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EDITOR'S NOTE

As the 8.9 magnitude earthquake that struck Japan on March 11, 2011 continues to teach the world a multitude of lessons, one of them is a clear reminder to companies of the need for contingent business interruption coverage.

In addition to the tragic loss of life caused by the tremors and resulting 23-foot tsunami, the decimation included numerous Japanese businesses whose timetable for return to productivity will be uncertain for some time. The interruption or slowdown is having a dramatic effect on those who rely on them for parts and materials, including American companies and Japanese firms with operations in the United States.

As author and insurance expert Donald Malecki points out in this article, "As has become evident from this Japanese catastrophe with its worldwide repercussions, insurance is not the only way to treat risk. In a perfect world, businesses would not become dependent on single sources. Unfortunately, that is not always possible. In that case, foresight is necessary to identify the potential causes of loss and to determine how best to handle them."

For more on this important wake-up call, read on.

—Sheila E. Salvatore, Editor

Japan Earthquake a Wake-Up Call for Contingent Business Interruption Coverage

By Donald S. Malecki, CPCU

In the wake of the recent catastrophic earthquake and tsunami in Japan, and the aftermath of radiation leaks from that country's nuclear energy plants, repercussions are being felt not only in that country, but worldwide.

Although only 4 percent of Japan's foodstuffs are imported by U.S. businesses, other U.S. industries have come to rely on Japan not only as a sole supplier of products necessary to make finished goods for export or sale, but also as the sole purchaser of U.S. products and technical assistance.

U.S. businesses adversely affected by this unprecedented disaster are pondering, perhaps too late in some cases, whether their business insurance will pay for their loss of income in being unable to continue normal operations.

One particularly important form of insurance that comes into play and which also took center stage following the September 11, 2001 World Trade Center disaster, is contingent business interruption. This insurance covers a business for its loss of income and other expenses resulting from total or partial suspension of operations because of physical loss or damage to dependent property that is not owned, controlled or operated by the business, provided the loss is caused by a covered cause or peril.

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Keys to Coverage

Property policies differ and so, too, does contingent business interruption insurance. The keys to triggering this coverage, in general, are: (1) direct physical loss or damage to the dependent property; (2) loss or damage from a covered cause of loss; and (3) the territorial scope of coverage.

For purposes of illustration, and assuming the territorial scope is not an issue, a U.S. business would need to maintain earthquake insurance to trigger contingent business interruption coverage because a Japanese supplier's business is damaged or destroyed by earthquake. If the Japanese business were damaged or destroyed solely by the tsunami, contingent business interruption coverage would not be activated for a U.S. business unless it had flood coverage in force. If, however, a U.S. business did not maintain earthquake or flood insurance, coverage still could be activated for any damage or destruction by fire following an earthquake and/or tsunami.

As stated, the foregoing illustration assumes that physical damage or destruction by a tsunami would be covered by flood insurance. However, it is likely that one of the big disputes (other than with ISO forms, as mentioned later) that will come out of this is whether, in fact, a tsunami falls within the definition of flood or an earthquake, particularly when earthquake insurance was purchased but flood and other water damage coverage was not. In such a case, businesses would likely argue that earthquake insurance applies to damage or destruction by the tsunami, because earthquake was the proximate cause of loss and, but for the earthquake, the tsunami would not have occurred.

A lot is at stake here, too, because earthquake deductibles in Japan are likely to be very high. Therefore, application of the deductibles is likely to be subject to argument.

The problem is that a business would have had to identify in advance the potential for such a disaster, which is probably something that few did since the entire world was shocked by the intensity and aftereffects of this catastrophe. With foresight on risk management, however, having identified that possibility of an earthquake and tsunami, the next step would have required evaluating the maximum loss potential and then determining how much insurance would be necessary during the period a dependent business was out of commission.

To the extent that there are U.S. businesses — with single-source suppliers from Japan — covered by standard Insurance Services Office (ISO) property insurance, the coverage portfolio would have had to be modified with an international form of contingent business interruption and/or extra expense coverage.

