

INSURING AGAINST SUPPLY CHAIN INTERRUPTIONS

ISSUE ALERT

By Kevin Amrhein



The Japan earthquake and Tsunami disasters have exposed many U.S. based manufacturers, distributors, retailers, contractors, and other service providers to potentially devastating income losses stemming from an interrupted supply chain.

These sort of indirect losses are very real, potentially devastating, and difficult to quantify. Examples can include:

- Businesses unable to sell specific products due to a lack of supply of key components originating in the disaster area. The same is true of manufacturers slowing or ceasing production.
- The impact of such interruptions on a business's ability to pay bills, including payroll.
- Businesses forced to negotiate contracts with new suppliers.
- Businesses in danger of breaching contracts due to the inability to supply a contractually determined quantity of product.

Business Interruption coverage is designed to cover indirect losses like these, but crafting the right coverage to meet an insured's needs can be tricky. You must consider some very important coverage issues, like:

- What cause(s) of loss can trigger coverage?
- What is the coverage territory?
- What if there is no direct physical damage to insured?
- Does the insured have adequate limits?
- What is the appropriate length of coverage (Period of Restoration)?
- Does the insured have adequate extra expense coverage?
- How do you determine dependent properties?

The following paragraphs discuss why simply purchasing Business Interruption insurance may not be enough to adequately insure a disrupted supply chain.

Cause(s) of Loss

Typical Business Interruption insurance is written as part of a package that includes commercial property insurance. For this reason, coverage under a typical Business Interruption policy is only triggered if the event causing the loss—such as windstorm or fire—is covered under the commercial property policy. A problem is introduced when the cause of loss is not covered by the commercial property policy. Using Japan as an example, major causes of property damage included earthquake and tidal surge; both of which are excluded by standard commercial property insurance. It's important to note that damage caused by a resulting fire, even if caused by an excluded cause of loss such as those above, is usually covered by standard property insurance.

In most cases, the commercial property policy must be modified to cover such events for Business Interruption to afford coverage. To do this, insureds should consider purchasing earthquake and/or flood coverage by endorsement. In the event such endorsements aren't available, the insured may consider looking to the specialty or excess and surplus marketplace for a "Difference in Conditions" (DIC) policy. Such a policy is designed to bring certain causes into coverage that may not be insurable by a standard policy. It's important to note that such policies are non-traditional and should be carefully reviewed in order to determine if Business Interruption is applicable.

Determining "Dependent Properties"

Many Business Interruption policies use the "dependent properties" to describe several different relationships. For example, there are those the insured depends on as a source of a key component or product, such as an auto dealership's dependence on a manufacturer's ability to assemble vehicles. The term also includes businesses the insured depends on to purchase product, such as a lumber distributor's reliance on a large home improvement store or building materials wholesaler.

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It's fair to say that every business's model is built on the ability for other businesses to operate properly. A disruption in the supply chain caused by a catastrophe such as a hurricane could easily trickle down, adversely affecting the balance sheets of businesses located hundreds or thousands of miles from the damage. For this reason, insureds must take the time to define dependent businesses and consider the severity of the result of that business being rendered inoperable for an indefinite period of time. Insureds should consider:

- “How long could I sustain the dependent business's inability to supply/purchase?”
- “Do I have a contingency plan, such as an agreement with an alternative supplier?”
- “Are there contractual obligations, such as a purchase agreement, that I could violate if the dependent business is unable to function? If so, what are the consequences?”

Covering Loss to Dependent Business

Most Business Interruption policies can be easily modified to cover damage to a dependent business. To endorse the policy with this coverage, most insurance companies will require information about the dependent business, such as the nature of the relationship and where it is located.

Insureds should carefully review the language of the endorsement. Some companies may ask for a separate limit of insurance applicable to the dependent business while others will pay the loss out of the insured's Business Interruption limit. Some insurance companies will offer coverage if the dependent business's operations are reduced due to the loss; others may require a complete cessation.

Unless the policy is specifically modified, the dependent business must be located within the coverage territory. For businesses located outside the coverage territory, a different version of the dependent business endorsement may be required.

Coverage Territory

Traditional property policies limit the boundary of covered losses to a defined territory: The U.S., territories and possessions, Canada, and Puerto Rico. Absent modification, if the insured's supplier is located outside of this defined boundary, no coverage for resulting Business Interruption will be covered. Many insurance companies can modify the coverage territory to include dependent businesses located in other areas. These businesses must be specifically defined and the policy endorsed to include them to trigger coverage resulting from their damage.

Period of Restoration

This term refers to the time between the date of loss that interrupts the business occurs and the date by when the damaged property should be repaired or reopened elsewhere. The Period of Restoration represents the amount of time the insured is able to receive payment under the Business Interruption policy up to the limit. Insureds hoping to protect against supply chain interruption must also consider any potential differences in this time frame if the loss stems from damage to a dependent business. In the wake of the recent disaster in Japan, where it is expected that repairs will take a great deal of time, the insured may wish to inquire about the dependent business's contingency plan.

Conclusion

In today's business environment driven by a global supply chain and just-in-time inventory management, interruptions to one link in the supply chain can be devastating. There are many important questions that must be answered to ensure adequate Business Interruption coverage. Hopefully some of those factors discussed above will bring into consideration the importance of this coverage when the direct damage happens to a business other than the insured.

ABOUT THE AUTHOR

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