Vendor-Managed Inventory – Whose Risk Is This Anyway?

“Vendor-Managed Inventory (VMI), introduced by Kurt Solomon Associates in 1992, is perhaps the most widely known system for managing supply chains. Under VMI, the buyer authorizes the supplier to manage the inventory of stock-keeping units (SKUs) at the buyer’s site(s) under agreed-upon parameters... The buyer provides the supplier with sales and/or inventory-status information; and the supplier makes and implements decisions about replenishment quantities and timing...

“...VMI provides the supplier with the opportunity to better manage its own production, inventory and transportation costs. In exchange, the buyer typically receives price discounts or improved terms of payment from the supplier.”

A form of supply-chain management, VMI has become an increasingly popular tool for supply-chain customers, whether they are themselves manufacturers, retailers or wholesalers. In addition to the benefits cited above, VMI cuts the time between capital outlays for materials and goods and income from the ultimate sale of products and services. Keeping finished stock and merchandise sitting on a customer’s books and unsold in a warehouse has gone out of fashion. This paper will deal with some of the insurance issues associated with this expanding business practice.

VMI takes many shapes and forms, but all have one characteristic – the vendor’s goods are stored at the customer’s location(s), not at the vendor’s. A customer may choose to have a vendor’s goods in stock in its warehouse; in its store, unpacked; or displayed and ready to fulfill sales orders. The vendor’s goods may be stored in locked trailers adjacent to the customer’s location(s) or in unlocked trailers backed into the customer’s loading dock.

In these arrangements, the vendor retains title to its products until the last possible moment – until they are incorporated into the customer’s own products or sold to end users. Payment is made, capital is laid out, only when title transfers – thus providing one of the chief benefits of the arrangement, improved cash flow for the customer.

When a vendor stores goods at a customer’s location(s), the question arises: what is the customer’s insurable interest in the vendor’s goods? This can be determined only by a review of the contractual agreements between the parties. There is no single answer. Different contracts will present different risks for both the vendor and the customer. We will look at these risks from the customer’s point of view.

Property Damage

From a Property Damage perspective, there are two ways in which goods can be insured, depending on the contractual agreement between vendor and customer:
• The vendor can agree to insure the goods until the title transfers (presumably passing on the insurance costs as part of the vendors’ selling price).

• The customer can agree to insure the vendor’s goods for the vendor, incurring the insurance costs directly and presumably receiving a corresponding price discount.

**Vendor-Insured Goods – Is the Customer Home Free?**

It may seem a simple matter if the vendor agrees to insure its own goods. However, the customer is not entirely without risk unless the contractual agreement between the parties contains a full waiver of subrogation against the customer. Without such a waiver, it is possible for the vendor’s insurer to subrogate against the customer in the event of a paid claim, citing negligence, say, for fire, theft or vandalism losses.

In the event of subrogation, which of the customer’s insurance policies applies? If the goods are considered to be in the care, custody or control of the customer (CCC), the General Liability contract usually excludes the claim. Such contracts contain CCC exclusions and the available write-back is normally for Fire Legal Liability and real property only. Most Property contracts provide “wrap-around” coverage for the customer’s legal liability for personal property of others while in its custody. But many of these contracts have sub-limits of liability applicable to this coverage, since their basic premise is that such risk is incidental to the customer’s operations.

In some, but not all, cases, Property contracts also pay costs of defending suits brought against the customer for this legal liability, but even then such defense costs may be severely sub-limited. (Unlike most General Liability policies, these defense costs are within the limit/sub-limits of liability, not outside it, so the overall policy limit available to the customer in the event of catastrophic loss at a given location is relevant here.)

*Absence of a full waiver of subrogation leaves the customer exposed,* perhaps in ways that are not readily measurable. If the customer has no insurable interest in the goods, other than its legal liability, how can the customer measure that potential liability? In some senses, the situation resembles that of traditional cases of bailment, e.g., warehousemen’s, truckers’ and jewelers’ legal liability, except that the customer performs no service on the goods, nor does it receive income or have the option to limit its liability, as warehousemen and truckers do, to a reduced value based on weight per package, etc.

Therefore, the customer could be liable for an amount equal to the vendor’s selling price for whatever goods are damaged at the customer’s location. In the worst case, a catastrophic loss at the wrong time in the supply-chain cycle could present a material legal liability risk for the customer.

Where the customer’s potential legal liability is material and unreported, the customer’s insurer could take the position that Property contracts are not meant to deal with other than incidental legal liability exposures, especially those that add considerable loss potential but are undisclosed. That is not a position the customer wants to hear following a loss.

