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Case Study—Business Interruption: An Exposure by Many Names

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In pace, ut sapiens, aptarit idonea bello (In peace, as a wise man, he should make suitable preparation for war).

—HORACE (65 B.C.–8 B.C.) *SATIRES* II, 2 (111)

Case Study—Business Interruption: An Exposure by Many Names

| William K. Austin, Austin & Stanovich Risk Managers LLC, Gail A. Bonitati, RPA, KPMG, and Thomas Gaitley, CBCP, Copper Harbor Consulting

Abstract: The sobering lessons on business interruption in this case could easily be applied to the devastation following the Gulf Coast hurricanes in fall 2005, or to the effects of a pandemic like the avian flu. Business Continuation Planning is essential, and must include all sources of institutional revenue, as well as Business Interruption insurance coverage at appropriate levels using appropriate forms and endorsements.

Template for Disaster

Judy is a risk manager for Aberdeen University, a private institution with 12,000 students in Aberdeen, North Carolina, a town with a population of 70,000.¹ AU, as it is known, is internationally recognized for its undergraduate and graduate biochemistry and biophysics programs, sophisticated laboratories and cutting-edge research. Research grants totaled nearly \$40 million in the prior fiscal year, and represent a significant portion of AU's total revenue. Judy accepted the position six months ago when her boss retired at the beginning of the fall semester.

Judy returned to AU in response to a telephone call received at home at 11:45 p.m. The Provost had called to report a massive explosion. While no injuries or casualties were suspected due to the late hour, the blast destroyed Bioscience Building 1, the building that housed the renowned biochemistry and biophysics laboratories. Bioscience Building 1 had long been associated with the University's reputation for academic excellence in the sciences. The Provost told her all department heads were needed immediately on campus to determine the critical steps necessary to keep campus operations as near normal as possible. As she drove to AU, Judy's mind was racing. She knew the property insurance coverage was very broad, based on what the broker said when the policy was renewed last month.

AU department staff attempted to gather at midnight to decide how to continue operations. It took each member nearly thirty minutes to navigate the campus scene and find one another. Police and fire personnel strictly limited access to the campus to only those who had an "emergency need," so their initial meeting site was difficult to reach, and they had made no provisions for a backup meeting site off-campus. With parking restricted, it took another ten minutes for Judy to walk to the meeting site. Judy wished she had some way to communicate with everyone before physically meeting.

Judy brought her disaster plan template, which her predecessor obtained from a neighboring university. While there had been talk of a "table top" walkthrough of the plan, it had never been done. As she inspected the template minutes before the staff meeting, Judy noticed it did not address the biochemistry or biophysics labs. The template was modeled on a liberal arts institution that had no bioscience research facilities, and focused instead on the need for housing alternatives as a result of

a dormitory fire.

The initial damage assessment was sobering:

- Because specialized research equipment had to be custom made, it would likely take more than a year to replace the laboratories. Consequently, an interruption of at least three semesters would also be likely.
- The biochemistry and biophysics programs, especially at the graduate level, were so specialized that no comparable facilities for teaching or research were readily available within 500 miles to accommodate AU.
- More than 1,000 undergraduate and graduate students relying on AU's bioscience labs would now experience major interruptions in their studies.
- A majority of bioscience students would have no other

Because specialized replacement research equipment would have to be custom made, a three-semester interruption is likely.

choice but to transfer to other schools if unable to stay on track for a timely graduation at AU.

- Transferring students could cost AU an annual loss of tuition and related income in excess of \$30 million. The ongoing impact of student transfers could result in multiples of \$30 million over the years. If AU were to relax its admission standards in an effort to reduce tuition losses, it could seriously jeopardize its long-standing reputation for academic excellence for many years to come.

