

INSURANCE COVERAGE

Expert Analysis

Insurance Coverage for the Ripple Effect From the Japanese Tsunami

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Although the disastrous Japanese earthquake and tsunami thankfully had very little physical impact on the United States, many companies here will suffer serious economic consequences in the weeks and months to come.

Damage to Japanese manufacturing facilities, roads, railroads and ports will result in unfulfilled orders for products and component parts, leaving some American companies to scramble to find alternate suppliers, and to pay higher prices. Other corporations here will lose access to markets in Japan.

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 coverage for business interruption or lost profits. 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 applies 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 effect upon prices and sales, and it reduced profits.



REUTERS/Kyodo

This combination photo shows a neighborhood in Sendai in northeastern Japan March 10 before (top) and after (below) being struck by an earthquake and tsunami March 11.

The profits lost because of the explosion at the supplier's plant were covered by the American company's contingent business interruption coverage.

WHAT ARE THE REQUIREMENTS FOR 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, agribusiness Archer Daniels Midland suffered a loss because it could not move crops to its 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. *Archer Daniels Midland Co. v. Phoenix Assur. Co.*, 936 F. Supp. 534 (S.D. Ill. 1996).

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.

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, as with a transmission for a car.

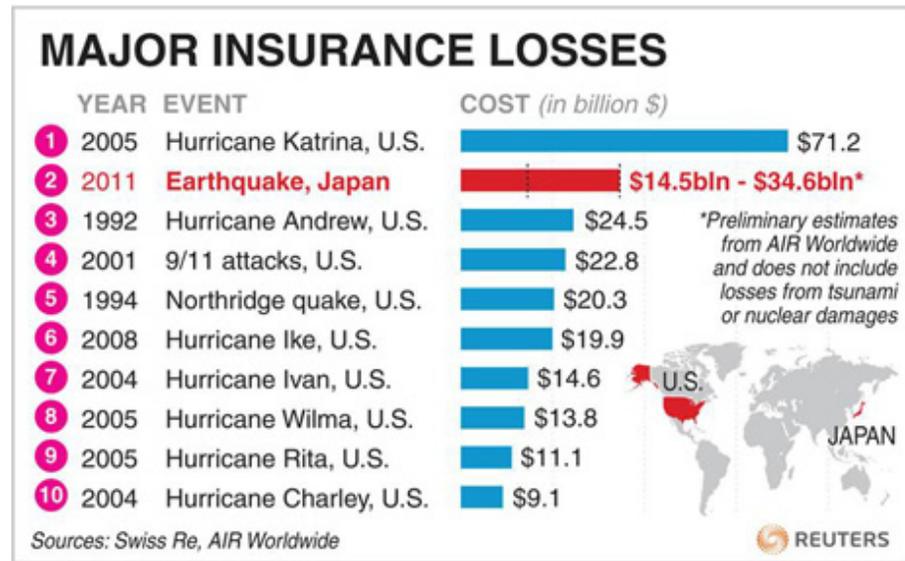
Faced with uncertainty, policyholders should analyze their coverage in light of the legal rules of insurance policy interpretation that grants of coverage are to be interpreted broadly and that exclusions are to be interpreted narrowly.

Second, contingent business interruption coverage is only provided if the physical damage to the supplier's or customer's 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 would 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.

Typically, contingent business interruption insurance applies when there has been damage to the property of the policyholder's suppliers or customers.



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.

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.

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: for extra expense to reduce loss and for "pure" extra expense.

Contingent business interruption coverage is often subject to sublimits that are substantially lower than the overall amount of coverage under a policy.

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.

WHAT SHOULD POLICYHOLDERS BE DOING?

Presenting and pursuing claims for contingent business interruption and contingent extra expense require 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 claim 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.

Requirements for contingent business interruption coverage:

- The damage that triggers the loss must have been suffered by a supplier or customer of the insured.
- The physical damage to the supplier’s or customer’s property that triggered the loss would have been covered if it had happened to the policyholder’s own property, and from the same cause.



REUTERS/U.S. Air Force Airman 1st Class Katrina R. Menchaca Handout

A house is seen adrift in the ocean east of Sendai, Japan, March 14, after a massive earthquake and tsunami hit the eastern part of the country.

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 insurer

The loss adjustment process is like an old-fashioned lawnmower; 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:

- Compliance with contractual requirements for notice of loss and proof of loss and with contractual limitations periods for suits or arbitrations against the insurer. Deadlines for filing proofs of loss and lawsuits can be extended by agreement, which should be done in writing.
- Frequent communication 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 insurer with prior written notification of major expenses for which you seek coverage.
- Procedures to ensure prompt responses to insurer 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.

Policyholders should also:

- 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 negotiated, 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.



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