Business Income Dependent Properties Limited International Coverage

The Business Income Dependent Properties — Limited International Coverage Endorsement CP 15 01 04 02, as its name indicates, is intended to provide loss of business income coverage in connection with contributing locations or manufacturing locations. Both of these locations are defined in this endorsement by the term "dependent property." Thus, a contributing location means "property operated by others whom you depend on to deliver materials or services to you, or to others on your account." A manufacturing location means "property operated by others whom you depend on to manufacture products for delivery to your customers under contract of sale."[1]

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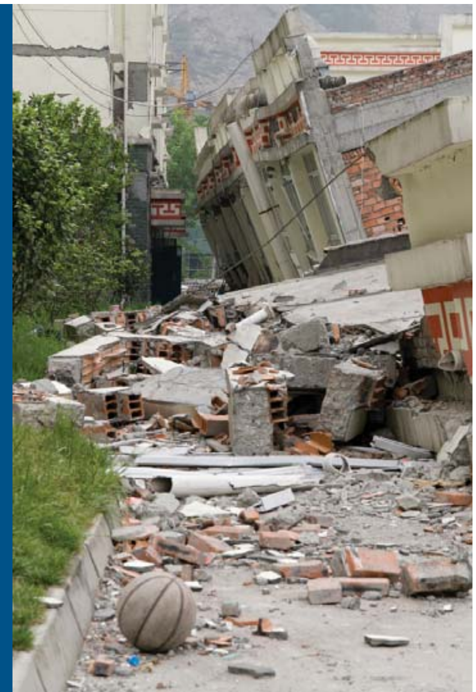


Whatever location is designated, i.e., contributing or manufacturing, a limit of insurance also is required to be shown on this endorsement. The limit applies in addition to the business income limits applicable to the named insured's own premises which, of course, also is necessary.

The fact that a business maintains a special causes of loss form (all risks) on its property exposures does not mean that the same causes of loss have to be applicable to dependent properties. This endorsement can be made applicable to the Basic, Broad or Special Causes of Loss Form. Space is allotted to also list other endorsements supplementing the covered causes of loss, such as earthquake and flood.

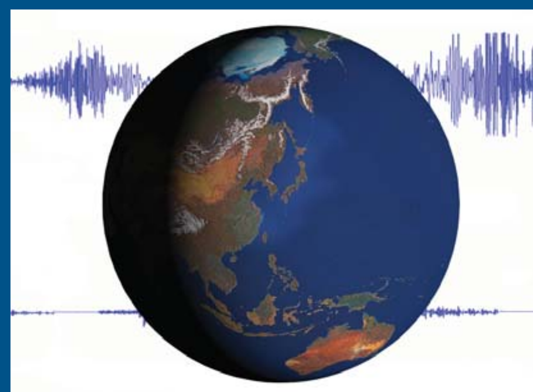
To compensate for this limited international coverage, the covered territory condition in the Commercial Property Conditions

CP 00 90 Coverage Part is stated not to apply. This Coverage Part contains a provision entitled "H. Policy Period, Coverage Territory," which states that the territorial scope encompasses the United States of America, including its territories and possessions, Puerto Rico and Canada. By this territorial condition not being applicable, the Business Income Dependent Properties and Extra Expense Endorsements can apply internationally.

The coverage of this endorsement is activated when there is direct physical loss or damage to "dependent property," at the premises described in the schedule of the endorsement, caused by or resulting from a covered cause of loss. When this occurs, and subject to the selected limit, the insurer promises to pay the actual loss of business income the named insured sustains due to necessary "suspension" of its "operations" during the "period of restoration."

The suspension, which can be a slowdown or complete cessation of the named insured's business, begins 72 hours after the time of the otherwise covered physical loss or damage.[2] Coverage ends on the date when the property at the premises of the dependent property can be repaired, rebuilt or replaced with due diligence and dispatch or, in the words of the endorsement, "with reasonable speed and similar quality."[3]

> ***"The coverage of this endorsement is activated when there is direct physical loss or damage to 'dependent property,' at the premises described in the schedule of the endorsement, caused by or resulting from a covered cause of loss."***



Not within the scope of the Business Income Dependent Properties — Limited International Coverage Endorsement is any increased period required due to the enforcement of any ordinance or law that regulates construction, use or repair, or has anything to do with pollutants and their cleanup. Coverage under this endorsement also does not apply when the only loss to dependent property is loss or damage to electronic data.

