



## The Japan Quake: How Should Insurers Respond When Cracks In The Supply Chain Lead To Contingent Business Interruption Claims?

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As Japan catches its breath and examines its losses, firms around the globe will take inventory of the quake's impact on their businesses. Japan is a significant supplier of auto parts, computer chips, electronics, and other components used in the production of innumerable goods around the world. Manufacturers who rely on Japanese supplies may sustain economic disruption and may look to their insurers for coverage under contingent business interruption insurance provisions. As one reporter recently noted, "[i]nsurance companies far from Japan could be on the hook for some of the lost profits at manufacturers whose supply chains were disrupted by the devastating earthquake." Erik Holm, *Insurers May Face 'Far-Reaching' Claims As Supply Chain Breaks*, Dow Jones News Services, March 16, 2011.

<http://fpn.advisen.com/articles/article140070099259317629.html>

Contingent business interruption insurance ("CBI") generally covers a policyholder's economic loss resulting from damage to a supplier's property. "The word 'contingent' is something of a misnomer; it simply means that the insured's business interruption loss resulted from damage to a third party's property." *Pentair, Inc. v. American Guar. & Liab. Ins. Co.*, 400 F.3d 613, 615, n.3 (8th Cir. 2005). Under a CBI provision, the "covered loss is caused by property damage that prevented the flow of goods or services to or from the insured and necessarily interrupted the insured's business." *Arthur Andersen LLP v. Federal Ins. Co.*, 416 N.J. Super. 334, 348, 3 A.3d 1279, 1287 (App. Div. 2010).<sup>1</sup>

It is important to distinguish between standard business interruption coverage and contingent business interruption coverage. Standard business interruption insurance covers business interruption losses caused by physical damage to the insured's *own* property. See, e.g., *United Airlines, Inc. v. Ins. Co. of the State of Pennsylvania*, 439 F.3d 128, 129 (2d Cir. 2006). Thus, if U.S. companies have sustained physical losses to covered locations in Japan as a result of the quake, they are likely to tender claims for such losses to their insurers under standard business

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<sup>1</sup> For example, a CBI insurance provision recently addressed by a New York federal court provided:

[The Insurer] will pay for the loss resulting from necessary interruption of business conducted at Locations occupied by the Insured and covered in this policy, caused by direct physical damage or destruction to:

a. any real or personal property of direct suppliers which wholly or partially prevents the delivery of materials to the Insured or to others for the account of the Insured . . .

*Park Electrochemical Corp. v. Continental Casualty Co.*, No. 04-CV-4916, 2011 WL 703945, at \*2 (E.D.N.Y. Feb. 18, 2011).

interruption insurance clauses, seeking to recover lost earnings for the period of time necessary to repair the physical damage.<sup>2</sup>

While standard business interruption clauses have been litigated frequently, cases interpreting CBI insurance remain relatively sparse. Nonetheless, three significant issues have come to the attention of the courts that may arise in the wake of the Japan disaster: (i) whether a particular entity falls within the definition of “*supplier*” for purposes of extending CBI coverage; (ii) whether the insured’s CBI loss was caused by *physical damage* to the supplier’s property; and (iii) whether the supplier’s loss was caused by a *covered risk* under the insured’s policy.

In *Pentair v. American Guarantee & Liability Insurance Co.*, the Eighth Circuit addressed all three of these issues in a context similar to the Japan quake. Insured manufacturer Pentair sought coverage for economic losses incurred when an earthquake in Taiwan disabled a substation that provided power to two of Pentair’s suppliers. The suppliers’ factories sustained no physical damage, but because of the extended power outage, the suppliers could not manufacture the products needed by Pentair. The Eighth Circuit found that Pentair was not entitled to coverage under the CBI provision in its policy or a related provision addressing business interruption losses from off-site power outages. *Pentair*, 400 F. 3d at 615-18.