A senior representative in AU's Office of Sponsored Research (OSR) told the group about a telephone conversation she had minutes earlier with a representative from AU's Office of Technology Licensing (OTL):

- While not yet quantified, it has been discovered that research worth several million dollars has been lost, and the quality or existence of duplicate information is unknown.
- This event could (best case) suspend research grant payments until the laboratories resume 100% capability, or (worst case) subject AU to immediate mid-term termination of several critical research projects.
- Research delays caused by the explosion could result in a loss of rights to a new bioscience tool created by AU scientists. Although public disclosure was already planned and is inevitable, the patent submittal paperwork was also lost and cannot be re-created prior to the imminent publication date. The fact that this situation may prompt a lawsuit by the licensor against AU is a matter of serious concern.
- If key faculty are unable to continue their research at AU, they could decide to seek teaching/research opportunities elsewhere. This could dramatically impact incoming students, current students (especially at the graduate level), and future research grants and licensing fees.

Several department heads argued about pecking order and what critical actions need to be taken to resume operations. Discussion based on assumptions about bioscience research and grants was tense. Those in attendance were

struck by the fact that the AU being discussed around the table bore little resemblance to the AU that existed just an hour ago. How could a university as renowned as AU be so misunderstood by its senior officials in its most critical hour?

What Judy will realize is that a number of assumptions made in prior years regarding business interruption (BI) exposures could affect AU for several years to come, and that a catastrophic BI event requires much more than an insurance policy. AU had fallen into a trap common to understanding and appreciating BI exposures in an academic environment: failure to thoroughly understand sources of, and exposures to, *all* revenues, and the fact that extra expense is only one of many time-element exposures.

AU relied on risk financing through its purchase of insurance, a process that is not a substitute for a risk management program. Risk financing should begin only after an analysis of key contributors to the value of the organization is completed (contributors both to revenue and to reputation), exposures are identified, and risk control, continuity and/or mitigation strategies are implemented.

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The Fundamentals

BI exposures are difficult to estimate since one cannot simply look at a building to determine its revenue contribution to the institution. The risk manager must understand: the function and use of a given building; any unique or special equipment and other contents contained within it; the time needed to recreate it after a catastrophic event; and the overall effect the loss of this building and its contents will have on other activities for the institution as a whole. A BI process that begins and ends with the completion of a worksheet is not sufficient for managing a catastrophic event, and will not provide essential step-by-step post-event guidance that is critical for an institution to resume normal operations.

Risk Identification and Assessment

An institution's annual financial statement can be used as a starting point to identify and break down all revenue

streams. This statement can also provide an order-of-magnitude analysis to identify any interdependencies within revenue streams, such as those from OSR and OTL. However, the chief financial officer or similarly positioned individual will need to identify any new revenue streams subsequent to the date of the financial statement and any planned for the foreseeable future. Other risk assessment steps include:

- Prioritize all revenue sources by contribution toward the aggregate value of the organization, not just by the dollar amount. Consider all revenue sources, including revenue obtained from outside users of on-campus facilities such as gymnasiums, sports arenas and theaters/concert halls. Tuition often appears to be the most obvious revenue stream, but it may be dependent on other revenue streams such as research grants, as in the AU story. As an example, biochemistry may presently rank 15th in overall current revenue, while the university has a goal to increase its overall contribution by a certain percentage by a specific time in the future. This potential change in revenue will require the university to recognize the future goal as it sets its BCP critical activities to ensure the goal is factored into all plans.
- Development normally follows research and can greatly contribute to new revenue growth. Since many departments share the same revenue streams—e.g., Admissions, Financial Aid and Registrar Offices—these departments need to avoid counting these revenue sources twice.
- Identify key buildings, facilities and laboratories critical to overall revenue generation. Are there redundant locations that can be placed into service quickly if something happens to key locations? What amount of down time is anticipated, with or without redundancies, while the institution rebuilds after a catastrophic event?
- Determine how grants and license fees are generated and their susceptibility to loss. Vital records and research materials should be duplicated and stored off site if possible to minimize single points of failure and to create redundancies. Time frames for recreating research subjects (animals, cultures, byproducts, processes) need to be accurately assessed for their impact on these revenues.
- Consider revenue from use of non-owned/off-campus locations such as theaters/concert halls, auditoriums and sports arenas. An example is a university's use of

a non-owned sports arena where it receives a portion of ticket sales and broadcast rights. Inability to use the arena may result in a loss of income to the university. These facilities may pose contingent exposures and will require special treatment when determining appropriate use of risk controls as well as insurance coverages.

