

Contingent Business Interruption (CBI) Casualty Loss Reserve Seminar (CLRS)

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Content

| | | | |
|---|------------------------------------|----|--------------------------------|
| 1 | Overview BI/CBI Coverage | 6 | Sample CBI Clauses |
| 2 | Basics of BI/CBI Insurance | 7 | Contractual Framework is Key |
| 3 | BI Coverage | 8 | Wording Issues |
| 4 | CBI Coverage | 9 | Ambiguity of Policy Provisions |
| 5 | CBI – Japan Earthquake and Tsunami | 10 | Case Study |

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1. Overview BI/CBI Coverage

- *“Business Interruption”* - Coverage extends until the end of the business interruption period, which is determined by the insurance company. Most insurance policies define this period as starting on the date of the covered peril and the damaged property is physically repaired and returned to operations under the same condition that existed prior to the disaster.
- *“Contingent Business Interruption”* – This coverage, if provided under the policy, pays the insured for loss caused by damage to a customer or supplier’s property that causes interruption of the insured’s business. All of the legal and coverage issues above can be relevant to a determination of whether or to what extent contingent business interruption coverage is triggered. The complicating factor is that the insured may have to prove what caused the closing of a third party’s business.



2. Basics of BI/CBI Insurance

- Purpose of **BI/CBI Insurance** is to protect the earnings or the profits of a business, but it is not a profit guarantee.
- **Business Interruption (also known as business income insurance)** is triggered by damage from a covered cause of loss to covered property of the insured business that causes a “necessary suspension” of business operations.
- **Contingent Business Interruption** is triggered by damage to a supplier or customer from a cause of loss that would be covered if it had occurred to property that would be covered if it belonged to an insured.
- Limited coverage provided for **certain situations** (ingress/egress to property, civil authority orders).



3. BI Coverage

Typically covered under a business interruption policy:

- Profits that would have been earned
(based on prior months' financial statements)
- Operating expenses and other costs still being incurred by the property
(based on historical costs)
- Some policies cover the extra expenses for moving to, and operating from, a temporary location
- Reasonable expenses (beyond the fixed costs) that allow the business to continue operation while the property is being repaired.



4. CBI Coverage

CBI coverage applies in the event of:

- Physical damage to property of a type insured under the insured's policy
- To a supplier or customer's property, either specified or blanket
- By a peril covered under the insured's policy
- Which causes an interruption to the insured's business operation

In such an event the policy covers:

- The business interruption loss under the provisions of the insured's business interruption policy
- For the defined indemnity period



4. CBI Coverage

CBI is **not**:

- Utility service interruption of an off-premises power interruption
- Civil or military authority interruption
- Lack of ingress or egress interruption
- Interdependency or downstream business interruption, when damage at an owned location causes a loss of revenue to another owned location
- Loss which results from a change in temperature due to damage to heating or cooling equipment



5. CBI – Japan Earthquake and Tsunami

The Tohoku, Japan earthquake and tsunami on 11 March 2011 resulted in a dynamic global CBI event, likely the largest CBI loss occurrence ever experienced by the insurance industry. As a result of the damage sustained in the Tohoku region, global time element losses were incurred due to

- third party supply chain failures;
- damage to customers' facilities;
- damage to customers' customers' facilities;
- damage to customers' suppliers' facilities; and
- the breakdown of intercompany fulfilment, leading to **interdependency losses** both upstream and downstream in the operational process.



