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Insuring Mid-sized Companies against the Risks of International Commerce

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WHITE PAPER

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Introduction

The globalization of commerce stretches back centuries. But thanks to innovations in transportation, communication, and information technologies, and the liberalization of trade policies, the process has accelerated at a blinding pace in recent decades. Companies of all sizes now conduct business with suppliers and customers in foreign lands. In fact, 97 percent of exporters are small businesses, according to the U.S. Small Business Administration.

While conducting business on a global basis has never before been so practical – or so necessary – doing so subjects companies to a wide variety of complex risks. Some risks may be familiar – a fire at a warehouse, for example – but may be more difficult to manage at a distant location. Others may be entirely new to a company, such as the risks of shipping goods overseas. To add complexity to the matter, insurance and tax authorities throughout the world have increased their scrutiny of insurance-related transactions, potentially subjecting non-compliant companies to regulatory enforcement actions and possibly leading to adverse tax consequences. As a result, it is important that companies and their brokers work with a multinational insurer that has both the expertise and the global resources to help structure a program that meets a client's corporate financing objectives.

Structuring a global insurance program.

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The global infrastructure necessary to conduct business across borders has improved dramatically over the past decade. Unfortunately, insurance regulatory and tax structures have not kept pace with these advancements. Insurance is regulated on a country-by-country basis, meaning that a multinational company needs to assemble an insurance program that conforms to a patchwork of local laws while still providing adequate, uniform protection. Additionally, tax laws in the United States and elsewhere can make it difficult for companies with multinational insurance programs to receive indemnification from insurers or to finance insurance losses at foreign locations without incurring significant tax liabilities.

For any company operating outside their home country, protecting their assets should go beyond simply buying an insurance policy. "Increasingly, corporations are involving tax counsel and in-house finance executives in discussions around global insurance program structure and the potential tax implications," says Alfred Bergbauer, Head of Multinational Casualty for XL Group. Bergbauer notes that the most effective way for a multinational company to manage risk is often a controlled master program (CMP) – a combination of local policies and a global master policy issued in the company's home country. But within the context of a CMP, companies still need to make decisions on how much risk to retain in each country, and how to best transfer or finance their risk. And they need to understand the tax consequences of those decisions. "The answers are different for every company," explains Bergbauer. "It depends a lot on where a company does business, its size, its financial sophistication and its risk appetite. These decisions should incorporate the firm's unique tax circumstances and balance sheet and income statement protection strategy."

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A single master policy providing protection wherever a claim is filed has the advantage of simplicity, but that usually is not a practical solution. Many countries require policies to be issued by a local insurer licensed in that country – so-called admitted insurance. These requirements extend to discretionary insurance purchases as well as to compulsory insurance. Compulsory insurance is insurance that a company is required by law to procure and maintain. Typical compulsory classes of insurance include workers' compensation insurance and auto insurance. Companies may face enforcement actions for failure to maintain compulsory insurance or for buying insurance from a carrier not licensed in the country.

If a claim occurs in a country requiring admitted insurance, the company may be barred from receiving recoveries from a non-admitted policy in that jurisdiction. Claims payments from non-admitted international policies are typically paid in the location where they are issued as opposed to the country where the loss occurred. In the case of the United States, the IRS may treat claim payments made in the USA for losses that occurred in a foreign country as income. Additionally, money transferred into a country by the parent company to pay for losses at a subsidiary may be treated as taxable by the foreign country. "After taxes, recoveries under a non-admitted policy can as low as 65 cents on the dollar," according to Bergbauer.

In addition to assessing the tax consequences for insurance claims proceeds, companies also should keep in mind the tax treatment of premiums for non-admitted insurance. Even though a policy may be issued in a company's home country, the company still may be responsible for paying premium taxes in each country in which it has operations.

Globalization is a business and economic reality, but since insurance still is regulated locally, multinational companies and their brokers should work with insurers that have fronting companies available in countries where the insurer does not have a locally licensed subsidiary insurer. Brokers also should look for an insurer with in-country claims and loss control expertise.

Coverages for international commerce

In addition to familiar coverages such as Property and General Liability, companies conducting business outside their home countries will likely need to purchase various insurance coverages designed for the risks of international commerce. These risks include:

- Financial and Professional Risks (D&O and E&O);
- Trade credit risks;
- Political risk exposures such as expropriation and currency inconvertibility;
- Shipping risks;
- Supply chain risks;
- Violations of the Foreign Corrupt Practices Act; and
- Injured employees working abroad.

