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Industry Analysis

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One month after Japan was rocked by a devastating earthquake, U.S.-based companies are taking stock of their businesses and trying to determine what a similar catastrophe would mean for them. And according to a panel of experts assembled by the Chartered Property Casualty Underwriter Society, the answers could be startling.

During an April 8 online seminar, Thomas Drennan, a partner in the Chicago office of Tressler LLP, said that many businesses have discovered that they wouldn't be covered in the event of a massive earthquake or tsunami. For example, the relatively few tsunami policies that have been sold in the United States largely don't cover flood damage, said Thomas Pavelko, an associate general counsel for American Agricultural Insurance Company and chair of the CPCU Society Reinsurance Interest Group. Similarly, earthquake policies largely don't cover fire damage or flood damage either.

The insurance aspects of a catastrophe the size of the Japan earthquake could also open up loss liabilities for third parties who might not have considered that they could face lawsuits. "In the U.S., with the tort environment the way it is, builders, architects, engineers, building managers and corporate managers may all be sued for damages for failing to ensure the building was up to code," Drennan said.

Those third-party liabilities would come in addition to the direct liabilities that are created by large unforeseen damages, including loss of life, health effects, direct economic losses and consequential economic losses. The latter liability is one that has become particularly relevant in the wake of the Japan earthquake.

Consequential economic losses include lost business as a result of global supply chain interruptions. CPCU Society president-elect Steve McElhiney said that in the United States, supply chain interruptions are among the most visible examples of how U.S. businesses have been affected by the Japan earthquake. And the global impact could be much worse if the earthquake occurred in the United States.

"Ninety percent of the Asian trade to the U.S. comes through the Port of Long Beach, which is in a state that is very active seismically" McElhiney said. "If it were hit by an earthquake or terrorist dirty bomb, it could push the U.S. into an immediate recession."

Thomas Pavelko said that because relatively few people in the United States have insurance policies that would cover an event like the Japan quake, it's hard to determine how big the domestic economic losses would be if a major catastrophe were to strike this country.

"That's the big unknown. How much damage in a state like California would there be and how much would be insured and how much would be reinsured," Pavelko said.

In Japan's case, because most of the businesses and residences affected by the earthquake and the subsequent tsunami weren't covered by those types of policies, the impact on insurers' bottom lines is likely to be relatively small. The damage in Japan is expected to total more than \$300 billion, but the insured losses will likely only account for \$30 billion.

Barring another massive catastrophe this year, the insured losses will likely only affect reinsurance earnings this year and not their capital, McElhiney said, noting also that even fewer companies were covered for contingent business income losses, which would include the supply chain interruptions.

If a similarly sized earthquake or a terrorist attack were to occur in the United States, the country could be pushed into an "immediate recession," McElhiney said. "As a result of the event in Japan, we're seeing more and more companies re-examining their coverage for earthquakes." He added that he has seen the market harden for catastrophe insurance and estimated that it could increase 10% by June.

That said, there are challenges facing property catastrophe insurance. Pavelko said that often those policies carry high deductibles, making it tough for small- and medium-sized businesses to deem catastrophe insurance a worthwhile expense. "Small and medium businesses look simply don't buy coverage," Pavelko said.

(By Jeff Jeffrey, Washington Correspondent: jeff.jeffrey@ambest.com)

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