(Source: Marsh)

6. Sample CBI Clauses

CBI is a result of the coverage terms...

| Example 1 | Example 2 | Example 3 |
|--|--|--|
| <p>"This policy ... also insures against loss resulting from physical damage to or destruction by causes of loss insured against to ... property that wholly or partially prevents any supplier of goods and/or services, or property that wholly or partially prevents any receiver of goods and/or services from the insured from accepting the insured's goods and/or services, such supplier or receiver to be located anywhere in the world ..."</p> | <p>"This policy covers against loss of earnings and necessary extra expense resulting from necessary interruption of business of the insured caused by damage to or destruction of real or personal property, by the perils insured against under this policy, of any supplier of goods or services which result in the inability of such supplier to supply an insured location."</p> | <p>"This policy covers the actual loss sustained and extra expense incurred by the insured during the period of liability: 1) directly resulting from physical loss or damage of the type insured; and 2) to property of the type insured, at any locations of direct suppliers or customers located within the territory of this policy. The term supplier or customer does not include any company supplying or receiving from the insured location... electricity, fuel, gas, water, steam, refrigeration, process for drawing heat from substances to lower their temperature, often for purposes of preservation. Refrigeration in its modern, portable form also depends on insulating materials that are thin yet effective or sewage."</p> |

6. Sample CBI Clauses

CBI is a result of the coverage terms.....

Example 4

"The insurer will pay for **loss** resulting from **necessary interruption** of business conducted at **locations occupied by the insured** and **covered in this policy**, caused by **direct physical damage or destruction** to:

a. any **real or personal property** of **direct suppliers** which wholly or partially prevents the delivery of materials to the insured or to others for the account of the insured ..."

Example 5

This Extension is subject to the EXCLUSIONS, CONDITIONS AND LIMITATIONS of the Policy to which this Extension is attached.

In consideration of the premium paid, it is understood and agreed that if this Policy covers Business Interruption such coverage shall extend to the loss resulting from necessary Interruption of Business caused by **Direct Physical Loss or Damage**, as covered by the Policy to which this Extension is attached, to **property of the type insured** by this Policy which is **owned or controlled** by the **following suppliers or receivers**:

{Missing}

(LIST NAMES DECLARED TO UNDERWRITERS).

[LMA5040, Form approved by Lloyd's Market Association]

6. Sample CBI Clauses

CBI is a result of the coverage terms...

Example 6

«We will pay for the **actual loss of Business Income** you sustain due to the necessary suspension of your «operations» during the «**period of restoration**». The suspension must be caused by **direct physical loss of or damage to «dependent property»** at premises described in the **Schedule** caused by or resulting from any **Covered Cause of Loss**...»

ISO Form

Example 7

«This Policy covers against loss of earnings and necessary extra expense resulting from necessary interruption of business of the insured caused by **damage to or destruction of real or personal property**, by the perils insured against under this policy, of **any supplier** of goods or services which results in the inability of such supplier to supply an insured location.»

7. Contractual Framework is Key

- The BI / CBI coverage is largely a result of the policy wording and therefore the negotiation of the contract terms & conditions plays a vital role.
- Policy has to properly express the parties' contractual intent.
- Certain terms may be determined by statutory legal definitions (e.g. the definition of what constitutes property in the legal sense or the interpretation of causation principles) or by virtue of the market practice.



8. Wording Issues – Suppliers

- The precise language controls the determination of coverage!
- As a preliminary matter, the insured's loss must result from the inability of a "supplier" to provide materials, goods or services. In some policies, the identity of the supplier(s) will be **explicitly listed** or the clause will refer to **direct suppliers**.
- If the policy does not identify a supplier or refer to a "direct" supplier, the issue arises as to whether an indirect or second-tier supplier, such as a supplier of a supplier, is covered.
- The use of the term "any supplier" in a contingent business interruption may suggest to include damage to indirect suppliers. Specifically, the court interpreted the phrase "any supplier of goods or services" as meaning "an **unrestricted group** of those who furnish what is needed.
- Can a subsidiary be considered a direct supplier? In *Park Electrochemical Corp. v. Continental Casualty Co.*, a federal court in New York found that the issue of whether "direct suppliers" would include subsidiaries was a question of fact that must be determined by a jury. The insurer relied upon common insurance industry practice as well as treaties and case law for the proposition that **owned suppliers** are not normally covered under the contingent business interruption clause.

