Companies with facilities outside the U.S. protect against the financial losses that can result from damage to those facilities through international property insurance programs. International property insurance programs and losses raise many of the same issues as domestic losses, but they also raise issues that are distinct to international programs. These issues range from basic (*e.g.*, in what currency a non-U.S. claim is paid) to complex (*e.g.*, what, if any, choice-of-law or choice-of-forum clauses should be used). Understanding and addressing these and other key issues when a program is placed will go a long way toward avoiding disputes when losses occur.

OPTIMIZING INTERNATIONAL PROPERTY INSURANCE COVERAGE

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COMMON STRUCTURES OF INTERNATIONAL PROPERTY INSURANCE PROGRAMS

International property insurance programs can be structured in a variety of ways, based on a range of factors, such as: (1) the magnitude of the international exposure; (2) the types and locations of non-U.S. facilities; and (3) insurance laws in the country where the facilities are located. Three common structures are single-insurer programs, where one insurer provides worldwide coverage for all of the policyholder's locations, both domestic and international; multi-insurer programs, in which the policyholder purchases policies from multiple insurers on a country-specific basis; and global master programs that combine a master policy covering the insured's property worldwide with local policies covering specific locations where the master insurer will not provide coverage or significantly limits coverage.

Single-insurer programs typically are used when a policyholder has limited property outside the U.S. and that property is in countries where either its U.S. insurer can provide coverage or it has a local affiliate that can do so. Such structures, of course, avoid coordination problems that arise when multiple insurers are involved, as well as potential gaps in coverage caused by differing policies. However, such structures are not always feasible; some countries prohibit foreign insurance companies from issuing local policies, necessitating the use of an approved domestic insurance company in each such country. If the available domestic insurance does not provide adequate coverage—in terms of scope, amount, or both—a global master policy that includes "difference in conditions" ("DIC") coverage (discussed below) can be used to fill these gaps.

Companies with substantial overseas assets generally use (and may be required to use) more complex structures. For example, many multinational companies have high-value or far-reaching global operations that involve financial risks that are too extensive for a single insurer to cover. In such circumstances, a company may place a program that is led or fronted 100 percent by a U.S. insurer but then reinsured in whole or in part either by a captive reinsurer affiliated with the policyholder[1] or by commercial reinsurers. Alternatively, a company may place its coverage directly in a quota-share program, in which the risk is shared in defined percentages by several insurance companies.

Each of these structures has advantages and disadvantages. There are, of course, tax and premium advantages associated with captive insurance/reinsurance programs, and quota-share programs can be used to get higher insurance limits than are available through a single insurer. However, when a company, or its captive insurance company, is insured or reinsured by a variety of different entities, receiving timely and complete reimbursement of claims may pose greater difficulty than under a single-insurer system. Furthermore, when a claim is made under a program with multiple insurers, there is a risk that the insurers will take inconsistent coverage positions (and unless the insurance or reinsurance agreements have identical terms, including choice-of-forum and choice-of-law clauses, the risk of inconsistent adjudications also exists). For all of these reasons, the administrative costs associated with a multi-insurer program are likely to be higher, perhaps significantly higher, than with a single-insurer program. The advantages and disadvantages of these different approaches, therefore, should be identified and carefully evaluated when an international property insurance program is formulated and placed.

KEY ISSUES IN PLACING COVERAGE AND MAKING CLAIMS

Inconsistent Terms of Local Policies. When a program includes the use of a local policy or policies, it is highly desirable to ensure, to the extent possible, that the local policies provide the same coverage as the principal U.S. or master policy. Otherwise, the company may be left with substantial international risk that may not be covered under either the local policy or the master policy. For example, U.S.-based insurance companies may write business interruption coverage on either a "gross profit" or a "gross earnings" basis, and some U.S. insurers offer a form under which the policyholder can select between a "gross earnings" and a "gross profit" calculation on a "loss by loss" basis. Non-U.S. insurers, however, may write only on one basis or the other. Such variations can lead to substantial gaps in coverage; for example, payroll coverage may be provided directly under one form but not the other, or certain losses to a U.S. entity resulting from damage to a foreign location may not be covered. A U.S.-based subsidiary or division may thus experience a loss involving an international location for which the available coverage is contrary to its expectations and experience with the domestic policy form.

