Contingent Business Interruption Coverage

What Happens When the Loss You Experience is Not Your Own?

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In today's business climate more focus is placed on lean operations. This trend is becoming increasingly more commonplace as corporations are divesting of business lines and returning to core competencies. As decentralization continues to grow and corporations are relying on supply and sales agreements with non-related parties, the impact of a supplier or customer's loss on a business' operations increases substantially.

Contingent Business Interruption (CBI) insurance coverage is designed to protect a company's earnings stream from the impact of key supplier or customers' catastrophic losses. This form of coverage has unique characteristics when responding to a covered event, which puts additional challenges on a policyholder's management of a claim. However, risk managers who develop at least a basic understanding of CBI coverage, and how these policies respond to losses and CBI claim management, will find these claims less daunting and more manageable.

Characteristics and Triggers of CBI Policies

One legal definition of contingent business interruption insurance is, "an insurance policy that provides benefits if earnings are reduced because of damages to another business on which one's business is dependent."[1] As legal definitions go, this is actually a simple description of CBI coverage. Another way to describe CBI coverage is to relate the coverage to a company's supply chain. This policy indemnifies the policyholder for lost earnings in the entire supply chain, from suppliers to manufacturers and customers.

CBI is usually obtained as an extension to Building and Personal Property policies and will often include contingent extra expense coverage as well. This coverage is not necessarily limited to any one type of policy, as equipment breakdown, HPR (Highly Protected Risk), international, marine, and manuscript policies can all include CBI language.

One of the unique characteristics of CBI coverage is that losses arise from damage to a business that is not a party to the insurance contract. In almost every other form of commercial insurance products, especially P&C polices, recovery for claims must result from damage caused to the policyholder's property. The policyholder by its very nature is in a contractual relationship with the insurer.

Additionally, CBI policies require that the event causing physical damage would have been a covered cause of loss under the policyholder's insurance policy. This again is an unusual characteristic of CBI coverage—that a non-contractual party to the insuring agreement is being held to the standard of the policyholder.

Furthermore, the interruption to the policyholder's business must be at a covered or scheduled location. Although this may seem obvious, plenty of claims have been denied or severely reduced due to a non-scheduled location clause.

For example, Company A, a covered location, has a sole source contract with Supplier B. Supplier B suffers a fire to its manufacturing facility, which causes an interruption of operations and results in the inability to fulfill its supply agreement with Company A. In order for Company A to recover losses under its CBI insurance coverage, it must have incurred an interruption of its operations due to a covered cause of loss.

The period of indemnity for CBI claims is limited to the period of restoration. This time period is usually described as the period from the time of loss until damaged property could have been repaired or replaced with due diligence and dispatch. In contrast, Business Interruption (BI) may have slightly different language that allows for indemnity beyond the period of restoration either as "operations returns to normal" or an extension of coverage. There is no such language for extended indemnity in standard CBI policies or coverage forms.

There are two common forms written in the U.S. for CBI coverage: Dependent Property and Suppliers and Customers forms. Both of these forms contain the characteristics described above. Where they can differ is the identification of the party that is physically damaged. In the chain of liability, dependent property coverage is specific as to who is a supplier or customer. In contrast, CBI language is generally very broad as to who qualifies as a supplier or customer.

Dependent Property Broad Form

The Dependent Property Broad Form identifies four specific groups an insured's business is dependent on for its operations: contributing, recipient, manufacturing, and leader properties. Each of these groups provides specific coverage for the policyholder. In most cases an insured's policy will likely contain one or two of these groups in its coverage.

In the first three groups a direct relationship must exist. This means that an arm's-length business relationship between the policyholder and the dependant entity can be documented. An indirect relationship, such as a supplier's supplier, would not trigger a claim even if all other conditions for coverage were present.

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Contributing Properties

Contributing properties are those properties that provide direct goods and services to the policyholder's operations. These properties are generally direct suppliers of raw material, intermediate/finished goods, and related services, such as freight forwarding.

As an example, a petroleum coke processing company has a contractual relationship to receive all of the output of petroleum coke from an oil refinery. A lightning strike causes a catastrophic explosion at the refinery. As a result of this incident, the refinery experiences an interruption of its operations and cannot supply petroleum coke to the processing company. This in turn causes an interruption of business to the coke processor. In this instance the coke processing company's insurance policy includes lighting strikes as a covered cause of loss. The coke processor can file a claim and receive payment on its losses under contributing property CBI coverage.

