Earthquake insurance: the dim reality

By Brian Kabateck
and Evan Zucker

Associated Press

Barrels filled with Cabernet Sauvignon that toppled on one another following an earthquake at the B.R. Cohn Winery barrel storage facility in Napa.

In the wake of the 6.0 earthquake that rocked Napa last month, property owners are now facing the financial fallout from the lack of insurance coverage. Earthquakes are all too common for California residents, and when they occur in densely populated areas, the impact may cause a severe burden for both residential and commercial property owners, as well as the entire regional economy. In light of the fact that building codes in California have steadily made structures more earthquake resistant, and that the number of homeowners with earthquake coverage is so low, it is time to take a renewed look at the regulatory scheme and identify methods to substantially increase coverage rates in California.

The rules changed after the 1994 earthquake in Northridge. Like the recent Napa quake, the Northridge quake hit in the early morning hours, largely while people were still in bed. While this limits the number of people in large high-rise office buildings, meaning less injuries, the amount of property damage is largely unaffected.

Every time there is a new quake, it reignites a debate and discussion about updating building codes and retrofitting existing buildings. This is progress in the right direction, but despite progress, the Northridge earthquake was the cause of immense property damage to the tune of approximately $12.5 billion in residential insurance claims alone. Insurers, trying to conserve profits and maximize assets, severely underestimated their exposure from losses to such a heavily populated area to the point that many carriers complained they were nearly forced out of business.

Years of litigation ensued as a result. In fact, the state Legislature, urged by homeowner organizations and trial lawyers, passed California Civil Code Section 340.9, which extended the statute of limitations through 2001 to bring a claim against an earthquake insurance carrier because of issues related to the Northridge quake. Some of the longest-running claims were not resolved until as late as 2008.

Prior to the Northridge quake, California law required that any insurer who offered a homeowners policy also had to make earthquake insurance available. Policy update notifications before Northridge required carriers to identify that earthquake coverage was available to homeowners who then had to affirmatively opt out if they did not want it.

As a result of lobbying by several of the largest insurance companies, the state Legislature created the California Earthquake Authority (CEA). The CEA is a publically managed organization, but remains privately funded for the express purpose of offering earthquake coverage, even if only minimal coverage options are available. At the same time, the requirement that insurers offer earthquake policies was also lifted. Unlike fire and flood insurance, mortgage holders do not require homeowners to carry earthquake coverage. The vast majority of insurance carriers either eliminated earthquake policies from their product offerings or severely restricted the policies offered.

As an offshoot of the changes after the Northridge quake, virtually all insurance companies in California have now stopped offering full coverage or guaranteed replacement cost coverage policies. Instead of offering replacement cost coverage after a loss, the carriers transitioned to limits-based policies. Now, during the underwriting phase of buying a homeowner policy, carriers endeavor to set the value of the asset being insured and identify that value as the maximum coverage limit that the insurance company will pay. Under this paradigm, if a homeowner suffers a total loss of their home they might not be put back in a position where they can rebuild their home — i.e., they are likely to be underinsured.

Without the option of purchasing earthquake insurance coverage from traditional insurers, California residents are left with the CEA. While the CEA offers a couple of different options, the coverages and requirements are limited. When it created the CEA, the Legislature defined low-cost earthquake insurance policies, known as mini-policies. With these policies you must maintain a homeowner policy from a participating insurer, and the first policies offered had deductibles set at 15 percent with no coverage for structures other than the primary residence.

With little to no competition, the rates for insurance under the CEA can make them cost prohibitive. Mandating carriers who offer homeowners coverage to also offer earthquake coverage was an effective method to keep prices at competitive levels. With constant improvements in building and structure codes, at least for new construction, the risk of serious or catastrophic damage is reduced, which also reduces the risk borne by insurance carriers. These forces provide incentives to implement the most up-to-date retrofit and building techniques, which could lower coverage premiums.

The CEA touts new policies with 10 percent deductibles and expanded personal property and additional living expense coverage, but these upgrades invariably raise the premiums. Some private insurance companies have begun to reenter the market, but not the big players that most of us are used to. Pacific Select and GeoVera are now offering California earthquake coverage policies. These are all steps in the right direction, but the coverage rates in California are still significantly under 20 percent. In Napa, it has been reported that the coverage number was closer to 5 percent.