8. Wording Issues – *Physical Damage*

- Requirement that a supplier's property suffered actual physical damage.
- Denial of coverage under a contingent business interruption provision where the supplier's property did not suffer actual physical damage.
- For example, in a Taiwan earthquake case, the court found that a supplier's inability to function after the loss of power did not constitute "direct physical loss or damage."
- With respect to the disaster in Japan, the earthquake and tsunami were followed by various other incidents, such as evacuation orders, embargos, aftershocks and service interruptions caused by the problems at the Fukushima Daiichi nuclear plant. Thus, if a supplier in Japan could not supply parts or goods to an insured because of a **power interruption** or other non-physical damage, there will likely be no coverage under the contingent business interruption provision.



8. Wording Issues – *Damage resulting from Covered Peril*

Further, a typical requirement for CBI coverage is that the physical damage at a supplier's premises results from a covered peril (*i.e. the designated contingency, risk, or hazard against which an insured seeks to protect himself or herself when purchasing a policy insurance*).

Peril meaning either a

- listed peril in a "named peril" policy or
- peril that is not excluded under an "all-risk" policy.

Therefore, if the policy did not include earthquake coverage (or exclude it) and a supplier in Japan could not provide parts because it suffered earthquake damage, there would be no contingent business interruption coverage.

However, exclusions from coverage must be reviewed and analyzed carefully to determine if there are any applicable exceptions to the exclusion, such as an ensuing loss exception, which may result in coverage.

8. Wording Issues – *Period of Liability, Waiting & Restoration Periods*

- Additionally, when evaluating coverage, issues concerning the amount and duration of coverage will arise. Deductibles, such as waiting periods (e.g. 72 hours after the time of the direct physical loss), are common and often require that a certain amount of days elapse before coverage is triggered. There may also be applicable sub-limits in the policy. Similarly, the policy will include a period of liability, period of recovery or period of restoration provision, which will determine for how long coverage exists.

9. Ambiguity of Policy Provisions

- Generally, if the provision is not ambiguous, it is given its plain and ordinary meaning. However, if a policy provision is ambiguous, a court will consider extrinsic evidence *such as* what the parties actually intended; industry custom and practice; and dictionary definitions.
- When considering the parties' intentions, the underwriting file and communications between the insurer and representatives of the insured, such as the insured's broker, when negotiating the policy will be important. When evaluating coverage, the insured and the insurer must review all information relating to the negotiations of the policy terms, such as emails between the underwriter and the insured's broker, and interview all representatives that were involved.



Case Study

- Where:

in the Pacific Ocean, off the coast of Korea

- What Peril(s):

A major EQ impacts South Korea. There is extensive damage to major industrial centers.

An ensuing Tsunami affects commercial shipping ports and floods coastal exposures.

Aftershocks similar in magnitude to the initial quake take place for 96 hours, restricting access to industrial sites.

Major power disruptions occur in the country for 60 days after the event.

