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FROM THE EDITOR

The answer to — which is more important to a company's success, those who make its products possible or those who buy them — is obvious: both are indispensable to the firm's operations.

Less obvious, however, is how the company would fare — or even survive — if neither contributed in their normal fashion. Losses that disrupt suppliers or customers can be devastating to the company that depends on them.

Fortunately, protection against such risk is available in the form of contingent business income coverage, specifically, contingent dependent properties insurance. In this issue of Adjusting Today, *expert Donald Malecki reviews the basics of this often overlooked and inadequately understood coverage, including the nuances of direct and indirect losses.*

This was one of the final articles prepared by Mr. Malecki before his untimely passing in 2014. One of the most respected insurance authors of our era, and a regular contributor to Adjusting Today, *his timeless understanding of complex insurance subjects and ability to communicate about them have enlightened countless business managers and helped them better protect their companies as a result.*

This article continues that tradition.

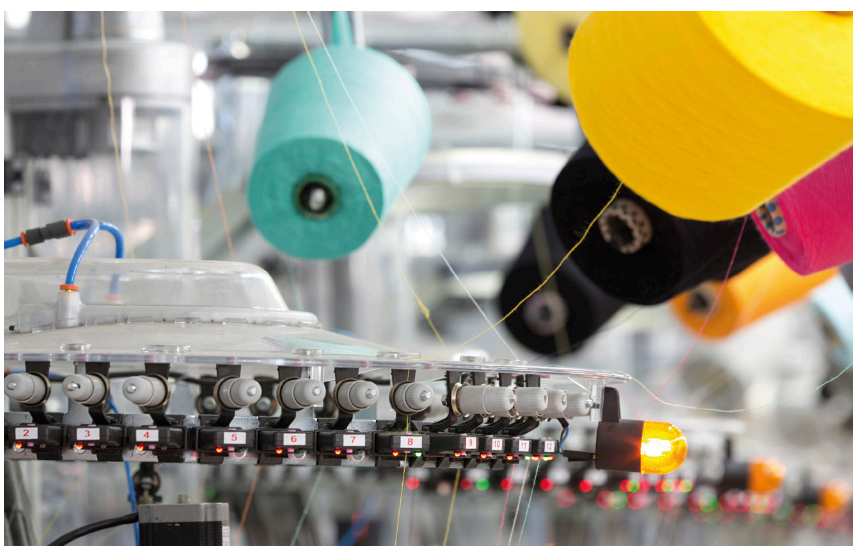
Sheila E. Salvatore
Editor

Contingent Dependent Properties Insurance:

Understanding the Basics – Including Direct Versus Indirect Losses

By Donald S. Malecki, CPCU

Whether it's to supply raw materials or component parts, or buy their products or services, most companies depend on other organizations to operate successfully. This is particularly felt when a key supplier or customer sustains a property loss and the company's operations are so specialized that it is very difficult, time-consuming or even impossible to find substitutes. That supplier or customer could be the company's only viable option.



However, there are steps a company can take to minimize the disruption caused when a supplier or customer sustains a loss that affects its business. A good solution is a form of insurance known as contingent business income coverage.

Insurance for dependent properties exposures varies, but its primary function is to put the policyholder back in the same financial position it was in before its operations were disrupted by the supplier's or buyer's loss.

This insurance has three components. When a business depends on others to supply its products or services, it falls within the category of a "contributing or manufacturing location." If a business relies on others to purchase its goods or services, it is referred to as a "recipient location."

Finally, there is the "leader location," which is a business that attracts customers. Many shopping centers, for example, would not attract as many customers if it did not include highly regarded anchor tenants. If, through damage or destruction, an anchor tenant was unable to operate, many customers might patronize other shopping centers.

Standard ISO Endorsements

The Insurance Services Office (ISO) offers two dependent properties forms: Business Income From Dependent Properties — Broad Form CP 15 08; and Limited Form CP 15 09. In addition, ISO offers an Extra Expense for Dependent Properties Form CP 15 34. It is not the purpose of this article to discuss these forms in depth. However, it is important to have a basic understanding of what they offer.

