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EDITOR'S NOTE

The recent earthquake and tsunami that struck Japan, caused loss of life and property damage of untold proportions. It will take years if not decades for this nation to recover from the catastrophic losses suffered by its people and the land.

Japan is an integral part of the global economy and the entire world will continue to be adversely affected by the economic impact of this disaster. Businesses worldwide are now beginning to assess their own economic and financial issues and are developing strategies to facilitate a recovery. Insurance will play a major role in the discussion and development of a viable recovery strategy for many businesses affected both directly and indirectly by this natural disaster.

The purpose of this article is to focus on the coverage issue that may be the most relevant to many United States businesses. That issue is contingent business interruption, also known as dependent properties coverage.

—Sheila E.
Salvatore, Editor



Contingent Business Interruption Issues Continue Following Disasters in Japan

By Anthony J. D'Amico, SPPA & Harvey M. Goodman, SPPA

In today's complex world of international supply and service chains, many business operations depend upon independent third party operations to provide or furnish raw materials, intermediate components, supplies, services, and even finished goods. These dependent relationships create a risk of loss should the "dependent" or "recipient" property be damaged, thus preventing the

primary policyholder from providing or receiving crucial goods and/or services.

As many readers know, time element coverage carried on one's primary business operations is triggered only when that subject property sustains physical loss or damage resulting from a covered cause of loss. Time element coverage does not apply to a



situation where business operations are suspended or adversely affected as a result of physical damage to the property of others.

In these situations, indemnification for time element losses arising from damage to the property of a dependent yet separate operation, is provided by contingent time element or dependent properties coverage. It is important to note that the existence of such coverage is only the first step in what is

often a complex road to recovery. As with many insurance policies, the language is arcane and often difficult to understand.

Three Perils

There is an insurance underwriting axiom that no two policies are created equally — meaning that every policy has different terms and conditions, exclusions and limitations that significantly affect the scope of coverage that is available in a given situation.

The inherent challenge in dealing with a contingent time element loss arising from the disaster in Japan is further exacerbated by the multitude of very complex coverage issues resulting from the occurrence of three separate and distinct perils: earthquake, flood and nuclear radiation. Identifying which peril caused or contributed to the loss, either independently or concurrently with another peril, is an extremely significant factor in assessing coverage.

It is rare that contingent time element coverage comes into play and as a result, there is limited precedent, custom, and practice to help one navigate through the loss measurement and loss adjustment process. The first step in the time element loss evaluation process is to read the policy thoroughly and become intimately familiar with every provision and term. This may seem self-evident, but it requires emphasis nonetheless. A colleague in the industry once described an insurance policy as the least-read best seller. Regrettably, this is true. Under the current circumstances, anyone who is confronted with a potential contingent time element loss would be very remiss not to thoroughly study the policy. To do otherwise will seriously compromise one's ability to recover the maximum benefits that may be afforded by the policy.

As indicated, no two policies are created equal. The differences in policy coverages, exclusions and language can be very significant.



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Manuscript type policies are unique by design. Standard ISO type forms can be radically different due to the myriad endorsements that can be attached to any given policy. This absence of uniformity in policy language makes the discussion of contingent time element coverage rather challenging. However, a focus on the wide-ranging terms and provisions of the insurance policy should provide the policyholder and their representatives with a better understanding of what is and what is not covered by the policy, as well as how to determine if coverage is available when others assert that none exists.

The Insuring Agreement

Generally speaking, the insuring agreement in a contingent time element policy form or endorsement can be summarized as follows:

we will cover business income and extra expenses losses that you sustain as a result of physical damage caused by a covered cause of loss that wholly or partially prevents others from delivering or providing to you goods and/or services.

While the specific language may vary from policy to policy, this is the general concept behind contingent time element policy coverage. The concept “caused by a covered cause of loss” is a critical component in triggering contingent time element coverage. The physical damage to the dependent property must be caused by a peril not excluded by your policy. The primary causes of loss in Japan were



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obviously from the earthquake and tsunami. Accordingly, in order for contingent time element coverage to be triggered, your policy must be endorsed for flood and/or earthquake, or alternatively, the policy must not exclude such perils. In the absence of flood and/or earthquake coverage, there may be a possibility that your contingent loss is covered if due to a resulting fire or other peril that ensued from the earthquake and/or tsunami. However, under these circumstances, one must pay close attention to the anti-concurrent causation language associated with the perils of earthquake, flood and nuclear damage, as this could preclude coverage even though the contingent loss was caused by an otherwise non-excluded peril.

Thus, the threshold issue of determining the applicability of contingent time element coverage is subject to all of the terms, conditions and provisions of the policy, including but not limited to the type of property insured, excluded causes of loss, loss valuation clauses, sub-limits, and coinsurance. Contingent time element coverage is not a standalone form of coverage, but rather an extension of the business income coverage that is afforded for your primary business. Therefore, you must have an understanding of the complete policy, as well as the contingent time element endorsement or coverage grant to perfect a contingent time element loss.