It seems clear that where a full waiver of subrogation is not in force, the customer must make a diligent effort to quantify both the average and maximum amounts of its potential liability and report this to its insurer(s). The rate for this exposure should be discounted from the policy rate, since the coverage is contingent on the customer’s being found negligent. *The contractual agreement between the customer and the vendor should spell out the extent of this liability.*

**Customer-Insured Goods – How Much is Enough?**

If the customer agrees to insure the goods, the question arises: for how much? Again, without having title to the goods, how can the customer assess the amount of insurance needed for adequate protection? The contractual agreement should require that the vendor set the amount of insurance required at any given time as well as specify the method of valuing the goods in the event of loss. Presumably, the latter would be at the vendor’s net selling price but this should be made clear in the contract. The contract should also stipulate the risks of loss (perils) and deductible requirements, if any, of the vendor – and should include a full waiver of subrogation for any residual risks.
Many Property contracts have sub-limits on the property of others, often just a throw-in sub-limit to cover leased equipment and the like. If insuring the vendor’s goods has a material impact on risk, it should be reported to the customer’s insurer(s) and the appropriate sub-limits, if any, agreed.

While there are some instances when title for goods may pass directly from the vendor to the customer’s client (more a consignment risk), by-passing the customer entirely (high-end cosmetics counters in department stores often operate this way), there is, more likely, a moment at which the goods do become the customer’s direct risk. Inventory values reported by the customer to its insurer(s) should take this into account, particularly for peak seasons.

In the US, the customer’s net selling price is often used as the valuation basis for these goods. But replacement cost can also be declared with the profit factor being covered by Business Interruption, discussed below.

Business Interruptions — Direct or Contingent?

Until title passes to the customer, how can the customer insure future profits from the use of the vendor’s goods in the event of their physical loss or damage?

In this case, the triggering of coverage under standard policy language may be as much a dilemma as the amount of coverage.

Basic Business Interruption covers the loss of profit and the necessary continuing expenses incurred as a result of loss or damage to the customer’s own property – not applicable here if title has not yet passed from the vendor. And Contingent Business Interruption covers losses as a result of loss or damage to the vendor’s property that prevents the vendor from providing his goods or services to the customer. If the goods are already at the customer’s location at the time of their loss, is this Contingent cover triggered as written? While we would certainly argue that to be the case (the goods are not available for title transfer), it seems preferable to amend the language to specifically address this contingent exposure at policy inception to avoid any conflicts at time of loss.

Even if Contingent Business Interruption coverage is triggered, almost all Property policies have sub-limits for this, and, absent policy language changes suggested below, these have to be reviewed in light of the VMI arrangement.

If title does transfer at some point in the life cycle of the arrangement, then the customer may be insuring these goods (“merchandise” as referred to in most Property policies) at the traditional replacement cost and reporting its profit margin in its estimated Business Interruption values. Alternately, the customer may be insuring the merchandise at selling price, and reducing its estimated Business Interruption values by one turn-over of merchandise.

Either way, the customer runs the risk of over-reporting certain items of insurance and under-reporting others, based solely on when in the VMI contract life cycle a loss occurs. It makes no sense, nor is it equitable, to report inflated values for both Property Damage and Business Interruption when only one or the other is going to respond to a certain quantum of loss, dependent on its time in the cycle of a contract.

If the customer never takes title to the goods but merely acts as a broker, it could well be argued that its exposure is akin to Loss of Commissions. Presumably, then, the reported values attributable to such goods would include no deduction for cost of goods sold, but only the commission value. But the customer’s Property policy will likely have a sub-limit on Commissions as well.

Traditional Policy Language May Not Do the Job

When title to goods has not yet transferred from the vendor to the customer, traditional Property contractual language does not easily respond to the customer’s residual insurable interest, absent his legal liability.

We recommend two options to provide protection for that interest:

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2 Other policies provide coverage for the customer’s loss resulting from physical loss or damage at any locations of direct suppliers. Insureds must ask how a location is defined by those policies.
• Amend the Property section to insure the customer’s interest in merchandise at his location(s) to be used by the customer but to which he does not have title, and report the value of that interest as the difference between his net selling price and his costs of such merchandise.

• Amend the Business Interruption section to insure losses arising from damage to merchandise at its location(s) to be used by the customer but to which it does not have title, and include the net sales value of all such goods in the BI values reported.

Endnote – The Contract is King

A customer may find that “one size does not fit all” in terms of VMI. A customer may have a variety of vendors and a different contract for each. Where operations are decentralized, individual supply-chain management groups may have great latitude in executing their contracts with vendors in order to gain the best possible business terms. This variety complicates the customer’s efforts to assess its risks of loss. Review of contractual agreements may be time-consuming but is necessary to ensure appropriate insurance protection in all scenarios.

Where a customer is not required under contractual agreements to insure vendor goods unless or until title passes, full waivers of subrogation and certificates of insurance evidencing same should be required from the vendor.

In many cases, VMI represents tens of millions of dollars of goods that were once reported to the customer’s insurer(s) as owned and that now may be unreported, partially reported or incorrectly reported. The obvious premium savings can be appropriate only if its risk has truly been reduced in the same proportion, either in quantum or time at risk — and only with the assurance that its policy responds appropriately.

If VMI represents a significant risk to the customer, whether through potential legal liabilities, direct insurance responsibilities or its own insurable interest, such risk should be discussed with the customer’s Property insurer(s). Any peak season exposures must also be considered to ensure that policy or location limits/sub-limits are adequate for these. And policy wording may need to be crafted to ensure that the proper coverage will trigger at the appropriate time.