Business Income From Dependent Properties — Broad Form CP 15 08

This endorsement includes a schedule which requires the name and description of the occupancy and location in the following categories: Contributing Locations; Recipient Locations; Manufacturing Locations; and Leader Locations. This Broad Form endorsement's advantage is that it provides the same business income limits that apply to loss from damage to the named insured's own covered property. However, the loss of business income limit(s) applicable to the named insured's described premises applies separately to each of the dependent properties listed in the schedule.

It is important to note that this Broad Form

If, through damage or destruction, an anchor tenant was unable to operate, many customers might patronize other shopping centers.

endorsement does not apply when the only loss to a "dependent property" is loss or damage to electronic data — including destruction or corruption of electronic data. If damage involves both electronic data and other property, the coverage ceases when the other property is repaired or replaced.

Those interested in this coverage should read the endorsement very carefully — including the definitions. "Dependent property," for example, does not consider any of the following to be contributing locations or secondary contributing locations (discussed below): water supply services; power supply services; wastewater removal services; or communication supply services, including services relating to Internet access or access to any electronic network. Organizations that require such coverage might be able to obtain the standard ISO Utilities — Time Element endorsement CP 15 45.

Also included with this Broad Form endorsement is Secondary Contributing Locations coverage, which applies only to contributing and recipient locations. Coverage must be designated on the schedule if it is to apply. Both "secondary contributing locations" and "secondary recipient locations" are defined in the endorsement. A secondary contributing location is a location not identified in the endorsement schedule and owned or operated by a business that delivers materials or services to the contributing locations identified in the endorsement schedule.

Finally, an additional coverage applicable to the Broad Form is referred to as "miscellaneous locations." Not considered to be a miscellaneous location, however, is a road, bridge, tunnel, waterway, airfield, pipeline or any other similar area or structure.

The insurer also will pay no more than .03 percent of the business income limit of insurance for each day's suspension of operations due to loss arising from any one location. This coverage, however, does not include the business income limit.

Business Income From Dependent Properties — Limited Form CP 15 08

This endorsement provides basically the same coverage as the Broad Form, with the following exceptions. This Limited Form can be written when the named insured does not also purchase business income for loss stemming from direct physical loss or damage to its own business premises. This means that a separate limit applies for each of the dependent properties shown on the schedule.

Apart from those differences, this Limited endorsement also gives coverage for secondary locations — limited, of course, to contributing and recipient locations. The miscellaneous locations limits are also for no more than .03 percent of the sum of all limits shown in the schedule.

A September 11, 2001 Loss

One of the cases that was an outgrowth of the September 11, 2001 disaster involved a dispute having to do with the dependent property provision of a property policy. The case is *Southern Hospitality, Inc. et al. v. Zurich American Insurance Co., 393 F.3d 1137 (10th Cir. 2004).* It arose after the Federal Aviation Administration grounded all airplane flights in the United States on 9/11. As a result, a hotel group claimed it sustained a loss of business income because customers cancelled their stays.

One of the provisions that came under dispute dealt with the civil authority clause. Another dealt with the dependent property clause. Under that clause the insurer agreed to pay for the actual loss of business income that the named insured sustained due to the necessary suspension of operations during the period of restoration.

This policy actually had two such clauses dealing with dependent property. Under the first one the suspension must have been caused by direct physical loss of or damage to "dependent property" at a premises described in the Schedule, caused by or resulting from any covered cause of loss. The second clause applied to "dependent property" not described in the Schedule. The policy defined "dependent property" in pertinent part as "property operated by others whom you depend on to … deliver materials or services to you … accept your products or services … manufacture products for delivery to your customers … attract customers to your business."

Since, according to the court, *Southern Hospitality* had failed to identify any scheduled contributing property or any unscheduled dependent property that had been damaged by a covered cause of loss, coverage was denied. Thus, the court agreed with the insurer's argument that physical loss or damage to dependent property was a necessary component of coverage.

In a sense, aircraft conveying passengers (customers) could be viewed as dependent property, but the way the coverage forms are prepared it is unlikely that the drafters had vehicles in mind when they defined "dependent properties."

Direct Versus Indirect Suppliers

According to Webster's New Collegiate Dictionary, the term "direct" is defined to mean "proceeding from one point to another in time or space without deviation or interruption." This same source defines "indirect" as "not directed straight to the point." What these terms mean in relation to an actual business situation might be difficult — but necessary — to determine if someone needs to purchase insurance for one or the other.