- Use the business continuity planning process (BCP) to enhance the risk identification and assessment process. The BCP² process pinpoints key operations and activities that are critical to the survival of a university. BCP is a triage process established pre-loss to concentrate recovery efforts on predetermined critical activities. A natural follow-up to the BCP process is a focused analysis to identify exposures to these critical activities.
- Create BI values from the BCP process. BCP will uncover revenue streams and the time needed for each to be fully reestablished. Using annual values may not be sufficient for operations that require more than a year to resume normalcy, as demonstrated in the AU story. Conversely, a viable and tested recovery strategy may show that the time required to recover, and the associated BI values, are half those originally projected.
- Consider any lag in revenue streams that may occur *after* all damage is repaired or replaced. As in the AU story, simply returning the campus to pre-loss operational levels will not be sufficient to immediately re-establish revenue at pre-loss levels. Communicating to key stakeholders (i.e., students, faculty and grantors) that their continued investment is worthwhile can help overcome “stakeholder jitters,” and reduce the lag time in restoring revenue.

Risk Controls

Once the BI exposure is understood, the risk manager can determine how to minimize the possibility of risk and how to mitigate it if an event occurs. BCP is a process to identify ways to minimize and mitigate identified risks (e.g., pre-loss and post-loss).

- Identify the risks that jeopardize all sources of revenue and develop a plan to reduce the frequency and severity of the exposures.
- Develop plans for critical functions that support key revenue sources and the institutional mission. All contingency plans must: (1) start from the top down, beginning with the mission; (2) identify the areas that

support the mission; (3) identify those critical functions that support those areas; and (4) develop an alternate recovery strategy and the necessary resources to support it should that function be impacted. Starting at the top and “drilling down” is a more efficient way to develop plans than the traditional middle or bottom up method. This approach facilitates focused data gathering in specific areas rather than gathering a lot of unnecessary data across the institution.

- Create redundancies in key operations by breaking down the risk into separate units, such as labs in several buildings instead of one building that houses all labs of a certain type. For example, a physically separated undergraduate lab may serve as emergency recovery space in the event of a loss to the graduate labs.
- Identify organizations (i.e., university and non-university) with similar instrumentation needs and capabilities where the institution may be able to subcontract certain research activities, such as renting time on another organization’s x-ray diffraction or mass spectrometer machine.

Risk Financing

BI insurance can be considered after the exposures are identified, quantified and risk controls are in place. Further, an educational institution should consider BI coverage issues such as:

- business income, including extra expense
- ordinary payroll
- extended period of indemnity
- extra expense only
- tuition and fees
- research and development
- contingent coverage, and
- service interruption.

Business Income

Business income coverage insures the loss of net income, including income taxes to the extent income would have been earned, and the continuation of normal operating expenses.

This coverage also reimburses the institution for expenses over and above those incurred to maintain operations at pre-loss levels. However, there are some restrictions on expenses that will be covered in the business income coverage.³

Each institution may look at business income issues differently. Some will insure all revenue streams, while others may deem that only certain income streams need to be insured if sufficient operational redundancies exist. These decisions should be made only after an in-depth understanding of the overall business interruption exposure has been evaluated.

Some institutions will insure all revenue streams, while others may deem that only certain income streams need to be insured if operational redundancies exist.

Institutions with specialized facilities that lack redundant space or backup facilities need to consider the effect of a catastrophic event on tuition. For example, AU may lose students midway through their college careers if they cannot wait for AU to resume normal operations. Incoming and transferring bioscience students may opt to matriculate at, or transfer to, a competing institution rather than wait for timely replacement of AU laboratories.