Extra Expense From Dependent Properties Limited International Coverage

The Extra Expense From Dependent Properties Limited International Coverage Endorsement CP 15 02 04 02, which is issued in conjunction with the Extra Expense Coverage Form CP 00 50, tracks closely to the limited international coverage dealing with loss of business income. This extra expense coverage would be appropriate where the additional costs to remain operational following physical loss or damage are more important than loss of business income.

The only difference between this limited international coverage endorsement and the preceding one dealing with income loss, is its references to extra expense and definition. In this endorsement, extra expense means the necessary expenses the named insured incurs during the period of restoration, which begins with the date of direct physical loss or damage from a covered cause. Coverage ends at the same time as does the above Loss of Business Income Endorsement.

The extra expenses, furthermore, are those that the named insured would not have incurred had there been no direct physical loss or damage to the premises of any described "dependent property," as described in the endorsement, from a covered cause of loss to (a) avoid or minimize suspension or continue operations, or (b) minimize the suspension if the named insured cannot continue operations.

For purposes of the ISO forms, any physical damage or destruction from the tsunami would have to come from flood or other water damage coverage. The reason is that both of the ISO Earthquake and Volcanic Eruption Endorsements CP 10 40 and CP 10 45 specifically exclude loss or damage caused directly or indirectly by tidal wave or tsunami, even if attributable to an earthquake or volcanic eruption.

Flood coverage, therefore, would have been necessary either from the National Flood Insurance Program (NFIP) or the ISO Flood Coverage Endorsement CP 10 65. This latter endorsement is commonly used as "wrap around" coverage to the NFIP. It can also be used with the Basic, Broad and Special Causes of Loss Forms to obtain coverage for loss from flood. Flood coverage would have been necessary because the water exclusion in all of the ISO causes of loss forms specifically exclude tidal wave and tsunami.

Other Coverage Formats and the DIC Policy

There are some independently filed property policies, modified with enhanced endorsements, that are broad enough to cover contingent business interruption when the territorial scope is worldwide. Depending on the covered causes of loss, it may be possible to obtain coverage stemming from

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earthquake and/or flood, including other water damage at locations around the world, without having to schedule them.

Multinational companies with global operations will likely maintain dependent properties interruption and extra expense insurance. Such insurance programs often incorporate a "master" global policy with underlying local policies for overseas locations/operations. To the extent the local policies do not afford coverage, the "master" policy will provide the needed coverage.

The big issues confronting these businesses other than limits of coverage are likely to be: which coverage, earthquake or flood, applies to their losses, and whether second-tier suppliers are covered, since most such policies only cover first tiers. Other issues will be loss of utility services, ingress/egress and delays brought about by civil authority.

The Difference In Conditions (DIC) Policy also may be beneficial here in light of the fact that one of its primary purposes today is to obtain coverages not otherwise available under primary property policies, such as collapse, earthquake, other earth movement and flood — including excess of the National Flood Insurance Program.[4]

Property policies were originally written on a named perils basis. In order to obtain broader coverage, the DIC policy was introduced.

What this policy was then meant to provide was coverage on an all risks perils basis, exclusive of the named perils of the underlying property policy. In other words, the DIC policy covered the difference between all risks causes of loss and named perils. Since many, if not most, property policies are written subject to the special causes of loss form (all risks), the DIC policy is not as significant as it once was.

In fact, the DIC policy is to property insurance what an umbrella liability policy is to liability insurance, with both having at least one characteristic in common: they both can "leak." What this means is that coverage under the DIC and umbrella policies is not as broad as it used to be. In fact, both policies appear to operate more as excess follow forms, and whether coverage is broad hinges on what the primary property or liability policy provides.