Territorial Considerations

An important issue in assessing a contingent time element loss arising from damage to dependent properties is the necessity to check the policy for territorial limitations. Many policies limit coverage to the United States, its possessions and Canada. Other policies may provide worldwide coverage either by manuscript or by endorsement, such as the ISO CP 15 01 Business Income for Dependent Properties International Coverage. In any event, it is imperative to first determine if your policy will respond to dependent properties located in Japan.

In addition to these territorial conditions, it is necessary to identify which suppliers or recipients of goods or services upon whom you are “dependent” were actually damaged. This is necessary, as many policies will specify which locations are covered. Other policies may not specify locations and state something to the effect of “all locations” or include unnamed or miscellaneous locations in conjunction with the specified locations. If a dependent location in Japan is specifically named, this may supersede any territorial limitation in the policy.

For such a covered location, the insured must establish that the dependent property was:

(1) damaged by a covered cause of loss, and

(2) that such damage caused a suspension in operations, which prevented the dependent property from providing or receiving essential goods and services.

This is not an easy task when the dependent property is located in Japan and there has been no access to or contact with the dependent property. Yet this must be accomplished as a condition precedent to any recovery.

Dependent Property

At this point, it may be beneficial to generally describe what constitutes a “dependent property.” First, for a property to be considered “dependent” it cannot be owned or managed by you, the policyholder. This is not always a straightforward inquiry. In many instances a company may provide to another company the designs, materials and supplies necessary to manufacture its product so that the former company closely controls the production process of the latter. Insurers will often contend that these close connections preclude such companies from triggering the definition of a dependent property, even though the two companies have no joint ownership. Putting aside these fundamental issues, a dependent property typically falls under one of the following categories:

- Recipient locations: properties that receive the insured’s goods and services.
- Contributing locations: properties

upon which the insured relies for raw materials, goods and services utilized in its manufacturing or production operations, as well as finished goods purchased for resale.

- Manufacturing locations: locations similar to contributing locations, however are distinguished in that the manufacturing location takes orders for the manufacturer of the insured’s component goods to be utilized in the insured’s manufacturing process.
- Leader locations: properties that attract or draw customers to the insured’s business.

Examples of properties that are typically excluded as a dependent property are roads, bridges, tunnels and pipelines. Accordingly, if the flow of goods to and/or from a dependent property is halted due to such infrastructure damage of the type excluded, coverage problems will occur. A related coverage issue that may arise entails a situation where the means of conveyance are destroyed, i.e., trucks, rail and cars. The question then is whether a loss resulting from such damage to conveyances is covered even though the damage to the infrastructure would have prevented passage of such conveyances.

Most contingent time element coverage forms exclude suppliers of utility services, including water and power, from the scope of dependent properties. In the event that the flow of goods and services is impeded by plants not able to operate solely



due to lack of power (as opposed to physical damage), ensuing time element losses may not be covered. This type of situation is commonplace in Japan due to the total loss of power in certain areas, as well as rolling blackouts ordered by the Japanese government.

These rolling blackouts lead to another coverage consideration. The proximate cause of the power interruption may be due to damage to the nuclear plants and power distribution infrastructure caused by the earthquake and tsunami, thus potentially triggering coverage. An argument in opposition to such coverage may be that the policy excludes losses caused by or resulting from nuclear radiation and other causes occurring in any sequence to the nuclear radiation (taking the anti-concurrent language into account). In the Japanese situation, however, there may be a strong argument that the fallout of nuclear radiation was a consequence of the physical damage to the plants and reactors. Regardless of the answer, the issue of a power generating facility not being a dependent property remains.

Suppliers

An additional and very complex issue in identifying dependent locations is where a secondary or even tertiary supplier is damaged, and such damage is the cause of the ultimate interruption of the flow of goods or services to the primary policyholder. For example, ABC Electric, located in the United States, supplies the policyholder

with component parts obtained from a manufacturer in Japan. The Japanese plant was totally destroyed by the earthquake and thus is no longer shipping parts to ABC Electric. Is the policyholder's resulting loss of income covered under these circumstances? When not defined or identified in the policy, insurers will often argue that lower-tiered suppliers or recipients are not considered to be dependent properties under the contingent time element coverage. This is a very significant issue and

one that will often be resolved by first resorting to specific language (or the lack of such language) in the policy.

Coverage issues can become even more complicated where contingent business income losses are sustained by parallel suppliers. By way of illustration: a computer manufacturer curtails its production due to its inability to obtain a certain type of chip manufactured by a firm in Japan that was destroyed by the earthquake. As a



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result, the computer manufacturer stops placing orders for printed circuit boards from its supplier in the United States. The printed circuit board manufacturer in the United States in turn sustains a significant income loss. The printed circuit board manufacturer carries a contingent time element policy. Is that income loss covered?

Of course, the policy must be referenced to determine if it would provide coverage for a loss sustained under the described scenario. It may be that the insured carries a manuscript type form intended to cover such a contingency.