Further, an institution may experience a continued reduction in tuition and related fees even after all damages are repaired and normal operations are resumed. Business income coverage will end on the earlier date of exhaustion of the coverage limit or the date when the property should be repaired, rebuilt or replaced with reasonable speed and similar quality, or the date when operations are resumed at a new permanent location.

The policy expiration date does not limit coverage under the business income form.

Tuition and Fees

Many insurers offer a “tuition and fees” endorsement to expand the normal definition of “income” to include tuition, student fees such as room and board and lab fees, bookstores, athletic events, and activities related to research grants. The wording used by the insurer is important, because it is possible that certain revenue streams, such as license fees, may fall outside the “income” definition and thereby not be covered.

Similarly, revenue contingent on certain property may

not be insured if the property is excluded, such as data, animals, or valuable papers and records. Coverage wording needs to be reviewed carefully to ensure it mirrors insurable exposures. An adequate coverage period is discussed in the next section.

Extended Period of Indemnity

Income may continue to be reduced even after all reconstruction efforts are completed. In the AU example, reconstruction could take as long as eighteen months, prompting students to transfer to other schools and causing a reduction in income for months to follow.⁴ The usual thirty-day grant of extended period of indemnity in business income forms will not be sufficient for AU or most educational institutions. This exposure needs careful review in order to ensure that there is both a sufficient coverage limit and indemnity period.

There are two key issues to optimizing coverage under an extended period of indemnity form. First, the business income limit must be sufficient for the extended period. Values used to establish the overall business income limit should recognize the loss during the period of reconstruction and the continued loss during the post-reconstruction period.

Second, the coverage time period must mirror the time period of decreased income. Some insurers will use a “Tuition and Fees” endorsement, as previously discussed, which includes a special definition for period of restoration as shown below. The purpose of this form is to recognize the peculiarities of educational institutions, especially the exposure from student attrition.

“For educational institutions, the Period of Restoration ends on the earlier of: a) the day before the opening of the next school term following the date the property should be repaired, rebuilt or replaced with reasonable speed and similar quality; or b) the date when the school term is resumed at a new permanent location.”

Under this wording, if reconstruction efforts are completed on October 4 for an academic year that began on September 1, then the business income coverage will continue until January 9 if the institution resumes its next semes-

ter on January 10. This wording will not cover any further reductions in income that persist in subsequent semesters. In the AU example it is thought that the residual loss could occur for a lengthy period, possibly far longer than would be insured under the wording identified above.

Ordinary Payroll

Employee payroll and employee benefit costs are covered as continuing expenses within a business income policy form. One way to decrease premium for business income coverage is to limit or eliminate ordinary payroll coverage. Ordinary

payroll is usually defined as payroll of all employees *except officers, executives, department managers, employees under contract, and similar key employees.*⁵ An institution’s workers’ compensation policy can be a guide to what may be ordinary payroll by looking at classification code 9101—“College—all employees other than professional or clerical.”⁶ The majority of the institution’s payroll will fall within the workers classification code 8868—“College—professional employees & clerical.”

The decision to limit coverage for ordinary payroll needs to be reviewed carefully. The limitation on ordinary payroll will include costs associated with employee benefits as well. Laying off ordinary payroll employees may allow the institution to save premium dollars pre-loss, but may also create delays in resuming normal operations post event if the labor market shrinks post-loss. This may occur if quality replacement workers are difficult to hire on a timely basis. In some instances, retraining time is not included in the period of interruption or restoration.

If ordinary payroll is excluded from coverage there may still be ways for the institution to pay wages and benefit costs to these employees. The cost of employee labor used for repairs, debris cleanup, and related post-loss costs can be part of the overall property damage loss settlement. This should be discussed with the insurer prior to making a decision with respect to ordinary payroll coverage. In either event, the payroll paid to the employees outside of the business income coverage may be less than would have been paid in the absence of an ordinary payroll limitation or exclusion.

The payroll to employees outside of BI coverage may be less than would have been paid without ordinary payroll limitations or exclusions.

