INSURANCE COVERAGE FOR THE ECONOMIC AFTERSHOCKS OF RECENT JAPANESE EARTHQUAKES

By: Finley Harckham*

Recent major earthquakes in Japan create, once again, the prospect of a natural disaster abroad having serious economic repercussions in the United States in the weeks and months to come. Damage to Japanese manufacturing facilities, roads and railroads could result in unfilled orders for products and component parts, leaving American companies to scramble to find alternate suppliers, and to pay higher prices. Other companies could lose access to accounts in Japan. The earthquake in Ecuador, taking a more severe human toll, will have far less economic impact but will still affect some U.S. and global companies.

Many companies have insurance coverage for their lost profits resulting from such disasters, even when there is no damage to their own property. This coverage is called contingent business interruption and contingent extra expense insurance, and is commonly included in commercial property policies. These types of insurance can be very valuable in times like these, but the coverage is narrowly defined and may be subject to sublimits.

What is Contingent Business Interruption Insurance?

Contingent business interruption insurance is a form of business interruption, or lost profits, coverage. Unlike regular business interruption coverage, which is triggered by loss of, or damage to, the policyholder's own insured property, contingent business interruption coverage is triggered by damage to the property of third parties who are not insureds under the policy. Typically, contingent business interruption insurance responds when there has been damage to the property of the policyholders' suppliers or customers. For example, several years ago an explosion at a factory in Japan destroyed the only production facility in the world for a specialty chemical used in products for cleaning computer chips. The loss of that supply forced the American manufacturer of the cleaning solution to use different ingredients. This had an impact upon prices and sales, and it reduced profits. The profits lost as a result of the explosion at the supplier's plant were covered by the American company's contingent business interruption coverage.

What are the Requirements for Contingent Business Interruption Coverage?

Contingent business interruption coverage is triggered when two basic requirements have been met.

First, under most contingent business interruption coverages, the damage that triggers the loss must have been suffered by a supplier or customer of the insured. Often, whether this requirement has been met is clear, but there are gray areas as well. For example, after flooding in the Mississippi River, Archer Daniel Midlands (ADM) suffered a loss because it could not move crops to its food processing plants by barge along the flooded waterways. It submitted a claim for contingent business interruption coverage, arguing that there had been damage to docks and dams operated by the Army Corps of Engineers, and that the Corps was a "supplier" of services to ADM. A federal court agreed, noting that ADM paid fees to the Corps for using its facilities, which brought the Corps within the insurance policy's coverage for loss resulting from physical damage suffered by a supplier. Based upon this case, policyholders would have a good argument that damage to a port in Japan that prevented the shipping of products to the United States or into Japan fulfills the requirement of damage to a supplier.

Uncertainty may also arise as to whether damage has been suffered by a customer. Many products are sold through distributors to retail establishments and then on to end users. An argument could be made that anyone who receives the product along that chain is the manufacturer's customer. Some insurance policies limit the uncertainty by defining customers as end users, but some do not. Even such a definition does not eliminate potential ambiguity, such as where a product is purchased and then incorporated into a larger product, such as a transmission for a car. Faced with uncertainty, policyholders should analyze their coverage in light of the legal rules of insurance policy interpretation that grants of coverage are to be interpreted broadly, and that exclusions are to be interpreted narrowly.

Second, contingent business interruption coverage is only provided if the physical damage to the suppliers' or customers' property which triggered the loss would have been covered if it had happened to the policyholder's own prop-arty, and from the same cause. For example, if a supplier's factory was destroyed in an earthquake, an American policyholder will only have coverage for a resulting loss of profits if it has earthquake insurance for its own property. Likewise, if a Japanese supplier's facility was destroyed by a tsunami, the American company will only have contingent business interruption coverage for a resulting loss if it has flood insurance.

Whether the U.S. policyholder has the appropriate coverage for its own property can be a complicated issue. Many companies have earth-quake coverage for their facilities in California, but not elsewhere in the country. Also, many have flood insurance for specifically designated flood zones. If the policyholder has substantial operations that are not included within those coverages, an insurance company might argue that it does not have the needed coverage to respond to a contingent business interruption loss stemming from the disaster in Japan. There is very little guidance from the courts on this issue, but it seems that the policyholder would have the better argument as long as it has earth-quake or flood insurance for its facilities that are subject to those risks.

What is Contingent Extra Expense Insurance?

Contingent extra expense coverage is extra expense insurance that applies when costs are incurred as a result of a business interruption caused by damage to the property of a supplier or customer. Like ordinary extra expense coverage, contingent extra expense insurance may be issued in one of two basic forms: (1) for extra expense to reduce loss and (2) for "pure" extra expense. The more common coverage insures only against extraordinary costs incurred to minimize or prevent a contingent business interruption loss. For example, in the example given above involving the destruction of a chemical manufacturing plant, contingent extra expense to reduce loss insurance would cover expenses incurred to find alternative ingredients at higher prices than the lost supply. Coverage for pure extra expense includes costs to minimize loss, but also insures against a wider scope of expenses incurred as a result of damage to the third party's property.

Presenting and pursuing claims for contingent business interruption and contingent extra expense requires expertise, a plan and aggressive execution. The time to begin those efforts is now, without waiting the weeks or months it might take to determine the scope of the loss.

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