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[the business interruption e-source]

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BUSINESS INTERRUPTION CONSULTANTS, INC.

IN THIS ISSUE

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Supply Chain Risk Management and Contingent Business Income Insurance

PART TWO (for part one, see January, 2012 newsletter.)

SUPPLY CHAIN BUSINESS CONTINUITY PLANNING

It is entirely possible that the most significant business interruption exposure for any organization is not related to its premises, but to that of a key supplier and/or key customer, adjacent building, or even a key object such as a bridge or roadway. In order to manage the risk, it is very important to have risk triggers in place that will provide measurement and reporting procedures.

Utilization of risk management in global supply chains can be a competitive advantage. It is not pure risk minimization. Think of it as an opportunity to get ahead of the competition by being better prepared. **Business Continuity Planning** is crucial for the survival of the organization. You cannot mitigate or finance your exposure if you do not know the dollar amounts involved. Business Continuity Planning when used correctly can be a dynamic process that identifies supply chain exposures and serves as a template for loss control strategies, such as alternate suppliers, customers, etc.

Supply chain interruption, both from a supplier and customer standpoint, must be a concern for everyone in the organization. Companies should be a part of the suppliers' and customers' Business Contingency Plan and vice versa. It is essential to have an in-depth understanding of the organization's work product, service process, and its ability to sustain itself without the critical supplier or customer in both the short and long term.

(continued pg 2)

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Contingent Business Income insurance replaces lost income and/or increased operating expenses and should be part of the solution, but must not be considered as the sole solution. Contingent insurance may not be available for needed perils such as earthquake, flood, riot, utilities, or civil authority, etc. and like any insurance coverage will have limits, exclusions, a waiting period, and a cost. Additionally, manmade events that trigger supply chain interruptions also may not be insurable such as the 2002 west coast shipping strike that created economic havoc and was as significant as a natural disaster. Before disaster strikes, it is imperative that an organization have back-up plans that have been tested to identify alternate supply sources as well as other customer outlets.

CONTINGENT BUSINESS INCOME (CBI) INSURANCE

Please keep in mind that no two CBI policies are the same. Each insurance company has its own form that is modified based on the business of the insured and the risks perceived by the insurer. As a result, the definition of CBI coverage available under individual policies differs from one to the next. That said, CBI coverage generally insures the lost or reduced earnings of the insured following physical damage to the property of a third party that has a specified relationship to the insured.

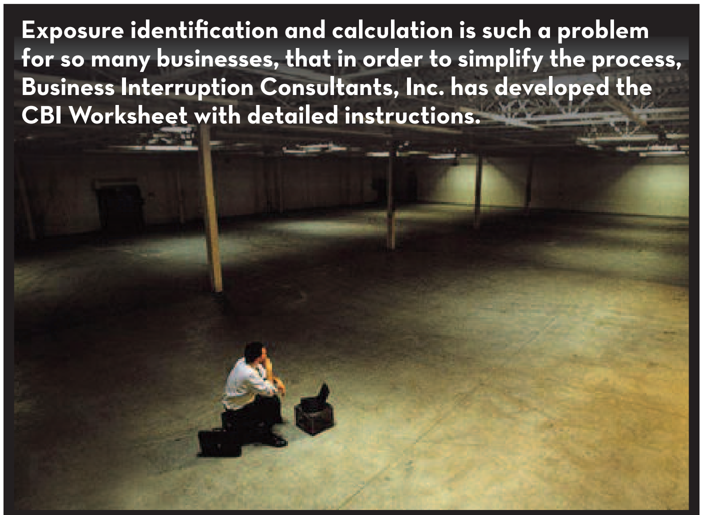
The standard coverage says, "We will pay for the actual loss of Business Income you sustain due to the necessary suspension of operations during the 'period of restoration.' The suspension must be caused by the direct physical loss of, or damage to 'dependent property' at premises described in the schedule, caused by or resulting from any Covered Cause of Loss." CBI coverage is written two ways: either blanket—usually $250,000, or specific—$1 million for Matson Manufacturing. For specific CBI, the underwriter must underwrite the named location in order to price the protection. However, sometimes it is difficult to access the facility so the insurance carrier has a difficult time pricing the coverage. Policy-holder's should also be aware of the CBI period of restoration and time deductible as this will affect the outcome of the claim. Read the policy and see if Contingent Extra Expenses are available.