The use of a payroll limitation or full exclusion may put the institution at risk of losing these employees by the time it can bring them back to full-time status. It is worth repeating that *this coverage decision needs careful analysis.*

Extra Expense

Some institutions conclude their need for BI insurance is strictly for the increase in expenses to run the institution after a major loss. These institutions do not foresee the need to insure the potential for lost income or for continuing expenses. As such, they purchase extra expense coverage and not business income coverage. This arrangement may be appropriate for a small, contained loss such as fire to a limited number of dormitory rooms. In this case, the institution should be able to move the students to temporary housing (e.g., a hotel) until the dormitory is repaired. The reliance on extra expense may not be sufficient for a catastrophic loss such as a major fire at a dormitory, dining hall, sports arena or specialized laboratory. The decision to insure only extra expense needs careful review and consideration.

Extra expense coverage will end on the earlier of the date of exhaustion of the coverage limit or the date when the property should be repaired, rebuilt or replaced with reasonable speed and similar quality, or resumed at a new permanent location. The policy expiration date does not limit coverage under the extra expense form.

Research and Development

Consideration should be given to research issues since this area generates significantly more expense than revenue during the research phase of a project. Coverage needs to be analyzed and discussed to ensure that these expenses, including the salaries of the researchers, are recoverable following a loss.

Contingent Coverage

An institution may derive income from properties that it does not own or lease but uses during the course of an aca-

demical year. An example is a non-owned sports arena used by the institution from which it obtains a portion of ticket sales and broadcast rights. A catastrophic event at such a facility may cause a disruption in income to the institution. A contingent business income and extra expense exposure may exist. Coverage should be considered.⁷

Service Interruption

An interruption of utility service such as water, sewage, electricity, steam, gas, chilled water, telephone, and internet access may result in a business income loss to the institution. Usually, coverage for damage off of the institution's premises that results in service interruption on-premises can be insured. Coverage should be considered.⁸

How AU Could Have Responded

What could AU have done differently? Let's use a technique that is not available to risk managers after the loss—turning the clock back. How could AU have responded to the explosion if its officers had planned and created a BCP for this potential event?

- During the planning process, AU prioritized the key contributors to the future value of AU. Preserving the undergraduate student credit hours and the ongoing graduate research activities in the biochemistry and bio-

physics programs were top priorities. The agreement to allocate limited post-disaster resources to these programs, at the sacrifice of other courses and activities, was discussed and agreed upon, eliminating the need to make this a hasty decision during a crisis.

- At the beginning of each semester, the deans and department chairs provided a list of their priority courses based on their contribution to meeting graduation requirements (e.g., whether they were prerequisites for other courses, etc.). This allowed the Provost to make informed decisions about how best to allocate all academic space in light of the disaster, even those classrooms and laboratory areas normally controlled by individual schools or departments.

An institution may derive income from properties it does not own or lease but uses, like a non-owned sports arena from which it obtains ticket sales and broadcast rights.

- Leveraging the relationships of the department chairs and professors, agreements were made with other educational and corporate organizations that use similar long-lead-time research, instrumentation and laboratory equipment. This allowed AU to purchase/rent time on key equipment for portions of research that couldn't be conducted locally, or to relocate graduate students, and their families, if necessary, to other areas in the state/country to resume critical research. The damage assessment portion of the plan allowed the department to quickly identify and communicate those research activities that could be continued elsewhere with a minimum of interruption.
- The BCP team had diligently practiced implementation of the plan several times in the past years, and Judy led one "table top" exercise after her promotion to risk manager. This experience allowed her to understand her role and the overall emergency and crisis decision-making framework within AU following an incident.
- All members of the BCP critical team had a copy of the BCP readily available at their homes as well as their offices in the event of a disaster. Judy did not have the only copy, and the BCP was specifically designed for AU. The template was only useful in helping her identify some of the major components that needed to be included in the AU plan.
- A call tree was created as a first step of the BCP, which required Judy to call all other team members after receiving the initial call from the Provost. This allowed the Provost to initiate other critical tasks such as calling the communication and public relations teams into action.
- The first post-incident emergency team meeting was held using a telephone conference bridge and was not held on campus. The conference bridge was arranged in advance and the call-in number and participant/host codes were disseminated to all Crisis Management Team members. This early key step was implemented to get BCP team members functioning on BCP issues, not wasting time commuting to a campus location. Subsequent meetings will be held on campus at one of several "emergency operations centers" pre-established in the BCP. The BCP also has an off-site location identified in case the campus locations cannot be used or are inaccessible.

