



## Spoiled goods coverage

Resource kit 90089

By Dan Corbin, CPCU, CIC, LUTC

This resource kit is going to address the chemical breakdown of organic matter, also known as animal rot and plant decay. Prepare yourself. It's going to get messy—sour milk, wilted lettuce, rancid fruit, decomposing fish, etc.

Insurers using the typical commercial property policy just don't have the appetite for insuring spoiled goods; that is, unless precipitated by an otherwise covered cause of loss on the premises (fire, vandalism, vehicles, etc.). It's not that insurers necessarily want to withhold their indemnification. Often it boils down to how much premium the average policyholder is willing to pay. Sometimes, consumer awareness of a coverage translates to an expectation of coverage, leading insurers to incorporate formerly elective insurance into the standard provisions of their policies (such was the case with ordinance or law coverage).

Not every business has a significant risk of spoilage, so why should those without the risk pay premiums to support those that do? Or, to use another example, if you don't keep electronic equipment in your car, do you want your auto insurance premiums being used to pay the losses of your neighbor who has a computer and fax machine in his car? At what point does it make sense to automatically include such peripheral coverages? Has the exposure become so commonplace that coverage is expected without endorsement? It is this perennial question of where to draw the coverage line that, at times, keeps the lights on in an insurer's product development department late into the evening.

### **Standard exclusions**

While the Insurance Services Office Inc. (ISO) offers open perils under its Cause of Loss—Special Form (CP 10 30) endorsement, two pertinent exclusions will spoil most hope of covering the self-destructing nature of perishables.

**Exclusion B.1.e—Utility Services.** The failure of power (or any other utility service) being supplied to the insured premises is excluded if the failure occurs off the premises, regardless of cause. The cause might be an earthquake at the generating plant, a fire at the transformer, an explosion at the substation or transmission lines downed by wind or vehicles.

The exclusion permits underwriting control over the exposure so that, when coverage is restored by endorsement, adequate pricing can be assigned to those having the risk. Also, because the potential exists for power to fail over a vast area, this exposure tends to keep too close company with catastrophe, something insurers have deepened their respect for these days.

**Exclusion B.2.d.** Seven types of maintenance-related causes of loss are listed under this exclusion. Mechanical breakdown (No. 6) is one that has special significance to the inherent risk associated with perishables. Whether the breakdown involves a refrigeration unit or an on-premises generator of power, the consequences can lead to spoilage.

Mechanical breakdown is a matter of inevitability. Property wears out, metal rusts, organic matter decays and every machine will eventually breakdown; though with care and maintenance its utility may be protracted. Thus, whenever the insured has a significant role in the prevention of loss, underwriters want to reserve plenty of room for their professional discretion in evaluating and pricing the risk. In fact, the underwriting of this coverage is usually passed over to the equipment breakdown (a.k.a., boiler and machinery) specialists.

### **Spoilage coverage**

A restaurant, bakery, food processor, warehouse, dairy, florist, cannery, meat packer, pharmaceutical, grocer and delicatessen all have potential exposures to spoilage loss. If the risk does not exceed \$50,000, an option introduced by ISO in 1988 might be the preferred coverage, assuming price and flexibility is not heavily weighted in the decision. Restaurants, in particular, make good candidates for this coverage option.

The ISO's Spoilage Coverage (CP 04 40) endorsement, which may be used with the Building and Personal Property Coverage Form or the Condominium Commercial Unit-Owners Coverage Form, covers property either owned by or in the care of the insured. An attractive coverage feature is the option to insure the perishable property at selling price rather than actual cash value, but for this enhancement, expect a 40 percent hike in the rate. Before the ISO changed its rules in 2008, a major disadvantage of this form was the restriction of coverage to \$50,000 at any one location.

To remedy coverage taken away by commercial property exclusions B.1.e and B.2.d, the Spoilage Coverage endorsement offers restoration for physical damage caused by mechanical breakdown, power outage or both. The mechanical breakdown of refrigerating, cooling or humidity-control equipment includes contamination by the refrigerant (ammonia has a rather nasty effect on perishables). Power outage is applicable to a supply located either on or off the insured's premises.

One reason spoilage coverage may be priced a little high (loss costs for both mechanical breakdown and power outage hover around \$10 per \$1,000 coverage, depending on the category of risk) is that it is not subject to coinsurance provisions. Another reason for the high price tag is that the scope of perils covered is quite broad, though limited in choice.

Since mechanical breakdown and power outage actually become covered perils under the Spoilage Coverage endorsement, the proximate cause which led to these perils need not be considered unless otherwise excluded. Only five of the property exclusions from the commercial property peril form (i.e., earth movement, governmental action, nuclear hazard, war and military action and water) remain active to eliminate coverage under this endorsement. In addition, a few supplemental exclusions are added for loss caused by:

- the disconnection of the power source;
- the deactivation of a power switch;
- lack of fuel for the power source or cutback of power by government order;
- inherent inability of the source to meet the demand; or
- glass breakage on the control unit.

