Presenting and pursuing claims for contingent business interruption and contingent extra expense requires expertise, a plan, and aggressive execution.

Water, Water Everywhere … But Is It Covered?

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It seems that every day this year we hear about another disaster involving floodwaters. First, it was the disastrous tsunami in Japan, and now a series of epically swollen rivers overflowing their banks from the Canadian border to the Gulf of Mexico. In addition to the tragic human toll, all of these calamities have caused enormous damage to property and billions of dollars in lost corporate profits. Companies that have flood insurance should have the wherewithal to rebuild their businesses once the waters recede. However, many businesses had no idea they could be harmed by floodwaters at home or abroad, and they will have to look carefully at their property insurance in the hope of finding coverage.

In Louisiana and farther upstream, the Army Corps of Engineers deliberately opened floodgates, inundating some areas in the hope of relieving pressure on the Mississippi River to spare cities like New Orleans and Baton Rouge. Thus, in a sense, some areas have been subjected to man-made flooding and would have been spared if the gates had been left shut. The distinction between water damage caused by the deliberate act of government authorities and that which results solely from the wrath of Mother Nature may provide a lifeline for some businesses when they argue against the application of exclusions for flood in their insurance policies.

In the wake of Hurricane Katrina, policyholders argued against the application of flood exclusions because the proximate cause of damage was human negligence, not storm surge. Those arguments were rejected by the United States Court of Appeals for the Fifth Circuit, on the grounds that even if human folly played a role, there was a storm surge that fell squarely within the exclusion in the policies. The court also predicted that under Louisiana law the so-called anticoncurrent causation clauses found in most policies would be enforced to bar coverage as long as an excluded flood occurred at any step in the causal chain reaction leading to a loss.

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To attempt to avoid the same fate as the victims of Katrina, businesses without flood insurance that have suffered from the recent flooding may be able to argue that the damage was caused solely by intentional human conduct and therefore falls outside the scope of exclusions. This will be an issue of first impression for the courts in the affected areas, but policyholders and insurers alike will find support for their positions in cases from other jurisdictions addressing analogous situations. For example, some courts have held that a flood and surface water exclusion does not apply to damage caused by a backed-up sewer system, even where the problem resulted from excessive rainfall, reasoning that water loses its character as surface water when it is channeled through a pipe. Victims of deliberate flooding could likewise argue that the river water does not take on the character of floodwater once it has been channeled and deliberately disposed of in an area that would not otherwise have flooded. On the other hand, an unreported Massachusetts court decision upheld a flood exclusion to business coverage for damage that resulted when a city deliberately discharged water from a dam.

When the Floodwaters Don't Reach You, But the Effects Do

Fortunately, the disastrous Japanese earthquake and tsunami had very little physical impact on American soil. Nonetheless, many U.S. companies are suffering lost profits as the economic impact of the severe disruptions of many Japanese businesses is felt here. Damage to Japanese factories and infrastructure has resulted in unfulfilled orders for products and component parts, leaving some American companies to scramble to find alternate suppliers, and to pay higher prices. Indeed, some automobile assembly lines and other businesses have had to shut down due to a lack of parts. Other corporations here have lost access to markets in Japan because Japanese customers are in no condition to purchase their goods and services. 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, or dependent properties coverage, and is commonly purchased under commercial property policies. This insurance can be very valuable now to companies with business relationships in Japan and in the flood-ravaged areas of this country, but the coverage is narrowly defined and may be subject to sublimits.

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 property at the policyholder's own premises described in the policy, 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 policyholder's 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. Likewise, after Hurricane Katrina, companies that sold goods and services in the Gulf region were able to recover the profits they lost because of the destruction of the property of their customers, including homes and businesses.

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. For example, a Japanese company that purchased beef from American meatpackers would be considered a customer for purposes of triggering the coverage; a Japanese manufacturer of parts used in an American company's products would clearly qualify as a supplier. However, in many instances, whether a third party is a customer or supplier may be unclear. 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. The insurance company rejected the notion that the Corps was a "supplier" and denied the claim. A federal court agreed with ADM, noting that it paid fees to the Corps for using facilities on the river, which brought the Corps within the insurance policy's coverage for loss resulting from physical damage suffered by a supplier.[1] 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 U.S. or into Japan fulfills the requirement of damage to a supplier. Keep in mind that generally, under standard forms, policyholders must describe the contingent location on the endorsement.

