Anderson Kill & Olick, P.C.
POLICYHOLDER ADVISOR
The Policyholder Law Firm
Volume 20 Number 2 www.andersonkill.com March/April 2011

Insurance Coverage for the Ripple Effect From the Japanese Earthquake and Tsunami

By Finley Harckham


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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 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,

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"Insurance Coverage for the Ripple Effect" continued p2

"Insurance Coverage for the Ripple Effect" continued from p1

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 property, 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 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.

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  Monday, May 2, 2011, 1:45 – 3:15 p.m.
- **What Every Insurance Professional Should Know About Insurance Coverage** *William G. Passannante*
  Tuesday, May 3, 2011, 10:45 a.m. – 12:15 p.m.
- **If You Must Let the Bedbugs Bite, Make Sure You're Covered**
  Marshall Gilinsky
  Wednesday, May 4, 2011, 9:00 – 10:30 a.m.

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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The Year in Emerging Risks

By William G. Passannante

The time is ripe to take a look back at key developments in insurance recovery in 2010 — and trends that are likely to be salient in 2011.

Bank failures continue to loom: In 2010, 157 U.S. banks failed, costing the FDIC $22.4 billion — the highest tally since 1992, the peak of the savings and loan crisis. At that time, the FDIC sought aggressively to recoup a portion of its losses through lawsuits against directors and officers. Moreover, from 1990 to 1995, federal officials prosecuted almost 2,000 bank insiders. Bank officers would do well to assume that the past is prelude, though the legal action is just getting started. Early this year, the FDIC said that as of mid-December it had authorized lawsuits against 109 directors and officers of failed financial institutions, seeking to recover nearly $2.5 billion. The FDIC is also reportedly conducting approximately 50 criminal investigations targeting executives, directors and employees of recently failed banks. The FDIC's problem list is over 884 banks.

Institutions whose directors and officers are subject to such suits, investigations and prosecutions should look to their D&O policies. They should note, too, that D&O insurance companies' past efforts to deny coverage for suits brought by statutory receivers by invoking the "insured vs. insured" exclusion have for the most part proved unsuccessful.

Shareholder and bondholder action against banks is also increasing: Late in the year, several foreclosure fraud class action lawsuits were filed, some seeking treble damages under RICO, with a number of large financial institutions among the targets. Banks are also fending off multiple foreclosure-related investigations, including one by all 50 state attorneys general. Bondholders likewise are targeting banks, alleging misrepresentations in the sale of collateralized debt obligations and other toxic securities. In all of these cases, D&O insurance should provide crucial protection to officers and directors.

Gulf oil spill: The release of millions of gallons of oil into the Gulf of Mexico following the explosion

"The Year in Emerging Risks" continued p4

"The Year in Emerging Risks" continued from p3

on the Deepwater Horizon oil rig entails billions of dollars in losses and liabilities for the principle companies involved, e.g., BP, Halliburton, Transocean and others. While hundreds of on-shore businesses that suffered business interruption losses will look to the BP fund established to compensate for such claims, many have opted out of the settlement and are suing the companies involved in building and operating the rig. Many may also seek coverage under time-element business interruption insurance included in their own property insurance policies.

Climate change liability risks won't go away: Late in 2010, the United States Supreme Court agreed to hear an appeal in *American Electric Power Co. Inc. et al. vs. State of Connecticut et al.,* in which a coalition of states and environmental groups sued several large coal-burning utilities, alleging that greenhouse gas emissions from the utilities contributed to beach erosion, droughts and floods. If the Supreme Court allows the suit to go forward, a raft of similar suits likely will follow. *American Electric* is one of three such suits currently pending in U.S. District Courts, one of which, *Kivalina vs. ExxonMobil Corp.*, has led to the first insurance coverage dispute concerning liability for greenhouse gas emissions. Should the Supreme Court uphold the Second Circuit in *American Electric*, then, as day follows night, greenhouse gas liability will become a major insurance coverage battleground. Under commercial general liability policies, much dispute will probably center on interpretation of the polluter's exclusion.

D&O liability for climate change: Directors and officers can be sure that increased regulation of greenhouse gas emission will lead to increased liability. A raft of SEC regulations address disclosure of a company's climate-change-related issues, including legislation that may have a material effect on a public company, or conditions that may reduce demand. Alleged failure to comply with these disclosure requirements may lead to suits against directors and officers.

Notwithstanding the large anticipated costs to the insurance industry stemming from the recent earthquake and tsunami in Japan, insurance markets remain soft in most property-casualty lines, and policyholders are thus well-positioned to purchase insurance products that will actually work when needed. As always, maximizing insurance protection will require informed purchasing, proactive claims pursuit and aggressive pushback when insurance companies delay or deny coverage.

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