Recipient Properties

Recipient properties are entities that receive direct goods or services from the policyholder. Generally, these are customers the policyholder relies upon to purchase its goods. Often there is a contractual relationship in place between the two parties. This coverage protects the policyholder's earnings through its sales/distribution chain.

As an example, a flat screen monitor company sells finished component goods to a computer manufacturer that assembles components into finished notebook computers. The computer manufacturer's Midwestern assembly plant is severely damaged by a tornado and cannot receive components from the monitor company. The monitor company has an open perils policy that does not exclude tornados as covered cause of loss and files a CBI claim based on its lost sales to the computer manufacturer.

Manufacturing Properties

A company that has a direct relationship with a manufacturer that produces goods for the company is known as a manufacturing property. Often these goods will be shipped directly from the manufacturer to customers. Also, manufactured goods could be stored at a company or third party warehouse. The coverage that is afforded protects the earnings generated through third party manufacturing.

An example of this form of coverage is a U.S. company that sells plastic utensils, containers, and bowls to retail grocery and department stores. This company has all of its products manufactured in Taiwan by a nonrelated company. The manufacturer produces packages and ships the products to the company's customers. A fire causes catastrophic damages to the manufacturer's plant, which results in an interruption of the manufacturer's operations. The U.S. Company's sales are interrupted due to the manufacturer's shut down; lost earnings can be analyzed and claimed under CBI manufacturing properties coverage.

Leader Properties

Leader properties attract customers to nonrelated businesses. This type of CBI coverage is common in retail businesses. Consider, for instance, a large retail shopping mall with a single anchor store such as a high-end department store. Many of the shops located in the mall derive pass-through business from customers who came to the department store and then shopped at other stores while at the mall. This pass-through traffic may be a considerable portion of a small retail shop's business.

An example of contingent business interruption might be that of a department store which experiences a major water pipe burst on the second floor, which results in the store shutting down for six months. This loss may cause a resulting decrease in sales for the small shop owner since the department store is no longer attracting customers to the shopping mall. In this instance a shop owner may recover lost earnings under their coverage.

Suppliers and Customers Form

In contrast to the Dependant Properties Broad Form, the Suppliers and Customers Form uses simple language in describing coverage. The following example is policy language from an Archer-Daniels-Midland Co. ("ADM") Suppliers and Customers CBI insurance form.

> *"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."*[2]

This specific language was the subject matter of a coverage dispute between ADM and its insurer Phoenix Assurance Company.[3] The dispute arose over denial of coverage for CBI losses related to the 1993 flooding along the Mississippi River. ADM filed claims based on the interruption of operations for "Midwest Farmers" and the "U.S. Army Corp of Engineers" as its suppliers. The reason, ADM argued, was that the farmers supplied grain to brokers who sold grain to ADM's processing plants. As for the Corp of Engineers, ADM reasoned that maintenance of the Mississippi River was a service provided to ADM. It is very likely that these two examples were beyond the intended scope of coverage.

What is remarkable about this case is that the judge ruled in favor of ADM on both of these issues. The very broad interpretation of this policy language opened potential unforeseen liability for underwriters. It is understandable that this particular form of coverage is declining in the U.S.

Managing CBI Claims

Most risk managers are familiar with standard business interruption insurance policies. It may stand to reason that many risk managers would consider CBI the same as a BI claim. The only difference is the damage to a noninsured party. Although this is essentially correct, there are substantial issues that are unique to CBI claims. Risk managers should take an active approach to managing these claims, especially with identifying the incident, documenting the claim, and proving the loss.

The first step in any claim situation is to conduct a thorough policy review to determine coverage, exclusions, and the specific form of the loss calculation. It is important at this stage to get your agent/broker involved in the policy review. They should have an in-depth understanding of the specific language and intent for coverage. Risk managers may also have general or outside counsel that is familiar with P&C insurance policies assist in the policy review. On most significant claims, risk managers will hire forensic accountants to advise on relevant language dealing with quantifying the claim and calculating loss earnings.

Identifying the Incident

For risk managers, identifying the incident is an intuitive process of linking the incident to a covered loss. The method used to determine this relationship is the "chain rule." Simply stated, the following items must be linked together: physical damage to property, of a supplier, customer or dependant property, for a covered cause of loss, causing an interruption of business, during the policy term, in absence of exclusions, and in excess of deductibles.