If a business knows unequivocally that it will suffer a loss if a supplier or customer sustains serious damage, then it should purchase contingent business income coverage. In some cases, depending on the insurer, unless a company purchases contingent business income insurance for both direct and indirect suppliers, there is likely to be a dispute. (An indirect supplier is one that does not have a direct connection with the insured; that is, is not an immediate supplier but is remotely involved.) What could happen when

"If a business knows unequivocally that it will suffer a loss if a supplier or customer sustains serious damage, then it should purchase contingent business income coverage."

a business purchases only direct coverage is that the insurer could maintain that what was involved was an indirect supplier situation. The same kind of argument may arise when the company purchases only indirect coverage.

The problem is that many insurers do not want to provide coverage for indirect suppliers. One reason is that the number of suppliers can be infinite. Take, for example, a supplier that has five entities supplying to *it* — and in turn each of those has five suppliers. This can really complicate matters and in fact did so when the tsunamis struck businesses in Japan (2011) and Indonesia (2010). Purchasing coverage for losses involving indirect suppliers is not always an option. This means that the door can be open to argument and anyone's guess as to whether the supplier is considered direct or indirect.

Court Case Ends Without Coverage
An actual legal case demonstrating the difficulty in distinguishing between a direct and indirect supplier is *Millennium Inorganic Chemicals Ltd. et al., v. National Union Fire Insurance Company of Pittsburgh, PA, et al., 2014 WL 642993 (U.S. Ct. App. 4th Cir.)*.

Millennium, which was in the business of producing titanium dioxide used for a variety of purposes, operated through interdependent factories near Bunbury, Australia — which relied primarily on natural gas for energy. Millennium purchased its natural gas from a supplier or so-called aggregator rather than directly from a producer. One such entity was Alinta Sales Pty Ltd.

Alinta obtained the gas from multiple producers in Australia, including Apache Corporation, which supplied at least 20 percent of the gas Alinta bought and resold. Pursuant to the agreement between Atlanta and Apache, Atlanta took title to Apache's gas when the gas entered a major Australian gas transmission line known as the Dampier to Bunmbury Natural Gas Pipeline. The pipeline was a government-regulated common carrier, owned by third parties, who charged pipeline users a fee based on the distance the gas traveled. After the gas left the pipeline, it was transported to end users via a network of distribution lines.

This case was brought about by a massive explosion and fire in 2008 at Apache's production facilities that interrupted 20 to 30 percent of the natural gas

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Relied on Natural Gas For Energy

↑

ALINTA SALES PTY LTD
Retail Gas Supplier of Natural Gas

↑

APACHE CORPORATION
Producer of Natural Gas

Millennium maintained contingent business interruption insurance from both National Union Fire Insurance Company of Pittsburgh, PA and ACE American Insurance Company.

There were other producers of natural gas, but Apache sold 20 percent of its production to Alinta.

supply in Western Australia. Apache immediately issued a notice of force majeure[1] to Alinta. Alinta, in turn, issued the same to Millennium. Shortly thereafter, Millennium notified its insurers of its claim for loss of business income, which the parties agreed totaled nearly $11 million.

Alinta consumed a small amount of the natural gas that it purchased for its own operations. Although it took title to the gas, it never physically possessed the gas it sold to its customers because the gas molecules were commingled as soon as they entered the pipeline — making it impossible to tell either the source or the owner of any given molecule at any given time. Despite this impossibility, title to a specified volume of gas passed from Alinta to Millennium at the inlet point of Millennium's production facilities.

Insurance Provisions

At the time Millennium sought insurance it was stated that they specifically required coverage "for direct suppliers/customers." Ultimately, Millennium chose to purchase coverage from National Union and ACE, each of which took 50 percent of the risk. The quote of National Union, moreover, provided, "THERE SHALL BE NO COVERAGE FOR INDIRECT SUPPLIERS/ RECIPIENTS."

ACE also offered a quote providing policy limits only for "direct suppliers." When these two insurers issued their binders, neither provided any coverage for "indirect" suppliers.