The best way to attempt to ensure uniformity of coverage between a U.S. policy and a local policy is, of course, for the local insurer simply to use the domestic form, translated by an agreed translator. However, this may not be a viable option, since many non-U.S. insurers will not write coverage using U.S. forms, or the required coverage form may be dictated by local law. And even using a translated policy cannot ensure complete uniformity, since nuanced differences in translation or interpretation, or the lack of pro-policyholder doctrines of construction common in the U.S. (discussed in more detail below), can still lead to potential coverage gaps.

DIC Coverage. As noted above, international programs involving a master policy and local policies often include DIC coverage, which is supposed to protect the policyholder against gaps in coverage that result when the local policy provides narrower coverage or more restrictive limits than those available under the master policy.[2] But even DIC clauses do not fill all potential gaps in coverage; for example, a U.S. insurer is likely to contend that its DIC clause does not cover a situation where local claim adjustment practice or the interpretation of a local policy provision varies from U.S. insurance adjustment practice or interpretation, because these are not *differences* in terms or conditions. A common example is certain professional expenses: Although the coverage provided under the master and local policies may be the same, the local insurance company may, by practice, refuse to pay certain types of professional expenses that are customarily paid in the U.S., such as the engagement of construction managers to manage a facility rebuild. Or the local insurance company, based on local custom or practice, may resist paying the full rates of U.S.-based or local forensic accountants or consultants used to quantify the loss. These coverage variations may not, in the insurer's view, fall within the DIC coverage of the master policy. When negotiating DIC coverage, therefore, the policyholder should carefully scrutinize the DIC clause to ensure that it is as favorable as possible.

Currency Conversion and Fluctuation. Currency conversion issues can add risk and complexity to international claims. These issues can be particularly complex in master/local programs, in which the per-occurrence and aggregate limits often are stated in dollars. Such programs attempt to address currency conversion issues in various ways. For example, the local policy may state that losses are payable in the local currency (or in dollars), and it may also specify a specific rate of currency conversion applicable to the loss (*e.g.*, the rate of exchange published in a specified newspaper on a specific date, such as the loss date or the date when the policyholder pays the reimbursable amount).

Unfortunately, neither of these provisions provides a risk-free solution. Consider the following scenario: A flood damages the insured property of an international subsidiary, resulting in the need to rebuild the facility, as well as business interruption losses both to that subsidiary and to other, U.S.-based operations. The international losses are accounted for in the local currency and ultimately are converted to dollars and consolidated in the books of the U.S.-based parent company. The U.S. company also sustains separate business interruption losses that are incurred and recorded in dollars. The local policy limits are stated in dollars, but that policy requires local losses to be paid in the local currency, and the currency exchange rate fluctuates substantially against the dollar during the period of the loss.

What happens if the local subsidiary pays for equipment in dollars fairly quickly after a loss occurs? Under the terms of the local policy, that loss should be converted to the local currency at the time the loss is incurred (*i.e.*, when the insured actually pays for the equipment). But if (as is usually the case) the insurance company does not reimburse the policyholder for that loss for several months, during which the local currency has experienced a substantial negative change in value against the dollar, the local-currency payment will not fully compensate the policyholder for the loss it incurred, since it will receive local currency that is worth less (at least in terms of dollars) than the currency was worth at the time the loss was incurred. Conversely, if the policyholder's local operation incurs losses in the local currency (*e.g.*, local business interruption losses), those losses do not need to be converted and should be paid in local currency. However, in the situation described above, the losses ultimately will need to be converted to dollars and applied toward exhaustion of the policy limits (written in dollars), and many policies do not specify the applicable rate of exchange in such circumstances. Should currency conversion be done at the end of the loss, when payments or advance payments are made, or at some other time? If the local currency fluctuates against the dollar during the period of a loss—and business interruption losses often go on for a year or more—each of those dates can lead to a policy limit stated in dollars paying a different total amount in local currency.