Generally speaking, coverage for a contingent time element loss is triggered by physical damage to a contributing or recipient property. In the case of the printed circuit board manufacturer, the Japanese chip manufacturer is neither a supplier nor recipient property. Instead, the computer manufacturer is the recipient property; however, the computer manufacturer did not itself sustain any physical damage. The absence of physical damage to the computer manufacturer may render the printed circuit board manufacturer's contingent time element policy inapplicable to the loss. Or perhaps not. Again, the policy and the surrounding facts and circumstances of the loss must be carefully analyzed to assess the availability of coverage.



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Hospitality Industry

The discussion thus far has focused primarily on contingent time element issues associated with the manufacturers and sellers of goods and services. However, many other types of businesses have been adversely affected by the damage in Japan. The hospitality industry is one such business sector. Many United States-based hotel chains and REITs own and maintain hotel operations in Japan that have been detrimentally affected by the disaster.

Even though the specific hotel property did not sustain any physical damage, occupancy may be significantly down due to the surrounding damage and loss of

customer base. Whether or not this represents a potential subject for a contingent time element claim is a function of the type of coverage that is in place. Referencing the description of the different types of dependent properties above, the leader location is applicable to the hotel model.

Due to the destruction of many business, recreational and leisure facilities, travel to and within Japan has diminished significantly. Accordingly, where a leader location is considered to be a dependent property and/or there is a provision for losses arising from damage or destruction of the customer locations, the hotel



operation may be able to recover its time element losses, again subject to policy terms and conditions. Historically, successful contingent business income recoveries from major hurricanes in Florida and Louisiana have been asserted where hotels identified percentage declines in business based on customers not traveling from hurricane-devastated areas to the affected hotels.

Boiler and Machinery, Interruption of Supply

Reference was made earlier to losses arising solely due to the loss or partial interruption of power, and the concern that the suppliers of such power are excluded as a dependent property. There may be a solution to such seeming lack of coverage in the boiler and machinery/equipment breakdown policies that many manufacturers have in force as part of their overall insurance program.

Many boiler and machinery policies provide a form of contingent time element coverage that is also known as interruption of supply coverage. This coverage indemnifies the insured for time element losses that are sustained because of an accident to the type of property covered by the insured's policy, however the damage occurs to the property of a supplier or recipient (dependent property) of the insured's goods and services. It should be noted that the type of accident which so damaged the dependent property must also be the type of damage covered by the insured's policy.

Finding coverage for a loss under the contingent or interruption of supply provisions is not without its challenges. The trigger for this type of coverage is much more restrictive than under a property form. This is primarily because a flood or earthquake, which was the primary cause of damage in Japan, is not a covered accident under a boiler and machinery policy. However, if flood or earthquake sets into motion a chain of events that resulted in an accident to insured equipment, coverage may be triggered.

For instance, coverage has been found where floodwaters from a river flowed into the electrical equipment room of a manufacturing concern. The equipment was energized at the time and when the flood waters made contact with the equipment, severe arcing ensued which caused the destruction of the equipment. The arcing constituted a covered accident and the policy did not contain any anti-concurrent causation language in connection with flood. Accordingly, the claim was paid.

A recovery under these circumstances is by no means a proverbial layup and is a very difficult type of claim to perfect. However, the prudent professional should leave no stone unturned when searching for coverage. Initial review of a policy or discussion with a policyholder may lead to a preliminary determination that coverage is excluded. However, a careful review of the underlying factual scenario, the detailed

policy language, the DIC policy (Difference in Conditions) and/or other endorsements will result in an ultimate determination of coverage for the loss.

Extra Expense

Throughout this discussion, we have referred to contingent time element losses. As many readers understand, these losses encompass both business income and extra expense. If the policy is such that it will trigger coverage for contingent business income losses, it will also trigger coverage for extra expense.

It is not the intent of this discussion to engage in the means and methods for evaluating a business income loss. We will stress, however, that very careful attention should be paid to the extra expense provisions of the policy. This type of coverage is very broad and it can be utilized in many ways to resume operations and mitigate income losses. Often the extra expense coverage is underutilized, thus resulting in greater losses not only to the insured, but also to the insurer. Again, pay careful attention to the extra expense coverage and utilize it to the fullest extent to not only mitigate your income loss, but perhaps to save the business. The extra expense coverage leads to a variety of issues, some of which can be internally inconsistent. Many endorsements contain a provision that requires the insured to exercise whatever means are at their disposal to influence or induce the dependent property to restore its operations so as to resume



the flow of goods and services to or from the insured. However, financial payments by the insured to the dependent property are not allowed unless approved by the insurer. It seems non-financial means of influence may have to be considered so as not to prejudice coverage by not being compliant with this policy condition.

Perseverance Essential

In concluding this discussion, our intent was not to argue coverage or provide specific solutions to the myriad complicated issues that will be encountered in connection with contingent time element

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claims arising from the Japanese catastrophe. In fact, we believe that the complex issues that arose after the September 11, 2001 terrorist attacks may pale in comparison to the issues that many will encounter in the Japanese scenario. Rather,

our point is that one must exercise the utmost in diligence and perseverance in working through the claims process. To do otherwise will result in covered losses that either are underpaid or are not paid at all.



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