With coverage rates this low, middle-class suburban families would be devastated by another quake on a fault line near a major city like Los Angeles or San Francisco. With coverage for only one of every five homes on a residential block, options for the uninsured are limited. In a populated enough area, government aid resources would be stretched too thin. Some families would be forced to take out large loans and put themselves further in debt, some homeowners would use Band-Aid repair methods leaving their homes even more vulnerable, and some homeowners would simply walk away. This would have ruinous consequences for the community economy.

Because earthquakes in a given area are relatively rare, it can be difficult to adequately assess risk. Many other natural disasters, such as large snowstorms or hurricanes, are a mainstay for certain geographical locations. California is a big state and it's easy to rationalize that the next big quake is not likely to hit your home. Many people assume that the Federal Emergency Management Agency or another government agency will bail them out. More likely than not, this will not be a reality. The bulk of FEMA benefits comes in the form of loans. While these loans often have a reduced interest rate, they are still loans that must be repaid.

The CEA was created to provide some relief from the almost complete lack of residential insurance coverage available after the 1994 Northridge earthquake. However, the low purchase rate and the corresponding high uninsured numbers militate in favor of reforms for the program. Over the years, the CEA has enacted some statewide rate reductions and new policy options have been added. However, the problem of millions of uninsured homeowners only continues to grow. California's population growth outpaces the national average and its property and home values are some of the fastest growing in the country. In addition to the property damage after the next large metropolitan quake, California could be left with entire abandoned neighborhoods of homes that are left in rubble. Failing to rebuild homes would have a cascade effect, lowering property values of the surrounding areas and reducing the tax base and income to utilities and social service programs. The threat of the next big earthquake grows each year in terms of the amount of uninsured damage and loss that can be expected, not if, but when a major metropolitan area is hit.

BRIAN KABATECK
Kabateck Brown Kellner

EVAN ZUCKER
Kabateck Brown Kellner

Brian Kabateck *is a consumer rights attorney and founder of Kabateck Brown Kellner LLP in Los Angeles. He is the immediate past president of the Consumer Attorneys of California.*

Evan Zucker *is an attorney at Kabateck Brown Kellner LLP in Los Angeles, where he practices consumer litigation.*

What does your firm's 'coverage ratio' really mean?

By Edwin B. Reeser

"Coverage ratios" are applied to businesses to forecast current and future solvency, a tool for banks and bondholders interested in the security for repayment of debt. But law firms typically don't have long term bank or bond debt. When they do, it's usually for tenant improvements and equipment purchases, which are usually "financed" in whole or part within the terms of the office lease. While this keeps it off balance sheet, it's still an obligation.

Law firms do have two significant types of debt. One is short term working capital loans with a bank; the other is a contractual capital repayment obligations to equity partners, which is really debt rather than true equity. As a practical matter, most big firm partners no longer have an undivided right to a proportional share of ownership in the assets of the firm. That is usually waived in the partnership agreement in exchange for a set capital contribution amount.

Coverage ratios are relevant for evaluating rate of return risk on investment by calculating what is left after servicing debt obligations. Applied to lawyers, this means evaluating risk in becoming, or remaining, an equity partner in a law firm. Below we will use the fundamental debt-to-total-assets ratio.

Debt to Total Assets

This ratio indicates the ability to withstand reversals without endangering debt holder interests. The lower the ratio, the more protection the creditors have if the firm stumbles. So how do we apply this to a law firm?

Looking only at cash and "hard" assets, there won't be much of a denominator. Surplus cash is usually distributed currently. If the firm uses a working capital loan, cash balances are often lower still. Long term assets are usually depreciable with little disposable or book value, and there shouldn't be much long-term debt, if any.

But we know law firms are cash behemoths, expending large amounts in monthly operating costs and partner distributions, and collecting large amounts from accounts receivable. There often are significant contributions of partner capital and balances of short-term working capital debt. Law firms don't invest in revenue producing assets — they are service operations based on labor. The "investment" comes with cost to create a stable balance of performing accounts receivable and work in process (WIP).