Today's risk manager faces many unknowns and will often look to CBI insurance as a way to soften the impact of a disastrous event. On the surface, CBI insurance may appear to be straightforward; however the documentation and analysis needed to validate an insurance claim can be quite challenging. Relying solely on the concept of CBI insurance and not understanding what is needed to document and collect a claim could create a false sense of security when buying CBI. Why? Because oddly enough, many CBI losses are so unique that insurers may not have contemplated such claims when writing the policy. The complexity of policy interpretation remains a problem and the claim profession continues to address these issues.

Additionally, whether the definition of a supplier under the policy includes entities that provide transportation-related services is illustrative of an area of dispute that many insureds will likely confront in the process of submitting a CBI claim in the aftermath of any catastrophic loss caused by a natural disaster. As an example, Hurricane Katrina caused extensive physical damage to channels of transportation, including airports, ports, rivers, roads, and bridges, so that many policyholders incurred additional costs and/or were unable to access these channels to transport goods. It virtually crippled the flow of commerce in and out of parts of southern Louisiana. To the extent that the damage to avenues of transportation of goods along these channels caused an interruption to the business of the insured, a claim may exist for CBI.

Another potential source of conflict involves whether the type of damage to the supplier constitutes covered property damage under the insured's policy, although there have been relatively few court decisions to-date on the subject. A business suffered a loss of earnings when its supplier was unable to operate due to a loss of power caused by an earthquake. Although the supplier's property was not physically damaged, the electrical substation serving it was. The court held that the insured was not entitled to CBI coverage because it did not suffer direct physical loss or damage. Despite this narrow interpretation of the property damage required to trigger coverage, other courts have found that impairment of a supplier's physical property does trigger coverage. This illustrates the importance of policy language regarding ultimate determination of coverage. That is why I always request a copy of the policy when I am working on a Business Interruption Appraisal, BCP, or a claim.

Exposure identification and calculation is such a problem for so many businesses, that in order to simplify the process, Business Interruption Consultants, Inc. has developed the CBI Worksheet with detailed instructions.



You supply the numbers; we do the calculations.

Visit www.BusinessIncomeWorksheets.com or www.BISimplified.com for the CBI Worksheet.

Where covered and uncovered perils act in concert or in rapid succession to cause property damage, policyholders must pay careful attention to the language contained in their policies. They must also carefully assess governing law which may be different in different countries, for example, France utilizes Napoleonic law and so does Louisiana. Under most first party commercial property policies, wind and rain are covered perils, but damage caused by flood may be excluded or subject to sub limits. If property damage is caused by multiple perils and one of these is excluded under the policy, insurers commonly take the position that there is no coverage for the entire loss. This position may be wrong. Generally, where a loss is caused by a combination of covered and uncovered perils the concurrent causation doctrine provides that coverage should be afforded if the covered peril is the efficient proximate cause of the loss. However, many insurers seek to avoid such a finding through the insertion of anti-causation language into exclusions. Such language is intended to exclude coverage if the loss results from a combination of covered and excluded perils. Accordingly, to accurately assess whether a CBI caused by property damage due to multiple perils is excluded, policy holders should look to the language of their policy for anti-concurrent causation language and to governing law concerning concurrent causation doctrine. See **BISimplified.com: *The Insurance Policy: Simplified!***

For example, the manufacturer of a supply of embedded microchips for an insured might be partially shut down by a fire at the suppliers' plant; the insured may be compelled to suspend production because it cannot get the chips. Alternatively, it may be put on an allocation of product. In such a case, the insured will have suffered a CBI loss even though the supplier has not been shut down. Another scenario would be when a fire closes the chip plant completely, but the insured has either ample supply or an alternative supplier and may not be affected or only slightly impacted. In this situation, there may be no CBI loss unless the insured cannot find another supplier or has to pay a premium to the new supplier. This scenario could lead into Contingent Extra Expense or CBI in an attempt to avert a BI loss.

