LEGAL UPDATES

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Captive Insurer Update: Contingent Business Interruption Claims, Reinsurance, and the Southern California Wildfires

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Captive insurers can offer enhanced control over coverage, claims, and premiums; however, they also face specific challenges when dealing with large-scale coverage events that have highly uncertain scopes, particularly when it comes to contingent business interruption (CBI) claims. Given the breadth of the destruction caused by the recent wildfires in Southern California—and the scope and nature of the businesses which likely have been impacted—the handling and resolution of CBI claims is of vital importance to insureds, insurers, and reinsurers.

Understanding CBI

Subject to policy terms, CBI insurance generally covers business income loss due to interruptions in the operations of a third-party supplier or customer. In the case of the Southern California wildfires, businesses may experience disruptions when third-party suppliers, logistics networks, or essential infrastructure are damaged or interrupted, even though the insured itself does not sustain direct property damage. For captive insurers, resolving CBI claims requires a clear understanding of the risks involved and the way reinsurance coverage might be affected by how the claims are handled.

Industries likely to see CBI claims

CBI claims resulting from the Southern California wildfires will vary across industries, but some sectors are particularly vulnerable due to their reliance on third-party suppliers, distributors, and infrastructure that could be disrupted by the fires.

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Retailers are highly susceptible to CBI claims. If key suppliers or logistics providers face fire-related disruptions, retailers may experience delays in receiving goods, resulting in lost sales and operational downtime.

Manufacturing industries are similarly exposed. A manufacturing plant could experience production delays or shutdowns if a supplier's facility or a critical distribution center is destroyed by the wildfire.

Agriculture is at significant risk. Southern California is a major agricultural region. Companies in the food production industry, including those relying on California-grown produce or processed food items, may find themselves unable to meet customer demand if their supply chain is disrupted.

The **energy and utilities** sector can be impacted by wildfires that damage power lines, substations, and pipelines, disrupting service to both businesses and residents. Companies that depend on a steady energy supply may face interruptions if critical energy infrastructure is affected.

Transportation and logistics companies, including those operating trucking fleets, railways, and shipping services, can experience delays or blockages due to fire-related road closures, damaged infrastructure, or port shutdowns.

Real estate and construction industries could face project delays if suppliers of building materials or critical labor are disrupted.

Technology companies that rely on data centers or cloud services located in wildfire areas may experience service interruptions, leading to operational losses.

The **hospitality and tourism** sectors are at risk of cancellations or booking reductions as tourists cancel trips in response to safety concerns or evacuations.

Key reinsurance issues for captives

With the potential for wide-ranging disruptions across industries, and thus the potential for companies which have elected to self-insure through a captive to have exposure for CBI claims, disputes may emerge between captives and their reinsurers concerning coverage for CBI claims.

> **Following form/specific contract wording**. While captive insurers often seek reinsurance coverage that is congruent with the coverage provided to the policyholder, reinsurance contract terms are often market-dependent and can change year to year and not provide congruency. For

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example, reinsurance contracts may limit CBI coverage to certain specified suppliers or customers. Ambiguity in contract language or intent concerning whether the reinsurer's coverage "follows form" to the underlying can lead to disputes.

Claims cooperation. A reinsurance contract reinsuring a captive might entitle the reinsurer to some type of involvement in the handling of the underlying claims. Such clauses can present challenges for captives as reinsurer involvement might slow down and/or prejudice the claims payment process or settlement. Managing the balance between cooperation and maintaining the integrity of the captive's internal processes is a critical consideration in these situations.

Arm's length relationship with policyholder. The captive insurer should handle claims like any other insurer. Reinsurers are likely to scrutinize the independence of the captive insurer, particularly if there is any indication that the policyholder's interests have influenced the claims process. To mitigate this risk, captives should implement strict governance procedures that ensure decision-making is based solely on objective, factual evidence and the terms of the applicable policy.

Geographic scope and exclusions. A captive's reinsurance contract(s) might include territorial exclusions, particularly in regions prone to catastrophic events. Additionally, some reinsurance treaties may impose specific sub-limits for wildfires or other perils, requiring the captive insurer to assess whether these limitations adequately cover the risks. Understanding these potential exclusions and limitations to reinsurance coverage is essential.

Loss estimation and valuation challenges. Estimating or valuing the losses resulting from CBI claims can be difficult given the nature of contingent losses. Given the complexity of wildfires, the risk of underreporting or overstating losses is higher, which could lead to disagreements between captives and reinsurers over the final settlement amount.

What this means for you

The Southern California wildfires highlight the increasing complexity faced by captive insurers in managing CBI claims. With the potential for wide-ranging disruptions across industries, it is critical for captives to carefully assess their reinsurance arrangements, ensure clear definitions and provisions for CBI coverage, and maintain robust internal governance processes. Doing so will enable captives to better navigate the financial and operational challenges posed by fires and other large-scale events.

Contact us

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If you have questions related to captive insurers and reinsurers in the context of natural disasters or other large-scale coverage events, contact Michael Robles, Brian O'Sullivan, Rachel Potter, or your Husch Blackwell attorney.

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