Case Study

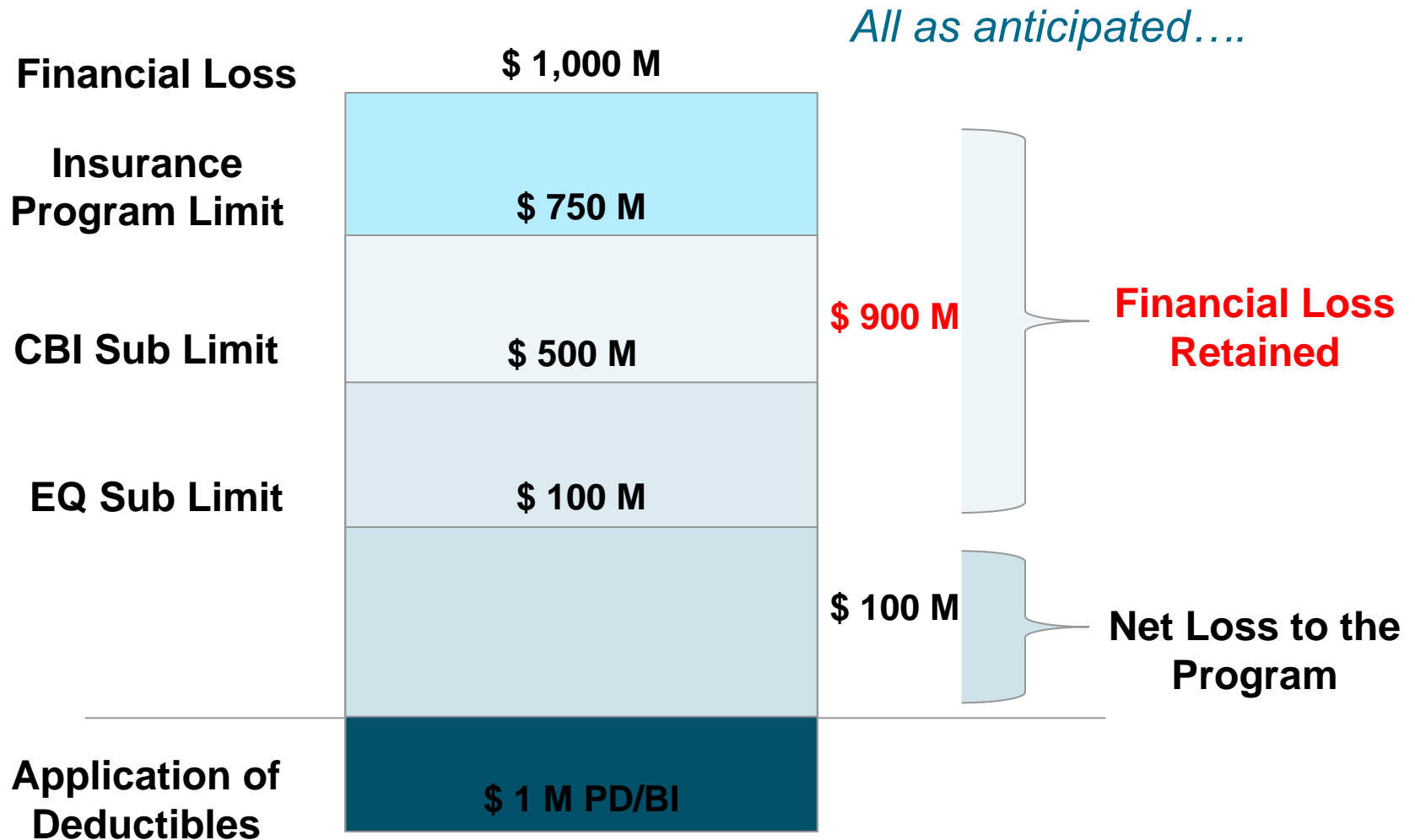
■ Who:

The insured: A major European based Auto Manufacturer (OEM) relying upon key part suppliers located in Korea but without any direct exposure in the region.

Multiple Suppliers who sustained direct physical damage:

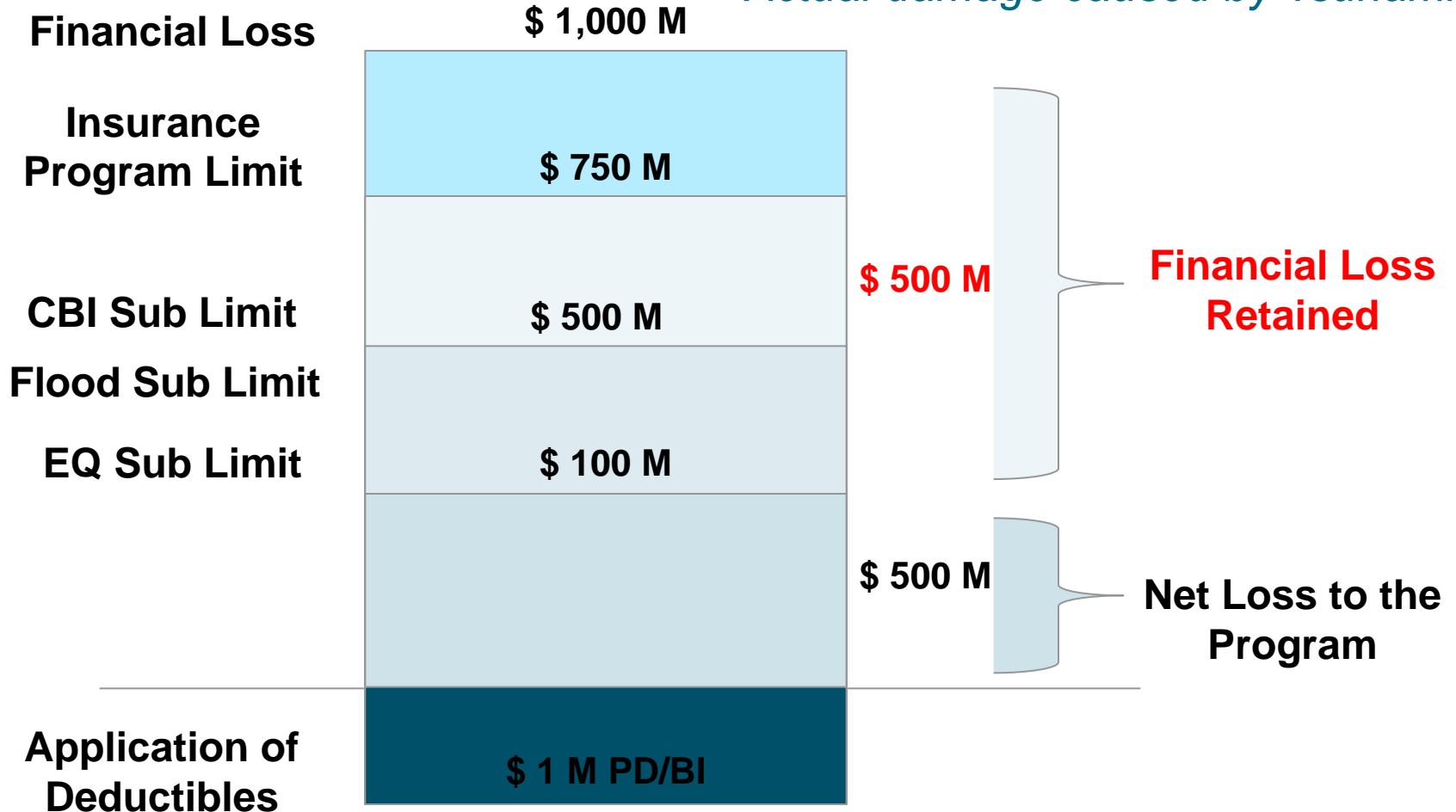
- direct manufacturer of interior rugs, car seats, upholstery
- direct/indirect suppliers of micro chips used in regulating engine performance, radio, navigation systems.
- indirect supplier of pigment used for paint color
- JVs manufacturing engines on behalf of OEM

