



Defense Base Act — Evolution and Insurance Issues

Context within recent U.S. conflicts in Iraq and Afghanistan

by George P. Flanigan, CPCU

Introduction

Defense Base Coverage has played an important, yet subtle role in evolving Middle Eastern conflicts of recent years. Originally designed in support of the U.S. foreign war efforts in 1941, the federal government “defense contractor” provisions have served a vital role in the development and reconstruction of war-torn regions. Similar to the development of statutory workers compensation provisions within state government throughout the early 20th Century, an Act of the U.S. Congress developed statutory Defense Base Coverage primarily to enforce a “no-fault” mechanism for U.S. civilian employees in reconstruction efforts (1941 Defense Base Act of U.S. Congress). The Act played an important role in post-war Europe; violent aggression had ceased and the world was beginning to adjust to post-war redevelopment.

Background and Recent Context

The recent Iraqi conflict, however, has marked the emergence of extensive foreign defense contracting in the private sector concurrent with ongoing military and police efforts. Whereas previous war aggression efforts were typically completed well before the onset of redevelopment efforts (or lack of redevelopment efforts), the post-Hussein Iraq regime has encouraged redevelopment and security efforts to occur alongside aggressive military and police efforts. In reference to U.S. Department of Labor statistics, Reuters reported on July 3, 2007, that total contractor deaths in Iraq and Afghanistan since the inception of armed conflict under the Bush Administration has exceeded 1,000 lives. This tally includes both U.S. civilians and foreign nationals, which further highlights the perception that the U.S. has not only outsourced military operational functions but also personnel related to completion and support of military functions as well.

Further, the emergence of elite, private security forces and extensive management consulting personnel has meaningfully expanded the breadth of potential government contracting. Reuters also reported in 2006 that the unofficial count of private contractors operating in Iraq has likely exceeded 100,000 people. In other words, it’s not just bridge building and other infrastructure development out there anymore.

Because of these issues, the line between “war efforts” and “reconstruction efforts” has been substantially blurred, and modern professional services firms (energy exploration and development, communications and logistics, security, etc.) are commonly employed in the field of battle under the supervision and protection of U.S. military personnel. Indeed, modern warfare often consists of various private suppliers providing goods and services directly to military personnel in the field.

Abstract

This article explores recent developments in international insurance in relation to U.S. military aggression of the early 21st Century. Specifically, this article attempts to bridge the gap of knowledge between traditional U.S. workers compensation programs and Defense Base Act coverage as currently regarded within the insurance community. Lastly, the article explores underwriting and brokerage concerns that are typically visited in the context of Defense Base Act insurance.

Coverage Issues

While redevelopment interests were certainly not isolated to American contractors and developers, there has been moderate interest in applying Defense Base Act coverage to a much broader array of potentially insurable parties, including foreign nationals. According to the Defense Base Act itself, coverage is intended to apply directly to foreign nationals, but undocumented black-market employment arrangements often exist. Indeed, employment of foreign national workers may remain unreported to U.S. insurance companies; even more so on the claims side. A January 17, 2007, *Wall Street Journal* cover story documented Iraqi Foreign National “Terps,” or local interpreters of language and custom, that have been routinely employed at low wages to perform dangerous services on behalf of military personnel and other operatives. As the *Wall Street Journal* indicates, these Foreign Nationals often find themselves directly in the line of fire, yet are rarely eligible for benefit levels comparable to those available to U.S. nationals. Injured Iraqi interpreters also often cannot return to their homesteads for fear of political suppression, according to the *Wall Street Journal*.

From an insurance coverage perspective, the interpretation of “covered employee” may have inadvertently expanded under usual policy provisions. In recent years, insurers have become much more mindful of the potential catastrophic losses associated with Defense Base Act claims. The *Wall Street Journal* article cited American International Group as a principal insurer for U.S. contractors. The Defense Base Act coverage serves primarily as a subset for multiple other foreign general insurance lines of business.

Separately, the U.S. Department of Labor also references ACE-USA and CNA Insurance as major underwriters of Defense Base Act Coverage. With the rapid onset of foreign operations, these underwriters have likely experienced growth in demand for Defense Base Act coverage in recent years as both the rates associated with the coverage have risen and payrolls have expanded dramatically due to the ongoing war efforts overseas.

Furthermore, the potential range of covered locations under these occurrence (or accident) trigger policies may have expanded in recent years as well. While the coverage was originally intended to serve primarily for covered U.S. civilian employees working on foreign U.S. military installations, the breadth of redevelopment efforts in recent years have caused the coverage territory to expand to a wide-range of locations at which an employer may direct employee activities. Clearly, an implication of the Iraqi conflict is that covered events may occur at locations far from traditional military installations. Indeed, the emergence of private police forces, often-former military personnel, serving as consultants throughout war-torn regions, has modified the potential roles of foreign operatives in their entirety.