When the policies were issued, both included an endorsement titled "Contingent Business Interruption Contributing Property(ies) Endorsement," which covered Millennium against certain losses resulting from the disruption of the supply of materials to Millennium caused by damage to certain "contributing properties." A general section of each of the policies scheduled sublimits and provided that any direct contributing properties were covered for $25 million; while any unnamed direct contributing properties were covered for $10 million. Millennium did not list any contributing properties on the provided schedules.

> *The purpose of this coverage is to protect the company when these suppliers or customers sustain a covered property loss that shuts down their businesses, leaving the company without a supplier or customer and thus resulting in signficant financial loss.*

Denial and Litigation

Two days after the explosion, Millennium sent notice of claims to both of its insurers. After an investigation and a report, both concluded that Apache was not a direct supplier to Millennium. As a consequence, the insurers denied coverage, but left the door open for Millennium to provide evidence of a direct relationship between it and Apache sufficient to establish coverage.

The United States District Court for the District of Maryland entered an order granting Millennium's motion for summary judgment. In doing so, the court reviewed and interpreted the policies, concluding that coverage under the policies extended only to "direct contributing parties." In determining the meaning of the term "direct contributing property," the district court reviewed existing case law on contingent business interruption insurance.

The court also held that Millennium's contract with Alinta "had no effect on the physical realities of natural gas supply between Apache and Millennium" because although Alinta took title to the gas when it traveled through the DB Pipeline, Alinta "never took physical possession of the gas and had no 'property' with which to do so."

On appeal, the U.S. District Court of Appeals stated that for Apache to have been considered a direct contributing party to Millennium it would have been required to supply Millennium with materials necessary to the operation of its business "without deviation or interruption from an intermediary." On the undisputed facts of the case, the court went on to say that neither Apache nor Apache's facilities could be considered a "direct contributing party" of Millennium.

From the appeals court's perspective, whatever the relationship between Apache and Millennium, it was clearly interrupted by "an intermediary," Alinta — which took full physical control of Apache's gas before delivering indistinguishable, commingled gas to Millennium. That relationship was also interrupted by an intervening step, the court added — the physical insertion of the gas into the DB Pipeline, at which point Apache relinquished all physical control over that gas. Under any view of the relevant facts, the court concluded, Apache could therefore be only an indirect contributing property to Millennium, coverage of which was not included in the policies.

Approaches of Independently Filed Policies

Insofar as manuscript and independently filed property policies are concerned, where larger risks are likely to be handled, insurers either exclude indirect suppliers altogether or provide a sublimit.

In one such manuscript policy reviewed, the limit for contingent business interruption and contingent extra expense (a coverage not discussed here) for direct suppliers and receivers as described in the policy was $10 million. For indirect suppliers and receivers, on the other hand, the limit was $2.5 million. Perhaps this kind of limit can be viewed by insureds as being welcome, considering that some insurers do not provide any coverage — sublimit or otherwise — for indirect suppliers and receivers.

Conclusion

If a company is dependent on other organizations for its raw materials or supplies, or dependent on customers who buy its products and services, it needs contingent business income coverage.

The purpose of this coverage is to protect the company when these suppliers or customers sustain a covered property loss that shuts down their businesses, leaving the company without a supplier or customer and thus resulting in significant financial loss.

Although this article has touched on some of the insurance provisions and disputes that can arise when a loss occurs, it is imperative that companies needing this type of insurance confer with insurance professionals who understand the coverage and the loss exposures the companies face.

Obtaining this coverage while being advised by an insurance professional can effectively mitigate or minimize the financial loss that might result in the absence of such coverage.

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[1] Force majeure is a common clause in contracts that essentially frees both parties from liability or obligation when an extraordinary event or circumstances beyond the control of the parties, such as war, strike, riot, crime, or an event described by the legal term act of God (such as hurricane, flooding, earthquake, volcanic eruption, etc.) prevents one or both parties from fulfilling their obligations under the contract. In practice, most force majeure clauses do not excuse a party's non-performance entirely, but only suspends it for the duration of the force majeure.

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Mr. Malecki was a principal of Malecki Deimling Nielander & Associates, LLC, an insurance and risk management firm. Over a career that spanned more than half a century, he held the titles of insurance underwriter, broker, insurance company claims consultant, archivist, historian and teacher.

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