Risk Transfer Mechanism through an All Risk Property Program

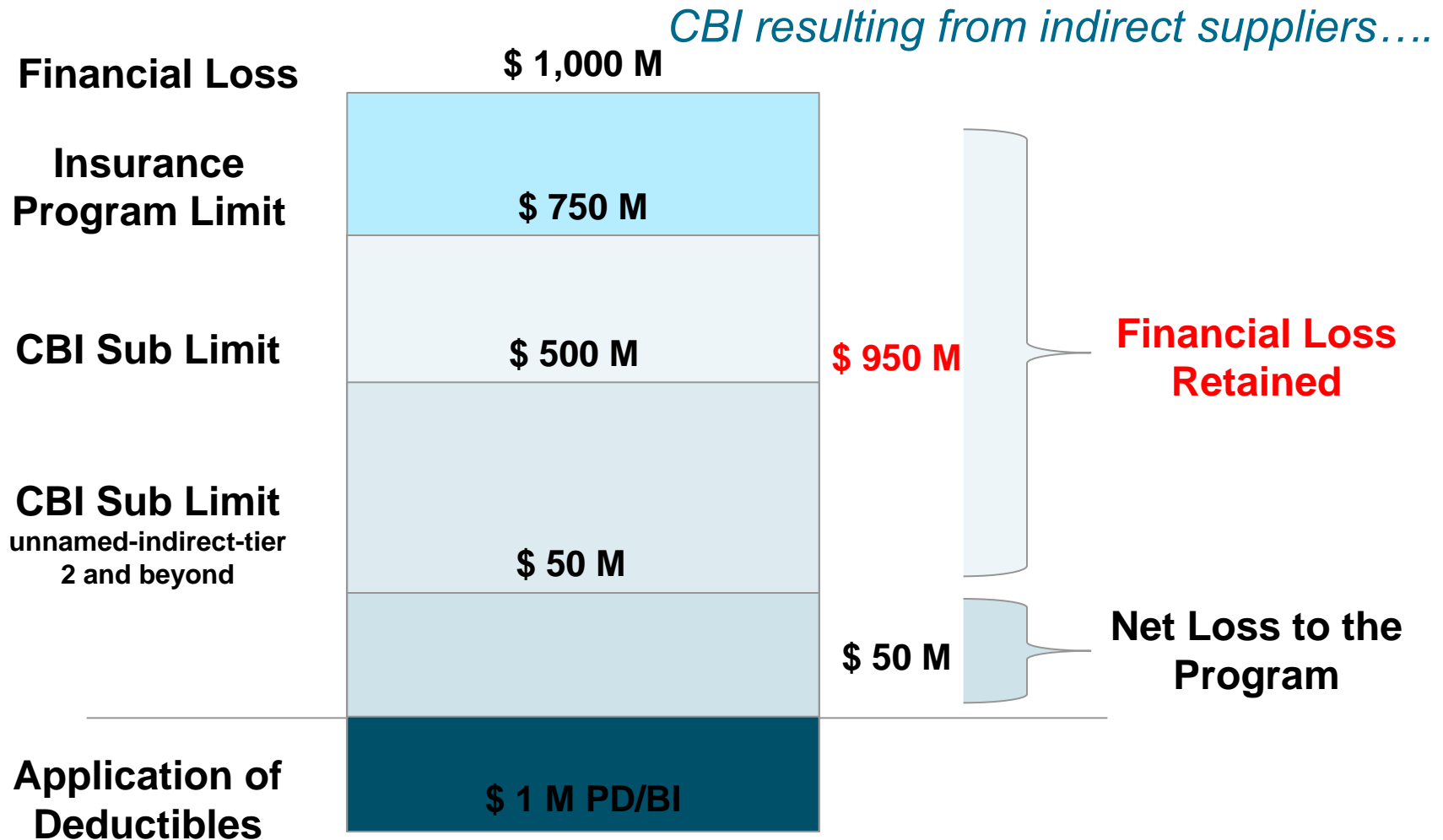


Risk Transfer Mechanism through an All Risk Property Program

Actual damage caused by Tsunami...