- Because AU officers understood the importance of its bioscience revenue and dependence on its laboratories, they created a second bioscience building two years ago as part of their normal expansion activities. This building provides needed redundancies should a catastrophic event occur.
- All critical research data is backed up daily to off site servers. Archived lab notebooks are stored off site, and can be used to resume non-generational research activities elsewhere if current notebooks become unavailable.
- AU's president is scheduled to call all major research project owners to notify them of any catastrophic event and how AU will be able to respond and keep research timetables or schedules on track.
- Senior members of the bioscience academic department will meet with small groups of bioscience students to apprise them of the event and how AU will work with them to minimize or limit any long-term impediments to their education. This is one of the key initial activities outlined in the BCP to manage reputational risk and limit student attrition.
- The property insurance program was modified several years ago and has a manuscripted form for an extended period of indemnity for business income loss. AU has coverage for up to three semesters after completion of reconstruction activities. This coverage should limit the possibility of insufficient insurance recovery for any residual reductions in revenue after construction is completed.
- As an added assurance, AU held pre-loss planning meetings with the insurer's adjustment staff to verify application of coverage through use of a scripted loss scenario and to create claim submission procedures.
- Due to the step-by-step nature of the BCP, the overall AU campus is seemingly unaffected by the explosion at Bioscience Building 1.

Conclusion

Clearly, Judy would have welcomed the chance to turn back the clock. The opportunity to determine risk management and recovery priorities, to evaluate insurance mechanisms to transfer a large part of the business interruption exposure, and to work in coordination with other AU departments to better understand the university's operations would have significantly enhanced AU's response and recovery position.

How many of us would be in Judy's current position if a similar catastrophe occurred at our institution today?

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Endnotes

- ¹ All names are fictitious.
- ² We use the term "business continuity plan" and not "disaster plan" in this article. A disaster plan typically refers to the recovery of the information technology infrastructure, not necessarily the business operations that are dependent upon them. While the terms are similar, BCP is more expansive and includes not only the disaster recovery plan but also those key actions, responsibilities and benchmarks, through time, necessary to resume previously identified critical operations within acceptable time limits. A crisis management plan may be a component of a BCP for events such as student death, sexual assault or student riot since the decision-making framework under any emergency/crisis condition should be the same.
- ³ The discussion of insurance coverage in this article is not to be considered the rendering of a coverage opinion or the rendering of professional services. An insurance policy must be read in its entirety to establish coverage intent. For the purposes of this article we have considered business

income forms that include extra expense coverage. We have not contemplated any business income forms that exclude extra expense coverage.

- ⁴ Ed. note: This very problem happened to Gulf Coast schools in the fall of 2005 after Hurricane Katrina.
- ⁵ The ordinary payroll definition used by insurers is not standard and may differ by insurer. Some policies do not use an ordinary payroll definition, which may pose loss settlement issues. These issues need to be reviewed carefully when making decisions on any limitation on payroll coverage.
- ⁶ The workers' compensation code 9101 payroll may not translate directly to the same amount for business income coverage as it does not include expenses such as overtime, employee benefit costs, and may be subject to payroll caps.
- ⁷ Contingent coverage and service interruption issues are often overlooked by risk managers and may pose significant exposures to an institution. It is not the intent of this article to delve into the exposures or coverages related to contingent coverage or service interruption.
- ⁸ Refer to note 7 above.

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