

## **SPECIAL REPORT**

### **IF YOU ARE A “JUST-IN-TIME SUPPLIER”, CONTRACT PENALTIES COULD SPELL DISASTER FOR YOUR BUSINESS**

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If you manufacture products that require sequenced delivery within a limited time parameter and fail to deliver as promised due to fire or other loss, the penalties that could be imposed by your customer could be enormous and may be uninsured.

#### **PENALTIES CAN BE SEVERE**

One major auto company, for example, will impose a \$500 per minute penalty if your late delivery shuts down their assembly line. This translates to major penalties. For example:

- \$500 per minute
- \$30,000 an hour
- \$360,000 for 12 hours
- \$720,000 for 24 hours
- \$3,600,000 for 5 days
- \$7,200,000 for 10 days
- \$21,600,000 for 30 days
- \$64,800,000 for 90 days

It is unlikely that this auto company, or any other automobile manufacturer, would tolerate a 90 day shut down. They could make arrangements with another supplier to perform your work, costing you the long-term loss of business. In the alternative, they could (or you could) place the work temporarily elsewhere, costing you the difference between your normal

cost and the extra expenses to have it done elsewhere, especially on an emergency basis. They could also deduct penalties for amounts owed to you.

Obviously, the impact of the disruption of your business could be enormous considering:

- Contract penalties at \$500 per minute.
- Long-term loss of the business.
- Extra expenses caused by subcontracting the work temporarily to another supplier (if this is even possible).

Even if you are not dealing directly with an auto manufacturer but are providing your services to another supplier, you face the same problems because of the indemnification clauses between the parties requiring that you indemnify your customer for its losses because of your failure to supply in accordance with the agreement between the parties.

## **THE FORCE MAJEURE CLAUSE DOESN'T HELP**

From our direct experience as insurance coverage attorneys, there is no forgiveness from automobile manufacturers in contract penalty situations. A “force majeure” clause in a contract may not be the solution to this exposure. Such clauses purport to limit liability for fines or other catastrophic events.

A “force majeure” clause at first glance appears to provide forgiveness in many instances; however, as indicated below, many such “force majeure” clauses indicate that the performance will be excused only to the extent that it is caused by an event or occurrence beyond the reasonable control of the party and without its fault or negligence. It is difficult to imagine an event or occurrence that would not be within the reasonable control of a supplier.

## **CONTRACT REQUIREMENTS ESTABLISH NEGLIGENCE**

For example, if we examine one auto makers Statement of Requirements for Sequencing and Subassembly, section 3.5 indicates some of the general requirements. For example, backup transportation and backup power and equipment are required and are the responsibility of the

supplier. Section 3.5 also indicates that the sequencer must develop and maintain a disaster recovery plan and/or risk assessment plan.

Section 3.6, Building Requirements, is very specific requiring ample heating and cooling equipment, a clean, safe, well lit and properly ventilated and heated building that meets all government ordinances and safety standards.

More importantly, this section requires that the building and all operations must be secure from theft and vandalism 24 hours a day, 7 days a week, and that a fire protection system approved by the state and/or the local fire marshal must be provided, installed and maintained for the entire site. The facility must meet all city, state and federal building codes.

It is also important to note that the contract requires that the sequencer will be responsible to have the appropriate insurance coverage for liability associated with the operation and will be required to present proof of coverage.

## **RISK MANAGEMENT AND LOSS CONTROL**

The requirements imposed upon a supplier are very broad, and it is unlikely that any event or occurrence as indicated above would be beyond the reasonable control of the party and without its fault or negligence and it is expected that all of the requirements of the contract be adhered to.

It is unlikely that there will be any forgiveness of any type of an interruption of the customer's production line.

Risk management and loss prevention are critical in this type of situation and this means that the supplier must be certain that the building, at a minimum, is not only sprinklered but adequately sprinklered for the occupancy. For example, a plastic product occupancy requires a much higher density sprinkler system than a non-plastic occupancy. Whether or not your sprinkler system is adequate can be determined by the loss control department of your insurance company or from your sprinkler contractor.

Building security is also critical, and it is recommended that a security system be installed, including video monitoring and recording of various aspects of the operations of the business.

Another recommendation is that criminal record checks be done on all prospective and current employees and that overall access to the grounds be limited.

Obviously, the requirements of the contract as far as backup generators, sprinkler systems, and security systems are expensive; however, certainly much less expensive than the loss of business, destruction of property, and the imposition of contractual penalties as a result of your failure to safeguard the premises.

## **INSURANCE COVERAGE NEEDED**

Assuming for a minute that despite your best efforts an interruption of your operations does occur resulting in loss of income, extra expenses, and contractual penalties, what insurance products are available to make you whole?

### **A. Business Interruption Coverage**

At a minimum, business interruption coverage must be carried for all manufacturing businesses. The coverage should include extra expense insurance and contractual penalties when coverage is available.

The limit of liability that is appropriate must be determined by examining the likelihood of a long-term shutdown, as a result of a fire for example, and whether or not your disaster recovery plan will allow you to maintain your production without any significant interruption.