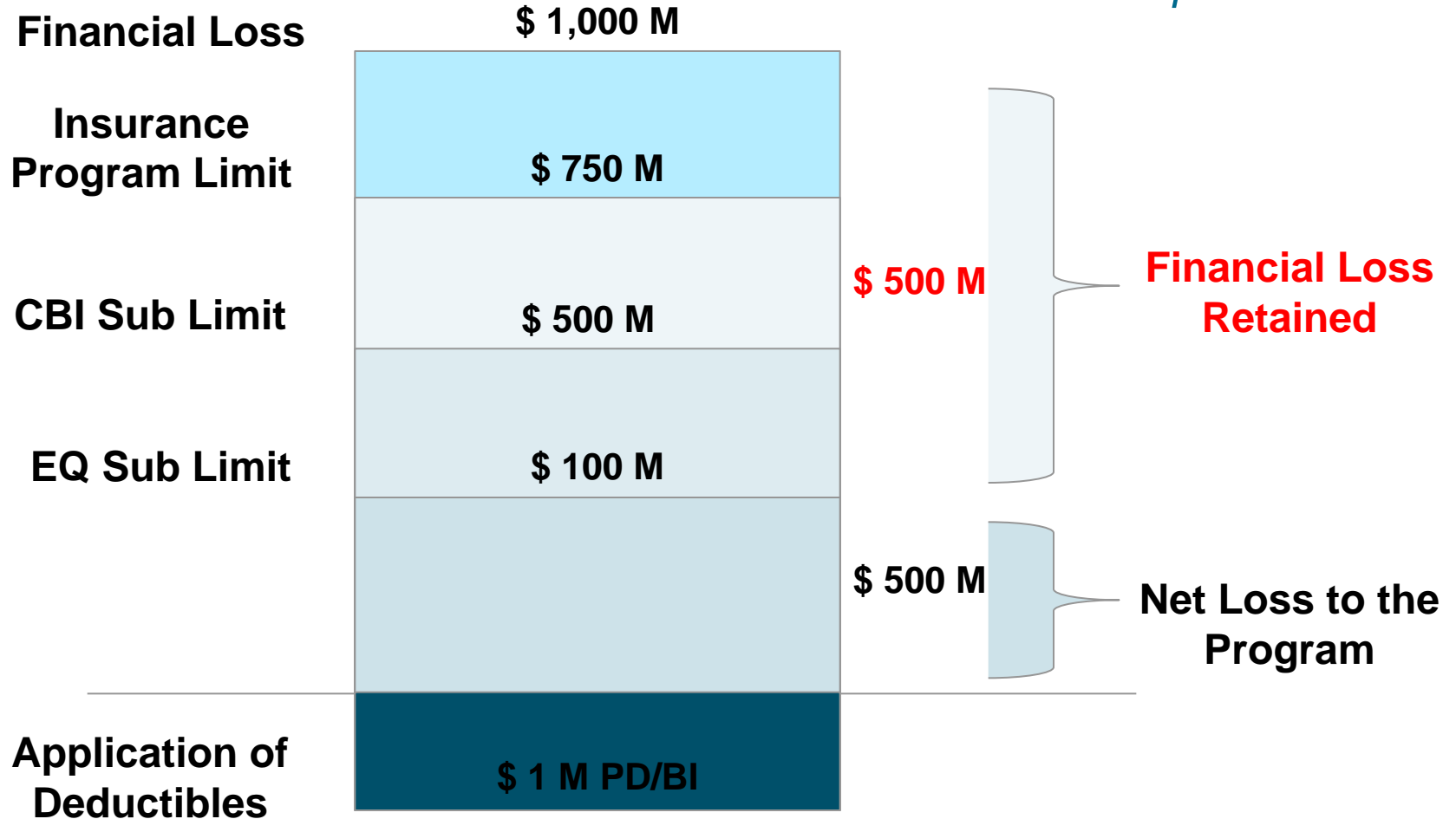


Risk Transfer Mechanism through an All Risk Property Program



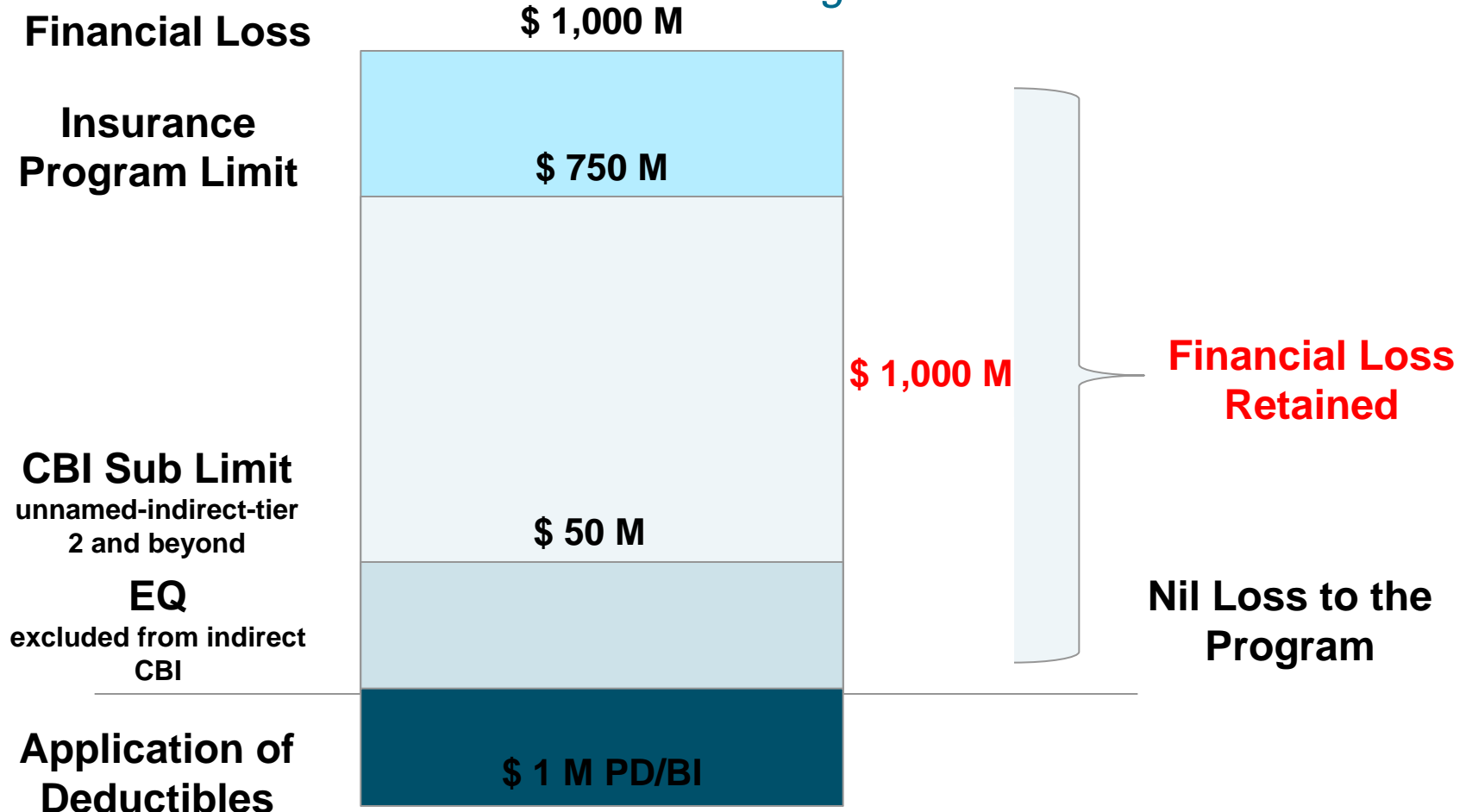
Risk Transfer Mechanism through an All Risk Property Program

No "LMA 5130" or equivalent....



Large EQ with Tsunami affecting a global OEM

High Hazard Cat exclusion....



Risk Transfer Mechanism through an All Risk Property Program

Insurance Program Limit

\$ 1,000 M

Application of deductibles....

CBI Sub Limit

\$ 750 M

Net Loss to the Program

EQ Sub Limit

\$ 500 M

Actual Loss Sustained

\$ 100 M FGU

1: 5% Cat. Ded.

~~\$ 50 M~~

No loss to insured location

2: Ori. Pol. Ded.

~~\$ 90 M~~

\$ 1 M PD & 5 days

Waiting Period or ADV unquantifiable/not applicable

3: \$ 25 M SIR

\$ 75 M

Annual Aggregate Exhaustion?

4: \$ 100 M Local Policy

~~\$\$\$~~

DIC - DIL

Application of Deductibles

1

2

3

Unpredictable Quantum of risk transfer?!