premiums are higher than for whole life insurance but the policyholder is guaranteed a future payment. Universal life insurance combines life insurance with

an investment plan. The premiums tend to be lower than those for whole life coverage, but the policy may include other fees.

Key Terms

You should now be able to define and give an example relevant to each of the following terms.

risk (A15)

speculative risk (A15)

pure risk (A15)

risk management (A15)

self-insurance (A17)

insurer (or insurance company) (A17)

premium (A17)

insurance policy (A17)

insurance (A17)

insurable risk (A17)

uninsurable risk (A17)

principle of indemnity (A19)

stock insurance company (A20)

mutual insurance company (A20)

fire insurance (A21)

coinsurance clause (A21)

extended coverage (A21)

fidelity bond (A22)

automobile liability insurance (A22)

automobile physical damage insurance (A23)

no-fault auto insurance (A23)

public liability insurance (A23)

product liability insurance (A24)

ocean marine insurance (A24)

inland marine insurance (A24)

business interruption insurance (A24)

workers' compensation insurance (A25)

healthcare insurance (A26)

health maintenance organization (HMO) (A26)

preferred provider organization (PPO) (A26)

life insurance (A26)

beneficiary (A26)

term life insurance (A26)

whole life insurance (A27)

cash surrender value (A27)

endowment life insurance (A27)

universal life insurance (A27)

Review Questions

1. What is the difference between a speculative risk and a pure risk? Why are speculative risks generally uninsurable?
2. List the four general risk-management techniques, and give an example of how each is used to manage risk.
3. Under what conditions is self-insurance a practical risk-management method?
4. How does the principle of indemnity affect (a) the amount an insurer will pay in the event of a loss and (b) the maximum amount for which property should be insured by its owner?
5. What are the five principal conditions that determine whether a risk is insurable?
6. Distinguish between a stock insurance company and a mutual insurance company.
7. What is the general effect of the coinsurance clause in a fire insurance policy?
8. What is extended insurance coverage, and what does it usually “extend”?
9. What is the difference between automobile liability insurance and automobile physical damage insurance? List three liability coverages and three physical damage coverages.
10. What is the difference between public liability insurance and product liability insurance? Why would a business need these two coverages?
11. How are premiums determined for workers’ compensation insurance? Who pays them?
12. In what specific ways can an employer reduce the cost of healthcare insurance?
13. What is a health maintenance organization (HMO)? How does an HMO plan differ from a more traditional healthcare insurance plan and a PPO?
14. List and briefly describe four different kinds of life insurance.

Discussion Questions

1. Suppose you were the owner of a retail clothing store. To what extent could you use risk avoidance, risk reduction, and risk assumption in your risk-management program? Cite specific applications of each of these three techniques.
2. As the owner of the retail store described in Question 1, which insurance coverage would you purchase for your business? How would you determine the amount of each type of coverage to purchase?
3. The principle of indemnity does not seem to apply to life insurance because people can, within reason, purchase as much or as little of this coverage as they wish. Why should this be so?

CASE

Product Liability Stalls Cessna's Production

In the Roaring Twenties, when Clyde Cessna founded his own aircraft manufacturing company, product liability was not a major concern. Cessna was a farm boy in Kansas when he taught himself to pilot a plane in 1911. He was soon barnstorming beyond his home state, putting on daring exhibitions and building a reputation as a skilled aviator. In 1927, two years after cofounding an airplane manufacturing firm, Cessna left to open his own manufacturing plant. During World War II, Cessna's T-50 Bobcats served as training planes for the U.S. military. After the war, increased demand for private airplanes led Cessna to start making small single- and twin-engine propeller aircraft.

But even as Cessna's sales zoomed skyward, its product liability problems were escalating, because more planes and more pilots meant more exposure to risk. Originally, Cessna purchased product liability insurance as a way of shifting risk. But over time, the insurance premiums became so expensive that the company switched to self-insurance, setting up a reserve account to cover potential losses.

Product liability became an increasingly costly headache during the 1970s and 1980s, when Cessna and other U.S. makers of small aircraft were caught in a rising tide of accident-related lawsuits. Legally, the manufacturers could be hit with product liability claims for every plane they ever made, regardless of the age or safety record of the aircraft. Even when the manufacturers did not appear to be at fault, they were seen as "deep pocket" targets for huge damage awards. By the mid-1980s, Cessna was paying up to \$30 million every year just to defend itself against liability lawsuits—an amount that equaled the company's annual budget for research and development. Ultimately, customers shared the burden—in the form of higher prices for light aircraft and replacement parts.

By 1986 the product liability situation had become so costly that Cessna management decided to shut down its production of single-engine propeller aircraft, choosing to concentrate instead on the company's Citation line of small jets. Piper, Beech, and other manufacturers of single-engine planes also decided to stop production, knocking the United States out of the market-leader position and allowing France to emerge as the front-runner in lightweight training aircraft.

Even after discontinuing production of single-engine planes, U.S. aircraft manufacturers continued to work behind the scenes to encourage legislators to change the way product liability laws apply to the aircraft industry. Industry representatives were able to explain their position publicly in 1993, when Congress took up the issue of airplane product liability. Initially, the Senate and the House of Representatives debated separate proposals, but these were eventually merged into a single piece of legislation that was signed into law in August 1994 as the General Aviation Revitalization Act.

Under this legislation, small-airplane manufacturers cannot be held liable for accidents involving planes and parts that were made more than 18 years ago. The cut-off of 18 years was chosen because the satisfactory performance of a plane or a part over such a lengthy period should be sufficient proof that the product does not suffer from defective design. Thus, once an aircraft or part reaches the 18-year point without major problems, it is no longer subject to product liability lawsuits.