One sobering example of the need for an adequate business income coverage is the powerhouse loss at the Ford Rouge Complex. On February 1, 1999 the powerhouse explosion and fire that killed six workers at the Ford Motor Company's Rouge Complex could turn out to be one of the costliest single site insurance losses in U.S. history. It is estimated that the combined loss of \$1,000,000,000 or more is possible and that certainly the insured loss will exceed \$500,000,000 according to an underwriter at Lloyds of London.

A spokesman for the Ford Motor Company indicated that the damages could be even higher because of the high value of business interruption

claims from Ford and from Rouge Steel which shares the Dearborn complex and its loss production. In that loss, the explosion and fire disrupted electricity, steam, mill water and hot high pressure air service to Rouge Steel and to six Ford plants in the 1,100 acre manufacturing complex.

The various plants in the Rouge complex fed production parts to 16 of Ford's North American assembly plants.

With round-the-clock work, overtime and rush orders, Ford and 80 or more of its suppliers and contractors got the auto makers Rouge plants running again a week after the accident, but half a dozen Ford Assembly plants across the country had their schedules disrupted.

Rouge Steel was able to resume partial production about 10 days after the accident, but the Powerhouse was so severely damaged that it could no longer be used. A new sub-station had to be assembled next to the old plant to power the Rouge complex until a new \$240,000,000 Powerhouse could be completed.

The point of this example is that a fire loss can be far reaching and extremely costly and adequate limits of business interruption are required.

## **B. Extended Period of Indemnity**

There are two basic issues that must be confronted when reviewing business interruption coverage. The first is the dollar limit and the second is the time limit.

In selecting the dollar limit to be purchased, one must be careful to not necessarily only select the limit that is required under the business interruption worksheet offered by your insurance carrier, but to look ahead as to the long-term implications to your business and to your customer's business as a result of disaster.

Typically, many insurance buyers or agents will think in terms of the period of time that it would take to reconstruct the business or to get back into business and only insure loss of profits and continuing and extra expenses for that period of time. As a matter of fact, most business

interruption insurance will cover only losses sustained during the reconstruction time plus 30 additional days.

This is a mistake, however, because the loss of your profits could extend well beyond the period of time it would take to rebuild your building or to resume your operations at another location. This is because of the long-term loss of your business that could occur when the contract is either cancelled or renegotiated by your customer or new sales go elsewhere.

Depending on your specific situation, you may want to select a loss of income and extra expense limit that would be appropriate for at least a two-year loss of business period, for example, and then negotiate insurance coverage that will cover this period. Inasmuch as the cost of securing adequate business interruption insurance for a properly sprinklered facility is usually between \$500 and \$700 per \$1,000,000 of coverage per year, it doesn't make sense to purchase an inadequate limit to cover you for an extended period of time in view of the relatively low cost to insure an adequate limit.

However, as we indicated, it is critical to determine if your business interruption will cover you for that extended period of time. In other words, you can secure a dollar limit that will cover you for, let's say, a two year period; however, the policy may still only cover you for the period of time it takes you to rebuild.

It is critical to have what is known as an "extended period of indemnity clause" on your insurance program. This clause will extend the covered recovery period beyond the reconstruction period. A sophisticated business interruption policy will have an unlimited period of indemnity. Most insurance policies provide automatically only 30 days after reconstruction is complete as an extended period of indemnity; however, you can increase this to 60, 90, 120 days, etc.

### **C. Extra Expense Coverage**

Another issue regarding business interruption insurance is to be certain that your policy does, in fact, cover extra expenses. Extra expenses are those expenses incurred over and above your ordinary expenses. Some business interruption forms only cover extra expense to the extent that it

reduces the insurance company's loss of income claim. Obviously, this is not the preferred form.

#### **D. Contractual Penalties Coverage**

An additional critical issue relates to contractual penalties coverage. Many insurance companies do not include contractual penalties within their business interruption form. In order to clarify the fact that coverage is not provided within their standard form, insurance companies will often include a sublimit or a separate limit for contractual penalties. That sublimit could be as low as \$10,000 and usually no more than \$100,000.

The reason for this separate limit is obviously to be certain that there is no misunderstanding that coverage is provided under the basic coverage form. This is because of the consequential loss exclusion. The standard business interruption form contains a consequential loss exclusion, which is a catch-all exclusion of any consequential loss not already specifically covered or specifically excluded. An example of a consequential loss in this category might be penalties for late delivery imposed by a contract. Although we would argue for coverage, it is better to avoid the dispute to begin with, where possible, and to negotiate specific contractual penalties coverage.

What is vital relative to contractual penalties coverage is to secure a specific limit that is adequate to cover the likely period of shutdown. With adequate disaster recovery plans, a limit of \$3,600,000 covering a five day shutdown of an assembly line might be reasonable. Each situation needs to be examined on its own merits.

Remember that the coverage that is provided for contractual penalties is a legal liability coverage. The insurance company will pay only if you are legally liable. This presents problems because it may require litigation between you and your customer, which could ultimately result in the long-term loss of your business. It would be preferable to negotiate contractual penalties coverage without the legal liability requirement; however, in today's property and casualty market this may not be available.

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