These types of issues, of course, are best dealt with at the time the international insurance program is negotiated and placed. However, some local insurance companies may write coverage (by law or practice) only on standard local forms that do not address these issues. In such cases, the issues should be raised as soon as possible after a loss occurs so that the insurer(s) and the policyholder can attempt to agree on how to resolve them. Ideally, the insurer that issued the master policy should also be involved, since currency fluctuation may result in potential DIC claims under a global master policy, although it is not at all clear that a U.S. insurer would view a DIC provision as providing this kind of coverage.

Another way in which coverage can be affected by currency fluctuation involves property valuation. Property values are often submitted at the beginning of a policy period and generally are stated in local currency. Some policies limit the maximum loss payment to the stated value, while some policies do not. Policyholders with substantial holdings in several countries may not reappraise each property each year. If the currency has experienced significant fluctuation (or does so during the policy period), the stated value may not be correct to begin with or may not remain correct during the policy term.[3] And if substantial currency fluctuation occurs, the coverage limits available for local properties that are stated in local currency may also diverge from the dollar limits stated in the global master policy, or with per-occurrence or aggregate limits in the local policy. The best solution to this problem is either to re-survey properties regularly in countries where currency fluctuation is occurring or to add a clause addressing this issue in the "stated values" section.

When currency fluctuation risks are identified in advance, they can be addressed—and, where possible, allocated to the insurer—through modifications to the policy when the program is negotiated.

Code Upgrade Coverage. Although coverage for the cost of bringing repaired or replaced property up to current code standards is very common in the U.S., non-U.S. insurance policies may not provide this coverage. And even if such coverage is provided, it may be of limited practical value as it is currently written.

Compared to those in the United States, building codes in developing countries are often less stringent or may be enforced less stringently (if at all) in the event of a loss. Thus, if a policyholder experiences a loss in a developing country, it may be allowed by local authorities to rebuild the facility "as it was," without (for example) upgrading building materials or fire protection systems to meet current standards. In such a situation, code upgrade coverage would not be implicated or necessary. If upgrading is required to bring a facility up to current code, however, the costs of doing so can be significant, and therefore it is essential to secure code upgrade coverage under local policies if possible.

Even if a policyholder is not required by local authorities to bring a facility into compliance with current code standards, code upgrade costs can still arise. After an older facility experiences a significant loss, the insurer may insist that the facility be rebuilt to higher standards in order for the insurer to continue to provide coverage (or to maintain a reasonable premium), or the policyholder's own corporate policies may mandate or strongly encourage safety-related construction upgrades when a facility is rebuilt. This can result in a substantial difference between the *actual* rebuild cost and the *covered* rebuild cost, since code upgrade coverage would not be triggered.

Obviously, it is best to address these issues before a loss occurs. While an insurer may not be willing to provide coverage for construction upgrades not mandated by local building authorities, it may be willing to provide coverage for upgrades it specifically requires after a loss, such as an enhanced fire protection system or other loss-prevention upgrades.

Control and Salvage of Damaged Property. Property insurance policies generally allow the insurer to sell damaged raw ingredients and goods for salvage, which benefits the insurer by allowing it to recoup some of its paid losses. Salvage of common or commodity materials (*e.g.*, scrap metal) generally is not problematic, but salvage of damaged raw materials or finished goods can raise difficult issues. Salvaged finished goods and raw materials often can be sold on the "gray market" either in the country where the loss occurred or outside it. It is not uncommon for there to be a market for gray-market products outside the U.S. (for example, in developing countries, whether the product originated in or outside the U.S.), and there are often markets for such products in the U.S. as well.

A policyholder with a substantial investment in a brand name, however, generally does not want gray-market goods that could negatively affect that brand name to be sold in a market where undamaged products are sold. Such policyholders should try to negotiate policy provisions allowing them alone to determine whether and how any potentially salvageable goods can be resold by the insurer. This additional protection can be critical, for example, when a policyholder wishes to protect a brand name or its corporate reputation by ensuring that potentially salvageable but damaged finished goods or raw ingredients cannot be resold by the insurer, inside or outside the U.S. Similarly, a policyholder may not want damaged (but otherwise salvageable) raw materials traceable back to it for liability or image reasons. While these issues may be less problematic (since raw materials are less likely to be immediately traceable to the policyholder than finished goods), the sale of damaged raw materials for certain uses (*e.g.*, human consumption) can pose problems that the policyholder may wish to avoid.