Law firms have hidden debt though. Suppose our example firm has 50 equity partners with an average capital contribution of $250,000, totaling $12.5 million. That's 35 percent of projected annual income of $36 million on $100 million in revenues. The firm also turns over four partners per year, returning capital without interest over four years, with nothing the first year and then the balance in monthly installments for three years. That obligation stabilizes at $2.5 million, with a $1 million per year payout rate.

What about an unfunded retirement plan? They tend to have a cap on payments tied to the firm's net operating income, typically 5 to 10 percent. At 7 percent on $36 million, it's an annual payout of $2.5 million per year.

Assume the payout is close to the cap, and equilibrium in the number of partners entering and leaving the payout group. We could review the balance monthly and the average outstanding balance through the year. This debt usually has a first priority secured position. While the lender may feel sanguine about repayment, partners value their claims after the lender has been repaid in full. Estimate this loan balance at about one-third of monthly receivables, or $10 million — which is conservative.

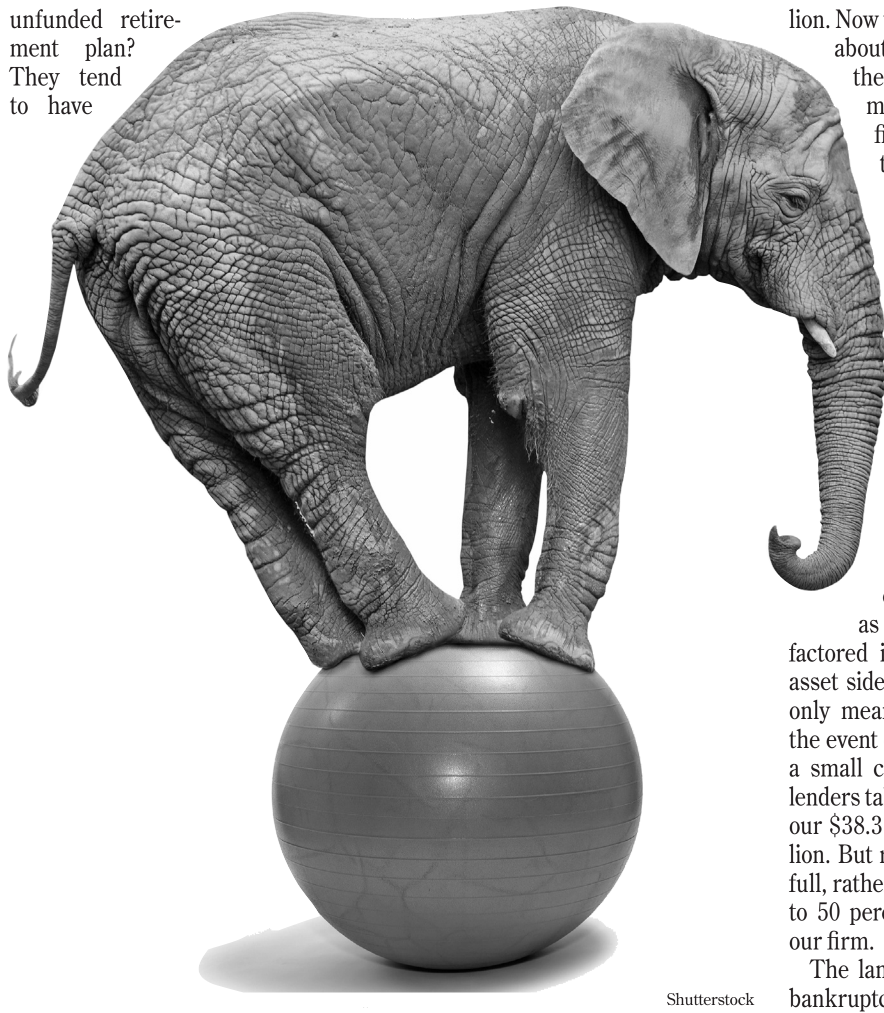
Since this firm has built in a continuing obligation as part of its partnership agreement, we could do a net present value calculation of a $2.5 million payment stream. That will require assumptions for an imputed interest or discount rate, and a term of years. The results will vary, so run a low-middle-high series to get a feel for the magnitude. We'll use 4-6-8 percent for the discount rate and 20-25-30 years for term (see chart).