TERRITORY

From the standpoint of the territorial scope of the policy, an insurer argued that the policy's CBI coverage provision required both physical property damage and loss of business to have occurred within the policy's territorial limits, concluding that, because the damage allegedly causing the business loss occurred in Singapore (outside policy territory), there was no coverage. The parent company responded that the only relevant loss was the financial loss, which occurred not at the company's Singapore facility, but at the location of the company in Arizona, which, undisputedly, was included as a named location in the policy; that is, the loss was said to be covered because it occurred not only within the territorial limits of the policy, but also at a scheduled location.

From the court's perspective, the CBI language was unambiguous and clearly provided coverage for the loss sustained by the company in Arizona. Referring to the policy, the court stated that the insurer "will pay for loss resulting from necessary interruption of business conducted at Locations occupied by the Insured and covered in this policy." The loss covered, the court explained, was not physical damage to property, but a "financial shortfall" and that shortfall had to occur within the territorial limits of the policy. The court, however, also stated that coverage was not totally open-ended, since it was required that the financial shortfall be caused by direct physical damage or destruction to real or personal property of direct suppliers. However, the limitation, the court went on to say, stopped there; that is, the policy was silent about where the direct physical damage or destruction must have occurred. The court therefore concluded that if the insurer had desired to place a territorial limitation on where "direct suppliers" must be located, in order for coverage to attach, it could have included explicit language to that effect. In fact, as pointed out by this court, the policy did include an explicit territorial restriction in its "Time Element—Gross Earnings" provision.

CALCULATION

In order to calculate the exposure, identify the percentage of gross margin or gross profit from the supplier or customer, and then calculate the percentage of a year to replace them. For example, 30% of a company's annual gross profit of $50 million comes from Mico Metals Corporation, or $15 million times four months, or 33% of a year to replace them, which equals $5 million.

SUMMARY

Fierce competition and a difficult economy create an imperative for a company to use every source of advantage. For many, holistic supply chain risk management remains one advantage yet to be tapped to its fullest potential. We need to impress upon companies the need for them to own and manage their risk, understand the exposures, and harden the supply chain. With knowledge of their exposures, tailored supply chain insurance solutions can be initiated. Businesses should have a broad master global insurance policy including Difference in Conditions, Business Income with extended period of indemnity, CBI, and extended CBI, if it is available.

Remember, CBI insurance is revenue protection and will not cover inventory. Also, it is necessary for businesses to consider all perils, not just flood or earthquake, including manmade, economic, and political exposures, as a strike can be as interrupting as a fire. The event may be something as simple, and at some companies potentially crippling, as the projected truck driver shortage in the United States that is expected to reach 111,000 in 2014.

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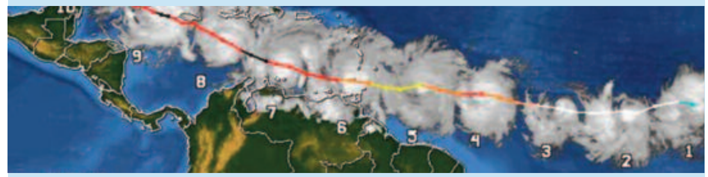
Business Continuity Planning is in some ways easier with a forecasted event such as a hurricane. Data and paper records can be backed-up offsite and systems can be shutdown without data loss. Relocation and protection of raw materials, finished goods, equipment, supplies and vital records can be done well before damaging winds or flood waters arrive.



However, a regional event such as a hurricane may impact a wide area that encompasses more than one company-owned facility. Planning must address all facilities potentially impacted by the storm. Competition for resources, including contracted back-up sites, may be keen forcing some users to relocate great distances to available back-up data centers or worksites.

A Business Continuity Plan must be based on a Business Impact Analysis that identifies the potential impacts from damage to or loss of all facilities within the path of a hurricane. Strategies must be developed to ensure continuity of critical functions, processes, and services. Sufficient resources, outside of the area impacted by the storm, must be available in the face of competition—even competition from government authorities. Following Hurricane Katrina in 2005, generators brought into storm damaged areas by private businesses were redirected by public officials and never reached their intended facility.

THE CONTINGENCY PLAN—GET STARTED!

Contact Business Interruption Consultants, Inc. today to develop a Business Contingency Plan or schedule a Business Interruption Appraisal.* Be certain you are well prepared for the next disaster. Contact us at: info@bisimplified.com.

*See archived June/July 2010 newsletter.