CBI losses pose several unique challenges when applying the chain rule. Since CBI losses are incidents causing damage to an unrelated party, notice of the event to the CBI policyholder may be delayed. Even when notice is given immediately after a loss incident, details of the loss may not be communicated in a complete fashion. Here lies the first major hurdle of identifying the incident.

Notice

Communication between the CBI policyholder and the damaged party is critical to understanding the impact of the incident on current operations. The damaged party usually experiences at least some confusion in responding to the incident. A communication plan between the CBI policyholder and the damaged party is an excellent means of sharing information. Having a communication plan in place before a loss incident occurs allows for streamlined communication after the initial incident occurs.

In the best circumstances a communication plan identifies the nature of incident, immediate impacts to both parties, and initial steps to recover from the incident. This plan can be as simple as a formatted e-mail, memo, or letter containing the following items.

- Time, place, and location of the incident
- Peril that caused the incident (fire, explosion, equipment breakdown, etc.)
- Immediate impacts to the damaged party (plant, property, or equipment)
- Remedial action of damaged party
- Anticipated or estimated period of restoration

These five items will generally provide enough information to identify the incident and determine if it falls within the chain rule.

Determining the Period of Recovery

After notice of the incident is given to the CBI policyholder and their insurer, the next issue will be identifying the period of recovery. This step also poses its own set of hurdles. Exactly

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how long it will take to rebuild a damaged facility and to what extent, can be questions that are open to much interpretation. One of the first considerations for the period of restoration is determining the length of time for rebuilding. This may seem a very straight-forward question; however the answer can be difficult to state.

Consider, for instance, a 40-year-old manufacturing plant that suffers a significant explosion that causes extensive damage to the facility. Most insurance policies require the rebuilding to be of like kind and quality as the original plant. In a replacement cost policy this is old for new construction cost. Over the last 40 years there may have been significant change that has not been previously incorporated into the plant. How do items such as code upgrades, changes in technology, and expansions to the original facility affect the period of restoration?

In this case it is imperative that sufficient information on the recovery effort is communicated to the CBI policyholder. If the damaged party decides to perform a plant expansion along with the insurance recovery construction can those costs be segregated? If the plant expansion adds additional time to the actual period of restoration, that additional construction time will have to be identified and excluded from the period of restoration. Additionally, the original construction timeline may have been aggressive on minimizing the amount of time to rebuild. Consideration must be given to reasonable delays in construction that may increase the period of restoration.

One of the best practices for this situation is the damaged party allowing plant tours for the CBI policyholder and their adjuster during the recovery period. This facilitates open communication and speedy recoveries for both parties. Non-disclosure agreements can be signed by all of the interested parties to protect sensitive information or documentation.

Documenting a CBI Claim

One of the biggest keys to managing CBI claims is documenting the loss. This may seem simple enough; however, as seen above, there are additional facts and circumstances that need to be recorded beyond a normal BI claim.

During the period of restoration a CBI policyholder may be faced with a timing difference between the actual date of loss and the point at which it experiences an interruption of its operations. For example, a chemical processor supplies a refined raw material to a customer at a contracted price and volume. The customer experiences a catastrophic explosion and its processing plant is shut down. However, the customer can still receive raw material from the supplier.

The customer may continue to receive raw material for several months until its inventory storage is full. The supplier would not suffer an interruption of its business until the customer stopped receiving raw material. Consequently, the supplier's period of indemnity would be reduced to the point at which the customer stopped receiving material until the damaged plant was restored. Situations such as this need to be adequately documented through correspondence and other communication between the suppler and customer.

Under P&C policies there is a duty to mitigate losses. With CBI claims, mitigating losses may prove to be difficult or unusual. Take or pay and sole source contracts with suppliers and customers may put a CBI policyholder in a tremendous bind. If the industry in which the CBI policyholder operates has only a few major customers that generally deal only with contracted suppliers, there may be no alternatives to sell their products. Secondary and tertiary markets may also have to be explored.

Often, secondary and tertiary markets will purchase at a much lower price than a primary market. Even though a CBI policyholder may make some sales it would have otherwise lost, those sales may be made at a loss. Documenting a circumstance such as this will become critical when explaining why certain actions were or were not taken by the CBI policyholder.

Additionally, the CBI policyholder should maintain documents related to their specific industry, especially historical and forward looking trends in the market place. The policyholder will have to work closely with the adjuster on their specific industry. External market reports and analysis is an excellent tool to provide an independent view of the market place. Providing this information to claim consultants and the adjuster will facilitate an efficient claim process.