Companies with assets in economically or politically unstable regions should consider political risk insurance.

Trade credit risks

Trade credit insurance has been widely used in Europe for decades, but only recently has a growing number of U.S. companies begun to recognize the value of this coverage. Simply put, trade credit insurance protects domestic and foreign accounts receivables against defaults due to insolvency or nonpayment. The coverage enables companies to confidently expand into new regions and to deal with customers with whom they have no history and little knowledge.

Political risks

Companies with assets in economically or politically unstable regions should consider political risk insurance. The product is designed to limit the economic risks associated with revolution, regime change and social unrest. Coverage typically is available for exposures such as governmental expropriation or confiscation of assets, frustration or repudiation of contracts, and inconvertibility of foreign currency or the inability to repatriate funds.

Shipping risks

Shipping goods to foreign countries involves different guidelines and procedures than shipping domestically. It also has different insurance requirements. If goods are being shipped by sea, the appropriate coverage is marine cargo insurance.

Whether the buyer or seller is responsible for insurance is established by the so-called Incoterm, a pre-defined commercial term published by the International Chamber of Commerce. CIF – "Cost, Freight and Insurance" – is the most common incoterm for international shipping. Under CIF, the seller is responsible for paying the freight and insurance costs in advance, which is later collected from the buyer when the customer is invoiced.

Supply chain risks

Global supply chains can be fragile, as the 2011 Tohoku earthquake and tsunami in Japan and the Thailand floods demonstrated. An important type of insurance coverage for supply chain disruptions is Contingent Business Interruption (CBI) which, subject to policy terms and conditions, covers lost business income resulting from an insured loss at a supplier or customer.

Manufacturers also need to be concerned about the quality of parts and materials from foreign suppliers, for whom it may be difficult to enforce quality control. Product liability insurance and product recall insurance are important coverages for almost every manufacturer, but especially so for those relying on far flung suppliers.

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Violations of the Foreign Corrupt Practices Act (FCPA)

The FCPA makes it illegal for a company, its employees, its directors or officers, or agents to give anything of value to any foreign governmental official in order to obtain business in a country. In recent years more cases resulting in large settlements have been brought by the U.S. Department of Justice and the Securities and Exchange Commission than at any time in the history of the legislation. Even scrupulously ethical companies may find themselves in violation as a result of a rogue employee, or even because of a lack of understanding as to what constitutes "anything of value." Fines are largely uninsurable, but insurance coverage is available for certain costs associated with investigations

Injured employees working abroad

Employees on assignment in foreign countries for extended periods typically want to be protected for workplace injuries to the same extent they would be back home. For these employees, a foreign voluntary workers' compensation program may be in order. This type of insurance allows an injured or ill worker to receive benefits as originally designated by their state of residency. Additionally, some insurers provide emergency medical assistance for employees working abroad. This covers the cost of transporting sick or injured employees home or to a location where they can receive satisfactory treatment.

Other insurance and risk management issues companies with foreign exposures should keep in mind include:

- Companies with foreign subsidiaries may need local directors & officers (D&O) insurance coverage.
- Firms that provide professional services to foreign clients may need specialized errors & omissions (E&O) policies.
- Companies with employees who travel to dangerous countries may want to purchase kidnap & ransom coverage.
- Companies providing services to the U.S. Government overseas may be required to provide Defense Base Act (DBA) insurance to their workers. DBA is intended to provide U.S. workers and reign nationals with insurance while working on a military installation outside the United States, or on behalf of the US Government under contract.
- With so much commerce being conducted – or at least facilitated – online, companies need to be aware of their exposures to privacy and data security laws everywhere they do business. Cyber liability coverage is available for regulatory proceedings brought by a government agency alleging the violation of any foreign identity theft or privacy protection legislation.

Conclusion

For a growing number of companies, doing business in foreign countries is more than an opportunity – it is a competitive necessity. Companies with foreign subsidiaries, branches – or even those simply having foreign customers or suppliers – need to be aware of their loss exposures, and must be certain that their insurance programs are appropriate to those exposures, in compliance with local regulations, and structured in accordance with the company's tax circumstances and financial objectives. Brokers should seek out insurers that not only have expertise in the risk financing issues of international commerce, but also have a global network of subsidiaries and affiliated companies able to issue local policies and service claims.