First, the Court found the power substation that sustained physical damage because of the earthquake was not “a supplier of goods and/or services” to Pentair within the terms of the CBI provision. *Id.* at 615. “Though the substation supplied power to the Taiwanese factories, the Taiwanese power company did not supply a product or service ultimately used by Pentair.” *Id.* Second, the Court found the Taiwanese factories that supplied Pentair sustained no physical damage. Rather, they incurred only a shutdown of manufacturing operations, which “did not constitute ‘direct physical loss or damage’ to a supplier’s property” within the terms of the applicable CBI provision. *Id.* at 616. Finally, addressing a separate provision in the policy regarding business interruption losses arising from damage to off-premises power suppliers, the Court held that the loss in *Pentair* did not arise from a covered peril. The Court found that while the policy covered losses arising from power outages to substations directly servicing Pentair, it did not cover losses arising from power outages “at unknown third party supplier premises.” *Id.* at 617-18.

The insurer did not fare as well in the recently-decided *Park Electrochemical Corp. v. Continental Casualty Co.*, No. 04-CV-4916, 2011 WL 703945 (E.D.N.Y. Feb. 18, 2011). There, the insured was in the business of manufacturing circuit boards for the computing and telecommunications industry. One of the insured’s wholly-owned subsidiaries, located in Singapore, supplied a vital component to another subsidiary, located in Arizona. An explosion at the Singapore subsidiary’s facilities temporarily halted supply to the Arizona subsidiary. The insured sought CBI coverage for the Arizona subsidiary’s lost income, and the insurer declined, asserting that subsidiaries are not considered “direct suppliers” under the CBI provision.

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<sup>2</sup> Disputes pertaining to standard business interruption insurance often revolve around the calculation of the business interruption loss. See, e.g., *Catlin Syndicate Ltd. v. Imperial Palace of Mississippi, Inc.*, 600 F.3d 511 (5th Cir. 2010) (upholding insurer’s calculation of business interruption loss based only on policyholder’s pre-catastrophe sales figures, without taking into account policyholder’s significantly higher, post-interruption sales figures).

On the insurer's motion for summary judgment, the Court acknowledged that the industry norm was to limit CBI coverage to situations in which the supplier is not owned by the insured. Nonetheless, the Court found that the term "direct suppliers" was not defined anywhere in the policy and that issues of fact precluded summary. *Id.* at \*2; *cf. Archer-Daniels-Midland Co. v. Phoenix Assur. Co. of New York*, 936 F. Supp. 534 (S.D. Ill. 1996) (Illinois federal court broadly interprets "suppliers" to find coverage under CBI provision, holding farmers who supplied crops to distributors, who in turn supplied insured, constituted "suppliers" within meaning of CBI clause, despite absence of contractual relationship).

It is not difficult to imagine the types of CBI claims that may arise in the wake of the Japanese earthquake, tsunami, and nuclear plant shutdown accompanied by government-ordered evacuation. Insured automakers may seek CBI coverage if their parts suppliers lack the power needed to maintain production due to the nuclear plant shutdown or were unable to man their manufacturing facilities due to the evacuation. Insured electronics manufacturers may seek CBI coverage if their component suppliers are unable to operate because of earthquake damage. Insured computer manufacturers may seek CBI coverage if their computer chip suppliers' facilities were swept away by the tsunami.

If a dispute arises regarding coverage under a CBI provision for losses sustained in connection with the Japanese earthquake, it will be important for the insurer to closely examine its policy language and analyze all facts relevant to the claim. The questions to consider will include: (i) did the insured's loss result from physical damage to the insured's supplier or some non-physical factor, such as a power outage that interfered with the supplier's ability to produce the needed goods? (ii) did the insured's loss arise from direct physical loss to the supplier's facilities or damage to one or more of the supplier's third-party providers? (iii) what level of radiation at a supplier's facilities is a direct physical loss? (iv) is the insured's loss the result of a risk that is covered under the policy, or is it barred by earthquake, flood, nuclear risk, or other potentially applicable exclusions?

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