

Solving The Warranty Dilemma On High Technology Equipment Losses

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Setting the Stage

You are assigned a claim for a fire that occurred yesterday in a one-floor, single-tenant building. The preliminary claim information relates that the fire started in the electrical room of the building, was well contained and only burned for approximately 15 minutes. Your insured is a plastic manufacturer and owns manufacturing and analytical test equipment.

After reviewing the initial loss notice, you place a call to the insured to obtain more information on the loss. The insured informs you that the fire destroyed the electrical switchgear and that varying degrees of smoke were deposited on the remaining equipment. The manufacturing equipment sustained the heaviest smoke exposure, while the smoke exposure to the analytical test equipment was minimal. The insured has already contracted with a company to stabilize the environment by utilizing water extraction, air scrubbers and portable AC units. You contact a consultant to provide an independent assessment of the equipment. Your consultant's initial assessment is that the manufacturing and lab equipment can be effectively restored to pre-loss condition. The insured agrees with this assessment and is interested in having both the manufacturing and lab equipment cleaned as soon as possible. A restoration estimate is obtained and totals \$250,000. You, your consultant and your insured are in agreement that restoration is a cost-effective option.

At this point, the claim seems to be progressing well, until...

The Dilemma

Several letters come through your fax a few days later, detailing how the manufacturers of both the manufacturing and analytical equipment recommend replacement. Their recommendations are based on their opinions that equipment will no longer function reliably. As such, the manufacturers state that they will no longer honor the service contracts and/or warranties, even though the equipment is still functional. While your insured still believes the equipment can be restored, he is now uncomfortable with restoration because the manufacturers will no longer honor their service contracts. He now is pushing for replacement of the equipment, which is valued at roughly \$1,000,000. He further states that he will not accept restoration unless the manufacturers agree to reinstate the warranties.

You are now faced with a situation where you and your insured know that the equipment is restorable, but the manufacturers appear to hold all the cards. How can you overcome this dilemma?

Potential Solutions

The situation described above is commonplace and is costing the insurance industry a considerable amount of money. Unfortunately, this is occurring in a market where insurance carriers are no longer able to cover underwriting losses with investment income. In short, now more than ever, insurance carriers need to pay *reasonable*, and not excessive, settlement amounts. Better dealing with “the warranty dilemma” can certainly help to this end.

Before discussing some potential solutions, it should be stated that there is no panacea or silver bullet to solve this issue. One approach will not work every time a manufacturer voids a warranty. However, the potential solutions discussed herein can increase the *potential* for a successful outcome – an equitable settlement for both parties.

First, although it is implied in the above scenario, restoration can be a viable and reliable option in returning contaminated equipment to pre-loss conditions. A study by the Department of Energy, entitled “Fire Effects on Electrical and Electronic Equipment” in their Fire Protection Handbook Volume II, provides quantifiable and independent research that substantiates the viability of restoration. Details of the study show there is *no probability of failure* to equipment as a result of smoke contamination if contamination levels are less than 20 micrograms per square inch (in chloride equivalents). As such, equipment restoration that reduces contamination below this level is reliable. Additionally, the results are quantifiable through sampling and chemical analysis.

Perhaps the most important aspect in handling the warranty dilemma is getting the insured to *work with you* in convincing the manufacturers to act more reasonably. Without the insured’s cooperation, the chances of success are substantially reduced.

How can you obtain the insured’s cooperation? The insured can be educated regarding the scientific research that validates restoration. Additionally, the insured should understand the benefits that equipment restoration will have on their loss history. Specifically, one of the primary benefits of restoration is that it is typically more cost effective than replacement. Given the current insurance climate, reducing settlements to reasonable levels helps to limit future increases in premiums. Finally, the insured needs to know that the policy pays for *actual* damages and that both parties (the underwriter and insured) are bound to the policy.

In dealing with equipment contamination losses, it is vitally important to find restoration contractors who specialize in equipment restoration. Many restoration contractors claim to be one-stop-shops but do not have the staff, experience, training or expertise to properly decontaminate and troubleshoot equipment. Specialization in the restoration industry is important and is analogous to the medical industry. Just as you would want a heart surgeon, and not a general surgeon, to perform a bypass operation, you want the proper specialists to perform restoration on equipment.

Another factor to consider in choosing your contractor is whether the contractor has relationships with the respective equipment manufacturers. These relationships can be leveraged to convince manufacturers to reinstate warranties, as they are familiar with the quality of work the contractor

performs. One potential downside here is that many manufacturers want their personnel to perform the disassembly and reassembly of the equipment, which can result in efficiency losses and can increase the restoration costs to a point where it is no longer cost effective.

As most policies cover actual damages, the manufacturers should be made to substantiate actual, and not theoretical, damage. Explain to the manufacturer that coverage only applies to actual and current damage and therefore the policy cannot pay for replacement unless they substantiate damage. By failing to do so, they place the insured, their customer, in a precarious position. This can be an effective approach because the market is highly competitive and manufacturers are reluctant to lose customers.

In conjunction with mandating that the manufacturer substantiate actual damage, it is useful to educate the manufacturer on the reliability of restoration. Many manufacturers are not familiar with the DOE study previously referenced, nor on proper restoration protocols. Conversations with the manufacturer's engineering staff regarding these studies and proper restoration protocols can build comfort and confidence in the process and can sway their skepticism. To further bolster confidence in the process, it may also be beneficial to offer the manufacturer the opportunity to perform clearance testing, which typically consists of chemical analysis of samples taken from the equipment surfaces and burn-in (functionality testing).

If the manufacturer is still uncooperative, your restoration expert can ask the manufacturer to provide their internal cleanliness standards for newly manufactured boards. Some manufacturers follow the IPC-RB-276, part 3.13.3.1, which suggests acceptable levels of contamination on newly manufactured boards. The IPC is a consortium of electronic manufacturers that perform research and set standards for its members. Other manufacturers do not utilize the IPC standard but set their own standards. Whatever standard the manufacturer utilizes, the restoration contractor should stress their willingness and ability to meet or exceed it. Again, this can be verified through chemical analysis. In doing so, the manufacturer can be assured that the equipment will be as clean and reliable as it was when it left the manufacturing floor.

As a final option, a third-party warranty matching terms and conditions of the original warranty can be obtained. While these warranties remove the obstacle of not having support for the equipment, they can be expensive and are not always economical when combined with restoration and repair costs. Perhaps the greatest advantage of obtaining a third-party warranty estimate is that it can be used as a negotiating tool to bring the manufacturer back to the bargaining table. Many manufacturers are reluctant to allow other manufacturers or vendors access to their customers and will offer new warranties at an additional cost if they feel the alternative is losing a customer.

While the potential tools and solutions presented above will not work in every instance, they will certainly increase the possibility of changing the manufacturer's position on voiding the warranty. By doing so, the desired outcome – a reasonable and equitable settlement – is more likely to occur. The benefits are lower combined loss ratios for the carrier and better loss histories, and the lower premiums that go along with it, for the insured.