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 provided only if the physical damage to the suppliers' or customers' property that triggered the loss would have been covered if it had happened to the policyholder's own property, and from the same cause. For example, if a supplier's factory was destroyed in an earthquake, an American policyholder will have coverage only 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. The ISO program contains an international dependent properties endorsement, under which the covered causes of loss are indicated on the endorsement schedule.

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Whether the U.S. policyholder has the appropriate coverage for its own property can be a complicated issue. Many companies have earthquake 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 earthquake or flood insurance for its facilities that are subject to those risks.

When property insurance is sold on a "blanket" basis, meaning that a single limit of coverage can be applied to any one loss, coverage for earthquakes is often excluded from the contingent business interruption coverage. Policyholders should look carefully at endorsements in such policies to see if earthquake coverage is reinstated by endorsement, and this exclusion should not be accepted lightly when it is time to renew coverage.

Contingent business interruption coverage is often subject to sublimits that are substantially lower than the overall amount of coverage under a policy. When faced with insufficient limits, the policyholders should carefully review their policies for other contingent coverages for damage to third-party property, such as for lack of access due to orders of civil authority or physical inability to gain access to premises. These coverages are commonly applied where there is an inability to gain access to the policyholder's own premises, but some policies extend that coverage to contingent business interruption.

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 contingent business interruption coverage, contingent extra expense coverage is typically only available when the loss would have been covered if the property damage belonged to the property holder.

Other Companies' Insurance

Companies that have been adversely affected by the earthquake or tsunami in Japan should also consider whether they are insured under policies sold to other companies in Japan or elsewhere. As an additional insured, an American company may be able to tap into policies with more favorable terms for contingent business interruption and contingent extra expense coverage.

What Should Policyholders Be Doing About Their Contingent Business Interruption and Contingent Extra Expense Losses?

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.

Assemble a Team of Experts

Many companies that lack in-house insurance professionals fall prey to the belief that a complex business interruption loss can be handled by an in-house accountant and an insurance broker. Those assumptions are often misguided, because preparing and pursuing a large insurance claim is a unique exercise that is closely linked to the arcane, and often ambiguous, language of an insurance contract. A policyholder needs a team of experts to prepare the claim and aggressively negotiate on the policyholder's behalf.

The policyholder's team for pursuing a contingent business interruption or extra expense must provide expertise in both calculating lost income and policy analysis. Some companies have risk managers and other personnel who know how to prepare an income loss claim, but this can often be a much more complicated process than it may appear to someone who handles insurance as just one of a number of other functions. So, policyholders should consider retaining an accountant who specializes in the preparation of business interruption claims for policyholders. Whoever prepares the claim must have a thorough understanding of property insurance forms and coverages. This is an important reason for employing loss adjustment specialists and, where the scope of coverage is unclear, obtaining legal advice on policy interpretation.

Develop a Strategy for Dealing With the Insurance Company

The loss adjustment process is like an old-fashioned lawn mower; it needs to be pushed hard to yield results. The policyholder's team must develop and implement a plan for preparing the claim, cooperating with the insurance company in the adjustment process, and negotiating disputed items. Every plan should include, among other things, the following steps:

- Comply with contractual requirements for notice of loss and proof of loss and contractual limitations periods for suits or arbitrations against the insurance company. Deadlines for filing proofs of loss and lawsuits can be extended by agreement, which should be done in writing.

- Frequently communicate with the insurance adjuster to try to develop a partnership approach to resolving the coverage claim. All important communications should be in writing or memorialized in writing after the fact to preserve a record of the adjustment process.

- Wherever possible, provide the insurance company with prior written notification of major expenses for which you seek coverage.

- Develop procedures to ensure prompt responses to insurance company requests for information. The most common explanation of insurance adjusters for inaction on a claim is that the policyholder has not provided needed information. This is often just an excuse for delay, but the policyholder should do whatever it can to not give the insurer that argument.

- Consider preparing and submitting the claim in installments if the entire loss cannot be compiled quickly, and request partial payments as losses are substantiated and costs are incurred.

- Attempt to resolve coverage issues while the claim is being adjusted. Those issues are much more likely to be resolved if they are addressed when other issues are being compromised on, rather than saving them for the end of the process because they are problematic.

Following these steps will allow you to influence the pace of the adjustment process, avoid the forfeiture of coverage for noncompliance with obligations under the contract, and hopefully obtain payment within a reasonable timeframe.

Endnotes

1 *Archer-Daniels-Midland Co. v. Phoenix Assur. Co.*, 936 F. Supp. 534 (S.D. Ill. 1996).

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