Cessna had pledged to resume domestic production of its single-engine planes if Congress modified the product liability laws—and once the law was signed, the company immediately took steps to keep its promise. By July 4, 1996, Cessna had an assembly line for single-engine planes ready to go in a new 400,000-square-foot manufacturing plant in Independence, Kansas. After receiving production certification from the Federal Aviation Agency, the plant delivered its first new single-engine plane in January 1997. By 1998 the factory was geared to turning out 2,000 single-engine planes per year to meet orders from all over the world, providing employment for 1,000 people and giving the industry a much-needed boost.

These days, Cessna is again flying high in single-engine aviation. In the course of more than seven decades of production, the company has turned out nearly 180,000 airplanes. Product liability is still a concern, but the company is in a better position to manage the risks because of the legal time limit on liability.

Questions

1. What type of risk was Cessna shifting by buying product liability insurance from insurance companies?
2. What are the advantages and disadvantages of assuming product liability risk through self-insurance, as Cessna did with its single-engine planes?
3. Do you think that the 18-year cut-off on legal liability for products like single-engine aircraft and airplane parts is reasonable? Explain your answer.

BUILDING SKILLS FOR CAREER SUCCESS

1. Exploring the Internet

Insurance companies are motivated to help businesses reduce risk in the workplace because it reduces the amount they must pay on claims for everything from fire to accidents to theft. The premiums they charge are directly related to the risk that the insured event will occur. Thus, when an insurance company representative recommends that a business install a better alarm system to reduce the risk of burglary, it is also a means of reducing the premium. Insurance companies have traditionally used printed literature and advertising to promote risk reduction. They are now using the Internet for the same purpose.

Assignment

1. Using one of the Web search engines, locate insurance company sites that suggest means to reduce insurable business risk. Try keywords such as *insurance* and *fire insurance*.
2. Summarize the advice provided by the Web sites you explored.
3. What other relevant information about insurance did you discover?

2. Developing Critical Thinking Skills

As careful as you may be, you can't eliminate all risks from your life, but you can try to manage them. One way to do that is to buy insurance to cover a possible loss. A typical family does this by purchasing insurance to protect its family members, home, car, and investments. Suppose that you have just had a second child and have become concerned about how your spouse and children would survive financially if you were suddenly killed in an accident. You want your infant and your four-year-old to go to college. At the moment no one in your family has any life insurance. You have a \$132,000 mortgage on your house; two car loans, one with a \$4,500 balance, and the other with a balance of \$12,000; and \$5,500 in a savings account. Your salary is \$47,000 and your spouse's is \$31,500. You want recommendations on what kind of life insurance you need, how much to buy, and what other types of insurance you might need.

Assignment

1. Analyze this situation by determining the following: (a) What types of insurance are needed? Why? (b) How long will each type of insurance be needed? (c) What is the appropriate amount of coverage? (d) Which family members need insurance? Why?
2. Prepare a plan of your recommendations.

3. Building Team Skills

When you buy a vehicle for personal or business use, you are required by law to purchase automobile insurance. A financing firm will demand it, and of course, you want to protect your investment. Imagine that you and your two friends, Austin and Sonya, are in the process of purchasing vehicles. You are buying a new Toyota pickup for \$19,500; Austin is purchasing a five-year-old, two-door Nissan sports car for \$20,000; and Sonya is purchasing a two-year-old GMC Suburban for \$27,000. You are 22 years old and live in the inner city, Austin is 28 and lives in the suburbs, and Sonya is 34 and lives in a rural area in the next county. You and your friends need to shop for the best buy in automobile insurance. Where can you get the best buy and what will be covered?

Assignment

1. Form groups of three, and have each member of the group contact an insurance agent for a quote on each vehicle. The quote should include the following: (a) the cost (premium) of the coverage for one year, (b) the coverage and limits of the liability insurance, (c) the coverage and limits of the physical damage insurance, and (d) the status of uninsured motorists' insurance.
2. Prepare a table comparing the quotes.
3. Select the company that offers the most insurance at the lowest cost and that has the best service record.
4. Report your findings to the class and field questions from your classmates.

4. Researching Different Careers

Since individuals and business firms continually have insurance needs, this area of business provides many career opportunities and excellent advancement possibilities. The most sought-after jobs in insurance include those of actuary, claims representative or adjuster, agent, broker, and underwriter.

Assignment

1. Use your local library and the Internet to research at least four jobs in the insurance industry.
2. Find out the following about each job: (a) job description—what is required in the job? (b) career path—what are the opportunities for advancement? (c) salary—what is the salary range? (d) education—how much schooling is required?
3. Prepare a table comparing the information for each job.

5. Improving Communication Skills

Assessment involves determining the amount of progress relative to a standard. It is a critical part of evaluating results in the workplace, as well as determining what you have learned in a course. Since you are nearing the end of this course, it is time to assess what you have learned about business and

business operations. Learning often takes place in bits and pieces, and when you take the time for review and assessment as you complete a course, you may be surprised at how much you have learned.

Assignment

If you have been writing a journal as suggested in Chapter 1, you should refer to your journal notes to complete this exercise. Otherwise, use your class or study notes. Prepare a report reflecting your thoughts on the following questions.

1. What are three things you learned about business that impressed you the most? Or what was the greatest surprise to you?
2. How will you use the information you learned? Give several examples applicable to your personal life, your career, and your job.
3. Has this course helped you make a decision on a career in business? If so, how did it make a difference?
4. What have you learned about systematically writing your thoughts in a journal? How important is this exercise for personal growth and development?