This means that when the DIC policy includes flood or water damage coverage — defined to mean waves or tidal waves — it should be broad enough to encompass tsunamis. Whether coverage will apply for contingent loss of business income and/or extra expenses will depend on the scope of the flood coverage and the coverage territory. Since the DIC policy is not standard, each one has to be tailored to fit the particular business, to the extent an insurer is willing.

Fire and Explosions

Fire is a cause of loss that is seldom, if ever, excluded. For example, whether a business selects the Basic, Broad or Special Causes of Loss Form to apply with its dependent property coverage, fire would be a covered cause.

Fire often remains a covered cause even when accompanied by a cause excluded or not otherwise covered. It is a cause of loss that falls within the category of an ensuing loss. For example, both the Causes of Loss — Broad and Special Forms — exclude earth movement consisting of earthquake, landslide, mine subsidence, and earth sinking (other than sinkhole collapse). An accompanying provision states, however, that if any one of those excluded causes results in a fire or explosion, the insurer will pay for such loss, but only to the extent of the fire or explosion.

This means that even if a U.S. business did not have the foresight to purchase earthquake or flood coverage in relation to its business income and/or extra expense dependent properties coverage, it is likely to still have coverage when the dependent property was also damaged or destroyed by fire. Since fire was widespread following the catastrophic event in Japan, some coverage for businesses will likely apply.

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Summary—Conclusion

Those U.S. businesses that have come to depend on single Japanese sources for their supplies or for their market of goods or services — and have arranged for some kind of international dependent properties coverage — may have the insurance necessary to continue what is likely to be a long, disruptive course of business.

As has become evident from this Japanese catastrophe with its worldwide repercussions, insurance is not the only way to treat risk. In a perfect world, businesses would not become dependent on single sources. Unfortunately, that is not always possible. In that case, foresight is necessary to identify the potential causes of loss and to determine how best to handle them.

Hopefully a U.S. business chose wisely and selected earthquake and/or flood coverage as causes of loss that could adversely affect its business, or purchased a DIC policy on an international basis. If the insured property was damaged by fire as a result of the earthquake or tsunami, the basic property coverage would trigger the contingent coverage.

Because of ambiguities, disputes will undoubtedly arise over some property policies written for U.S. businesses dependent on foreign sources. Considering how some property policies are structured, with a mix of standard and nonstandard forms and endorsements, it does not take much imagination to surmise potential arguments — issues that are very likely exacerbated by the enormity of financial loss.

These disputes will also include such questions as whether a tsunami is associated with earthquake or flood coverage, particularly if a business did not purchase flood coverage or maintains it for lower limits than may be needed, the application of deductibles, and limits.

Finally, what the impact might be from nuclear radiation and whether it was insured, is uncertain. The way the nuclear facilities were constructed, it was said that they took into consideration earthquakes given that Japan is earthquake-prone. The severity of the earthquake in this disaster of 2011, however, apparently was not contemplated. Whether first and third party liability coverage therefore was purchased through the nuclear pools is something that was unknown initially.

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[1]Copyright, ISO Properties, Inc., 2001.
[2]One should not assume that "suspension" means slowdown, since some independently filed policies, unlike ISO, limit suspension to complete cessation of business.
[3]Ibid.
[4]Use of the term "DIC" may appear to be archaic in the minds of some insurance and risk management people, given the common reference to "global" as the term to connote broad and all encompassing property policies today. The old term is still referred to here because some insurers still refer to it by that name, particularly when issued for businesses that do not have international exposures.

Donald S. Malecki, CPCU

Mr. Malecki is a principal of Malecki Deimling Nielander & Associates, LLC, an insurance and risk management firm. He began his career over 50 years ago and has held the titles of insurance underwriter, broker, insurance company claims consultant, archivist, historian and teacher.

Adjusters International

CORPORATE OFFICE
126 Business Park Drive
Utica, New York 13502
1.800.382.2468
Outside U.S. (315) 797.3035
FAX: (315) 272.2054

Editor@AdjustingToday.com

WEB ADDRESSES
www.AdjustersInternational.com
www.AdjustingToday.com

PUBLISHER
Ronald A. Cuccaro, SPPA

EDITOR
Sheila E. Salvatore

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