Proving the Loss

When due consideration is given to documenting CBI claims, proving the loss becomes considerably easier. Just as in a normal business interruption claim, there are several issues that should be addressed in the CBI claims: appropriate modeling of expected versus actual performance during the period of the loss, and efforts of mitigating losses and incurred extra expenses. In some cases the insured should consider the cost benefit of hiring forensic accountants to prepare these claims. Forensic accountants are uniquely qualified to assist in these matters and provide an overwhelming benefit when it comes to analyzing and defending CBI claims.

Regardless of the form of a CBI claim, an historical analysis of the income statement is performed. This analysis takes into consideration past performance of the business. Historical sales revenues and volume are analyzed to determine trends and seasonality. In CBI claims this will generally focus on the individual supplier, customer, or dependent property that is the subject of the loss.

Sales and revenue analysis should also include a review of significant contracts between the parties. In most cases, contract reviews provide qualitative information as to performance issues and costs and volumes purchased or supplied. Relationship analysis, such as price to volume or cost plus, may provide pertinent information considered in analyzing and modeling expected operations. Additionally, historical minimum and maximum volumes purchased or sold will give insight into expected sales.

The next step in proving the loss is analyzing cost of sales, either as cost of goods sold or cost of goods manufactured. If the damaged company is a supplier, due consideration should be given to any contracts in place between the two parties. Specifically, supplier side CBI claims may involve contracts that are indexed to market pricing for raw materials. This can have a significant impact on determining gross margins. For example, if the cost of raw materials is indexed to a market that is decreasing in cost while the finished goods are increasing in sales price, the impact of the loss may be greater than a historical average may indicate.

One of the most difficult parts to proving out the claim is determining continuing and discontinuing expenses. As a general rule, any expense that continues to be incurred during the period of restoration is a continuing expense. This is a straight-forward definition, and the converse is also true—those expenses that are not incurred during the period of restoration would be discontinuing expenses.

But what happens if continuing expenses do not continue at the same rate as pre-loss? This condition is very common in CBI claims, and since the policyholder has an obligation to mitigate its losses there could be fluctuations in expenses due to a partial shutdown of operations. In this instance, the analysis of continuing/discontinuing expenses should address partially continued or discontinued expenses.

Since CBI claims are generally focused on one significant supplier, customer, or dependent property, the business interruption claim may be segregated to that one entity. If that is the case it may be beneficial to the CBI policyholder to hire a forensic accountant to assist with preparing the claim. Segregating sales, costs, and expenses to a single entity requires a firm understanding of accounting. As is often the case, not all expense may be attributable to a single entity. Thus, the expenses will have to be analyzed to determine the relevant portion to be allocated to the claim.

Working through the Challenges

In the end, CBI claims have the same goal of any other commercial claim—putting the policyholder back in the position it would have been had no loss occurred. There is a considerable amount of analysis that must be performed to determine what that position would have been. However, through utilizing good communication with the damaged party, documenting all of the facets of the loss, and proving damages, risk managers will find that these claims can be managed.

It is quite likely that CBI claims will continue to increase as businesses decentralize and enter into long term contracts with suppliers and customers. Being knowledgeable about these claims will benefit the parties involved in providing the right coverage, as well as the process involved in managing a claim in the event of a loss. ■

Learn More, Earn More

Attend a CIC Commercial Property Institute to learn more about time element coverage, such as business interruption, and the recommended endorsements. For a more basic approach, try the CISR Insuring Commercial Property Course. Some Ruble Graduate Seminars also examine business interruption coverages and endorsements—check the specific seminar's agenda to see what topics are scheduled.

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Scott is a certified public accountant who has practiced in forensic accounting for over 16 years. He assists corporate clients recovering from catastrophic events through claim investigation and quantification of damages. Scott has testified as an economic damages (business interruption) expert in federal and state courts and has prepared numerous contingent business interruption claims for policyholders. Additionally, he routinely prepares business interruption, extra expense, and property damage claims for corporate clients. He regularly lectures and teaches CPAs and other professionals through continuing education programs.

[1]USLegal.com, US Legal, Inc., 24 Oct. 2011, http://definitions.uslegal.com/c/contingent-business-interruption-insurance/

[2]Archer-Daniels-Midland Co. v. Phoenix Assur. Co., 936 F. Supp. 534, 536 (S.D. Ill. 1996).

[3]Ibid at ii citations omitted.

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