Such restrictions, however, can be the subject of difficult negotiations with insurers, since they limit an insurer's ability to recover amounts it has paid to the policyholder for damaged goods or raw ingredients. If this issue is not specifically addressed in the policy, the insurer may not be receptive to an after-the-fact argument that it cannot or should not exercise its salvage right merely because the resale of gray-market goods could negatively affect the policyholder's brand image. And if the policyholder is able to prevent salvage sales by the insurer, the insurer may insist on a credit for the lost salvage, which can result in a substantial financial detriment to the policyholder.

Choice-of-Law and Choice-of-Forum Clauses. While a full examination of the myriad issues that can arise from different choice-of-law and choice-of-forum clauses in U.S. and non-U.S. policies is beyond the scope of this article, a few key points are worth emphasizing.

First, a choice-of-law clause that provides for the construction of a policy under local laws may well preclude the application of pro-policyholder doctrines common in the U.S., such as: (1) *contra proferentem* (pursuant to which ambiguous or unclear terms are construed against insurers); (2) narrow construction of exclusions and broad construction of coverage grants; and (3) a requirement that an insurer show prejudice to avoid coverage based on late notice (or breach of certain other conditions) by the policyholder.

Second, whether or not it is less favorable than U.S. state law, local insurance law may not be as fully developed on the somewhat arcane areas of property insurance that may be involved in disputes. This can lead to uncertainty and a lack of predictability as to what coverage is likely to exist for certain types of losses.

Third, certain choice-of-law clauses—for example, those common in Bermuda-issued policies—also attempt to eliminate pro-policyholder policy-construction doctrines by stating that the policy will not be construed against the insurer as drafter and that policy provisions will be construed in an evenhanded fashion without reference to drafting history, expressed intent, etc. The elimination of these doctrines can have a dramatic negative effect on coverage.

Finally, arbitration clauses can have a similar effect. Many arbitration clauses, inadvertently or advertently, can result in a pro-insurer bias (for example, by specifying that the arbitrators must be former executives of insurance or reinsurance companies). While such bias may not always result in practice, policyholders generally should resist these types of clauses and insist, if possible, on clauses allowing a broader range of potential arbitrators. Certain arbitration clauses may also attempt to eliminate pro-policyholder policy-construction doctrines from the arbitrators' consideration; again, such clauses should be resisted.

CONCLUSION

Securing sound and predictable coverage for international risks is one of the most complex insurance tasks facing U.S.-based companies today. International insurance programs can be modified to protect against many gaps and risks, and good claim advice can help ensure that potential problems are identified and addressed as early as possible in the claim process, which can avoid later disputes. ■

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[1] Captive reinsurers, in turn, are often reinsured in large part by commercial reinsurers, U.S.-based or non-U.S. based, with each company taking an agreed percentage of the retroceded risk.

[2] Although the wording may vary depending on program structure, a common DIC provision states:

> This Policy is designated the Master Global Policy for Insured Locations under this Policy and which are insured under an underlying policy(ies) issued by the Company or its representative companies. As respects such Insured Locations, this Policy covers:
> 1) the difference in definitions, perils, conditions or coverages between any underlying policy and this Policy.
> 2) the difference between the limit(s) of liability stated in any underlying policy and this Policy, provided that:
>   a) the coverage is provided under this Policy;
>   b) the limit(s) of liability has been exhausted under the underlying policy; and
>   c) the deductible(s) applicable to such claim for loss or damage in the underlying policy has been applied.
>
> Any coverage provided by the underlying policy that is not provided in this Policy does not extend to this Policy.

[3] If this occurs, providing incorrect values might be viewed by the insurer as a breach of a policy condition, which could result in an insurer declining coverage for a loss in its entirety.