	Term of Years		
Discount Rate	**20**	**25**	**30**
4%	$34M	$39M	$43.2M
6%	$28.7M	$32M	$34.4M
8%	$24.5M	$26.7M	$28.1M

Let's use the middle at $32 million. Add the $10 million of bank debt and $2.5 million of capital for withdrawn partners, and we get $44.5 million. Take assets of $30 million and the ratio is 1.48 times (full coverage is 1 times).

Why the ugly ratio? Should we include "solid" unbilled work in process as an asset? Assuming it is two months on balance, apply half, or one month of billing, for another $8.3 million. Now the ratio is 1.16 times. What about all of the paid-in capital for the active partners of $12.5 million? The moment the firm collapses, that's a creditor claim. Add that and the ratio jumps to 1.49 times.

OK, dismiss the retired partners payout, just look at the $38.3 million in "assets," retain the $10 million bank line, $2.5 million of withdrawn partner capital, and the $12.5 million of active partner capital. That is $25 million debt, dropping the ratio to .65 times. Good, but is it realistic?



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Note we have not included partner paid-in capital as an asset since it is already factored into the cash/receivables/asset side of the balance sheet. The only meaningful realizable asset in the event of failure is receivables and a small cash balance. The secured lenders take the first $10 million from our $38.3 million, leaving $28.3 million. But receivables don't pay out in full, rather collection rates are closer to 50 percent, about $14 million for our firm.

The landlord will have a claim in bankruptcy ahead of the partners. The firm has a solid $700,000 in revenue per lawyer (RPL), which means about 143 lawyers. Estimate the landlord claim at 18 months of rent on 75,000 square feet (500 per lawyer) at $40 per square foot per year, which is $3 million, leaving $11 million. Equipment lessors, vendors, WARN claims are another few million, and what they don't take the liquidation process will reduce further. That should still leave perhaps $5 million to return to partners, right?

Remember, firms don't tend to fail with average levels of debt. Bank working capital credit line agreements often top out at around 60 percent of receivables. When firms fail, they tend to be much closer to the maximum level, and if so, that means $10 million more debt. There is unlikely to be anything left for partner capital repayments. Retirement payments have been completely lost.

This exercise reveals that law firms simply do not have the ability to deliver realizable value beyond a conservative secured lender and a landlord with a lease claim limited by the bankruptcy rules. Third-party unsecured claims are fortunate to get a good recovery. Furthermore, to the extent the firm is deemed insolvent prior to filing, partners may be required to disgorge distributions they received during the deemed insolvency period.

Almost all law firms operate without the ability to cover debt and return partner capital in the event of hard times. Even our example firm reflects no bad metrics as normally reported. RPL is good, profit margin on operations is solid, office space is close to perfect, rent is reasonable, and third-party claims were modest. Yet, $15 million of partner capital returns would barely be satisfied if the firm collapsed.

Unfortunately, there is another catch. Unless partners were prepared to take distributions on a "pay it when we get it" basis, they must have a source of cash to pay partners. Having no debt is not necessarily the answer. Partner capital is essentially an interest-free loan to the law firm. If the firm turns to a heavier capitalization model, it does not change the dynamic, it just puts all risk on the partners. If partners borrow with full recourse loans to the bank for capital contributions, all the firm did is push down the liability to partners individually.

The danger law firms first encounter is when they are not able to operate without revolving lines of credit, and each year begins with the assumption that robust credit line is available. When it is not, the structure can unravel with almost blinding speed. And as we have seen in recent firm failures, taking a pay cut or putting in more capital doesn't solve the problem.

Thus, the coverage ratio is valuable for demonstrating the core challenge to law firm operations, the critical nature of maintaining liquidity. And it raises powerful questions about compensation models, guarantees and distribution policies.

Edwin B. Reeser *is a business lawyer in Pasadena specializing in structuring, negotiating and documenting complex real estate and business transactions for international and domestic corporations and individuals. He has served on the executive committees and as an office managing partner of firms ranging from 25 to over 800 lawyers in size.*

EDWIN REESER
Pasadena