By way of U.S. risk management practice, workers compensation coverage is usually supplemented by traditional life insurance and accidental death and dismemberment coverage mechanisms that provide remuneration to covered employees’ beneficiaries. These traditional life and health benefit programs may not necessarily apply to accidents that occur outside of the United States or Canada. Often with higher death benefit potential, the Defense Base Act coverage can potentially be viewed as stand-alone life and accident insurance in the event that an employer fails to procure benefit programs that would apply for employees working under foreign supervision. This predicament can be just as pronounced in the corporate, or national accounts sector, as it can be to the traditional “middle market” domain. Furthermore, corporate health insurance plans often do not necessarily provide for medical expenses incurred outside the United States coverage territory, and this leads to circumstances where coverage ambiguities may exist as employees return to the United States with latent injuries requiring treatment

George P. Flanigan, CPCU, is a consultant and licensed insurance producer based out of Chicago, Ill. Flanigan has multiple years of underwriting experience at leading international insurance firms related to both domestic and international insurance issues. A CPCU since 2006, Flanigan holds an MBA in finance and accounting from the University of Chicago Graduate School of Business and a BBA in finance from the University of Wisconsin-Madison. Flanigan can be reached via e-mail at gflaniga@chicagogsb.edu, or via phone at (312) 498-0439.

sometime in the future. Indeed, life and health insurers are mindful of this situation, and commonly incorporate “coordination-of-benefits” provisions that can potentially limit or eliminate their exposure to overseas employee injuries.

In the context of pinpointing this potential exposure, a financial institution or consulting firm may for the first time experience an opportunity to develop new business in connection with a federal government contract overseas. However, this message may not reach the appropriate level of corporate control until much later in the business reporting process. For example, a remote business unit may undertake various new federal contracts, and, subsequently, the message of these developments may not reach appropriate levels of corporate accounting or human resources control, until the annual financial reporting and business review process. Indeed, the firm may have not only violated statutes in failing to procure mandatory Defense Base Act coverage but it also has inadvertently transferred potential workers compensation and employee benefits liabilities to U.S.-based primary carriers. This phenomenon could be potentially troublesome for employees who suffer latent, long-term injuries such as back trauma or occupational disease where multiple events over time may have triggered multiple occurrences under separate policies. Thus, an appropriate allocation of damages methodology would be required to subsequently spread damages across multiple policies, lines of business, policy periods and reinsurance periods. In the context of valuation of damages, it is important to consider an ultimate net loss potential that could be incurred in the context of a traditional workers compensation injury and then applying a “lost earnings” approach to generate sufficient understanding of how employees’ available coverage programs will apply. Indeed, a qualified level of insurance and financial expertise is necessary to reach proper conclusions as respects valuation and appropriate consideration in claims scenarios.

In addition, the Defense Base Act coverage mechanism largely serves to supplement an existing workers compensation program in the United States. The Defense Base Act policy construction serves functions (i.e. reducing coverage gaps) similar to that of foreign voluntary workers compensation. This coverage exists primarily to operate as a traditional “stop-gap” mechanism to dovetail with U.S. workers compensation policies that specifically exclude occurrences experienced outside of the United States, Canada, and Puerto Rico. Further, U.S. workers compensation may also specifically exclude coverage for Defense Base Act benefits entirely and may apply only for appropriate state benefit levels as specified in typical workers compensation programs.

Underwriting and Brokerage Issues

The underwriting process for Defense Base Act coverage is theoretically very similar to that of a traditional U.S. workers compensation underwriting exercise. The underwriter should not only seek information regarding class of labor and remuneration but also must extensively explore risk management and precautionary techniques that occur prior to undertaking any potentially covered activities. The questions can range from the relatively straightforward, such as, “Will the covered employee carry personal armaments?” to the precise, such as “Will covered personnel enter regions that are targeted as ‘high risk’ by an appropriate level federal contracting agency (such as the National Security Agency)?” Foremost, an underwriter must also be concerned with the overall approach to life-health employee safety that an employer utilizes in consideration of employees operating under federal contract.

From an insurance company perspective, claims allocations for this line of business can be potentially far reaching as well. One can quickly implicate a wide-range of traditional workers compensation injuries (such as repetitive motion back injuries) that could potentially be classified as Defense Base Act benefits for traditional lost time and medical

expense associated with employee injuries. Provided that the injury occurred through the course of employment overseas on behalf of the employer, an injured employee may be eligible to receive similar benefits under a Defense Base Act policy *rather than, and in addition to, a primary workers compensation policy in the United States.*

The term “war-risk coverage” has been largely shunned by the underwriting community in the United States because Defense Base Act coverage is intended to supplement a U.S.-based firm’s existing workers compensation coverage portfolio. Rates should primarily reflect the relative hazard of the covered employee activities, and should reflect relative higher hazard locations. In theory, an employee performing a certain labor assignment at Riyadh Air Force Base should receive the same rate as an employee performing identical tasks at a peaceful seaside Air Force base in the Azores. Assuming that the Riyadh Base experiences the same military threat levels as the Azores base, the proximity to a war region in and of itself should not precipitate a higher rate, or price of coverage.

Other important considerations include any contractual provisions that specify the need for Defense Base Act coverage and how it is to be obtained according to government regulations. Some U.S. Department of State and U.S. Army Corps of Engineers private contracts, for instance, specify procurement of Defense Base Act Coverage through pre-arranged intermediaries associated with specified insurance companies pursuant to the contract itself. This arrangement will commonly be available in standard types of labor contracts (such as service or construction) and will also have standard rates and applications. This mechanism often compels insureds to complete in the insurance procurement function simultaneously with entering the contract itself, thus removing an important competitive element from the insured’s insurance procurement operations.

From a broker’s perspective, of course, Defense Base Act coverage has served as a growth engine in recent years as U.S. military presence persists in the Middle East. For the most part, the Defense Base Act insurance market remains highly fragmented with most small to middle market business coordinated through various managing general agencies throughout the country. In the future, changes in the U.S. political and economic climates may have a dramatic effect on this line of business. Presently, it remains important that insurance buyers and their insurers understand this line of business so as to enable proper risk management procedures.

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