An industry publisher has expressed concern that coverage otherwise available to the insured may be eliminated by some of the above supplemental exclusions. The publisher began with the assumption that spoilage caused by vandalism is covered under the basic-, broad- and special-peril forms (which is true, as long as the failure occurs on the premises). Then, the publisher suggests that the Spoilage Coverage endorsement revokes this coverage when a vandal, for instance, disconnects the power source (because of the added exclusions). The reason why this loss would be covered by a policy endorsed with the Spoilage Coverage endorsement is the same reason that the basic-, broad- and special-peril forms would cover it. The proximate cause of the loss is vandalism, not the disconnection of the power source.

According to ISO rules, insurers may offer a credit for obtaining a refrigeration maintenance agreement applicable to equipment subject to mechanical breakdown. Beware though, the insured's failure to notify the insurer of its termination of the agreement is cause for denial of coverage.

### **Consequential damage coverage**

Let's assume you want to more carefully tailor coverage for your client who owns a cold storage warehouse. You sold him an equipment breakdown policy to cover physical damage to the refrigeration equipment. Now you are looking to cover spoilage losses that are likely to follow a breakdown of the equipment.

A Spoilage Damage provision is included in the current ISO Equipment Breakdown Protection Coverage Form (BM 00 20), which pays for spoilage damage due to a lack or excess of power, light, heat, steam or refrigeration. In order to activate this coverage, the word "included" must be shown on the declarations or a limit must be stated. There is coverage for damage to raw materials, property in process or finished products that are either in storage or in the course of being manufactured. Covered property must be owned or the insured must be legally liable for its damage under a written contract. Per ISO rules, even the loss of admission charges may be considered spoilage damage (for example, admissions lost at an amusement park).

Using the language of the equipment breakdown policy, the loss must be caused by a "breakdown" to "covered equipment." Such "covered equipment" generally must be owned or controlled by the insured and located on the premises (unless the equipment is owned by a public or private utility and serves only your premises), providing power, light, heat, steam or refrigeration. In order to cover spoilage damage resulting from a breakdown to utilities located off the premises (and not solely serving the insured's premises), Utility Interruption coverage must be activated on the declarations page.

An analysis of the definition of "breakdown" (something beyond the scope of this resource kit) will reveal that coverage under the Spoilage Damage and Utility Interruption provisions of the equipment breakdown policy is slightly inferior to coverage provided by the Spoilage Coverage endorsement on the property policy. This is because a mechanical breakdown is not as narrowly defined in the Spoilage Coverage endorsement as it is in the equipment breakdown policy.

According to the ISO property rules, the Spoilage Coverage endorsement is not subject to coinsurance. However, the ISO rules do include coinsurance in the rating of Spoilage Damage coverage in the equipment breakdown policy. The limit a policyholder should purchase is the coinsurance percentage chosen times the value of all property at risk for spoilage damage. The ISO offers 80, 50 and 25 percent coinsurance choices, as well as an option to have no coinsurance, if your policyholder doesn't mind a 400 percent increase over the 80 percent coinsurance rate. Oddly, there is no coinsurance penalty in the Equipment Breakdown Protection Coverage Form to back it up, though.

While the deductible applicable to the Spoilage Coverage endorsement is tied to the business personal property deductible of the property policy, the Spoilage Damage coverage of the equipment breakdown policy allows an insured to choose from an array of deductibles ranging from \$250 to as high as \$2 million. The standard deductible is \$500.

### **Utility services coverage**

If your cold storage warehouse client has Spoilage Damage coverage and Utility Interruption coverage, there will be compensation for damage if a "breakdown" occurs to the refrigeration equipment or its power source, whether on or off the premises. However, we now must discover how to obtain coverage for the failure of power when an event other than a "breakdown" occurs off the premises (for example, windstorm). The solution is the Utility Services—Direct Damage (CP 04 17) endorsement, which may be added to the ISO property policy.

Spoilage coverage provided by the Utility Services—Direct Damage endorsement depends on direct physical damage to off-premises properties that provide power; including overhead power transmission lines, if that option is selected and a premium charge is indicated. The ISO rules offer the policyholder a choice of the basic, broad or special cause of loss forms, as well as a selection to cover earthquake damage and flood.

Unless you use the Your Business Personal Property—Separation of Coverage (CP 19 10) endorsement to isolate the perishable stock from all other business personal property on the premises, the utility services coverage will apply to (and, therefore, be rated upon) the entire business personal property limit shown in the declarations. This obviously is not an efficient use of premium, so the separation endorsement is recommended under most circumstances.

### **Summary**

Before your client raises a stink, you had better attend to his spoilage coverage needs. First of all, events that damage property *on the premises* and subsequently lead to spoilage can be covered with an appropriate cause of loss form under a property policy. Next, loss of power resulting from physical damage to property located *off the premises* can be insured with the Utility Services—Direct Damage endorsement. And, since neither of these first two coverages will respond to the *breakdown* of refrigeration equipment or its power source, the Spoilage Damage coverage and the Utility Interruption coverage of the equipment breakdown policy may be needed to embrace the entire spoilage risk.

On the other hand, you can contain the entire stink with the Spoilage Coverage endorsement, if cost is not a major factor. 9/11

Think PIA first