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Commentary

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The sheer amount of physical damage caused by what was left of Hurricane Sandy when it made landfall in New Jersey on October 29, 2012, is difficult to comprehend fully even now. Hundreds of communities along the coast were inundated by the storm surge and torrential rain. Large cities and small towns from North Carolina to New England were lashed with high winds for hours on end. Roads, boardwalks, electrical substations, subways, and cities alike suffered devastation on a scale unseen in modern times.

But public infrastructure was not alone in being battered by Sandy. Houses, industrial parks, warehouses, and office towers alike had roofs ripped off, doors forced in, and windows broken. Dozens of office buildings in Lower Manhattan remained closed for weeks because their basements flooded floor-to-ceiling with brackish water, ruining telephone switches, electrical equipment, and elevators. Current estimates indicate that the insurance industry may see losses of $20 billion or more from Sandy.

As the insurance industry moves to help policyholders rebuild the routines of ordinary life, it should be mindful of a likely wave of contingent business interruption ("CBI") claims. Policyholders who (fortunately) sustained little to no damage to their facilities or their inventory may nevertheless have had to suspend operations for a period of time on account of damage to third party property. Businesses with servers maintained by third-party vendors located in the devastated regions, for example, may have suffered significant disruptions to their operations due to their IT issues. Goods may not have been able to get to market. And the inability of businesses to receive component parts and supplies, either because those supplies could not be shipped or because they could not be made by their vendors, could seriously impair any business whose operations rely on just-in-time supply chains.

These types of CBI claims are likely to have significant value, on the order of billions of dollars. Even so, CBI insurance is perhaps the least well-understood type of business interruption coverage. In this article, we offer a brief outline addressing the contours of such coverage.

I. Contingent Business Interruption Insurance

Basic business interruption insuring agreements typically do not extend to losses suffered on account

of damage to a policyholder's suppliers, customers, or "leaders" (i.e., nearby businesses that attract customers to the policyholder). In order to protect against such losses, insurers may add CBI coverage (also known as "dependent properties" coverage) to a first-party property policy. Like any other type of insurance, CBI coverage is defined by the terms and conditions in the relevant insurance policy. There are several different forms of CBI wording in the market. A typical CBI insuring agreement may read:

> [This policy covers against actual losses sustained] due to the necessary interruption of business as the result of direct physical loss or damage of the type insured against to properties not operated by the Insured which wholly or partially prevents any direct supplier of goods and/or services to the Insured from rendering their goods and/or services, or property that wholly or partially prevents any direct receiver of goods and/or services from the Insured from accepting the Insured's goods and/or services.[1]

As courts have explained, the term "contingent" in CBI coverage is something of a misnomer. It simply means that the insured's business interruption loss must result from damage to the property of some third party.[2]

Looking just at the foregoing clause, for example, in order for CBI coverage to attach, a number of conditions must be satisfied. First, there must be a necessary interruption of the insured's business. Second, that interruption must have been caused by damage to or destruction of real or personal property. Third, that real or personal property must have been damaged by a peril against which the policy insures. Fourth, under this clause, CBI coverage is applicable only when damage to such property *not* operated by the insured prevents a direct supplier or receiver of goods or services to/from the insured from performing those functions, resulting in actual damage to the insured.

II. Analyzing CBI Coverage

Given that CBI coverage is a fairly recent development in the insurance industry, there is a relative paucity of caselaw that squarely addresses the coverage.[3] One of the first reported cases to discuss CBI insurance was *Archer-Daniels-Midland Company v. Phoenix Assurance Company*.[4] There, unprecedented flooding of the Mississippi River system in the summer of 1993 caused the U.S. Army Corps of Engineers and the Coast Guard to close the river to navigation. The floods also inundated 20 million acres of farmland, causing some $6.5 billion in crop damage.[5] ADM, a global agribusiness company, submitted a claim for over $50 million in damages, mostly as a result of having had to incur substantial extra expenses to procure raw materials and then transport them over land.[6]

Addressing the CBI portion of ADM's claim, the court first looked to the insuring agreement, which promised coverage against loss of earnings and necessary extra expense resulting from a necessary interruption of the insured's business that was caused by damage to or destruction of the real property of "any supplier of goods or services" to ADM.[7] The court did not find – and neither party contended – that the language used in ADM's insurance policies was ambiguous.[8] Applying dictionary definitions of the terms "any," "supply," and "supplier," the court concluded that the insuring agreement embraced an unrestricted group of those who furnished "what is needed or desired" to ADM.[9] Accordingly, the court concluded that each of the various farmers that supplied grain to ADM, the Corps that constructed locks and improvements along the Mississippi River system, and the Coast Guard that provided aids to navigation along the entire waterway all qualified as suppliers of goods or services.[10] The result was that the damage to their property caused by the flooding potentially triggered coverage.[11]

As the chain of suppliers becomes further removed from the insured, however, courts have displayed a greater willingness to deny coverage for a CBI claim. The matter of *Pentair, Inc. v. American Guarantee & Liability Insurance Company* is illustrative.[12] There, certain subsidiaries of the insured Pentair manufactured electrical products. Those subsidiaries contracted with various factories in Taiwan to supply components of those products. In September 1999, an earthquake in Taiwan disabled a substation that supplied electricity to the Taiwanese factories for two weeks,

but did not otherwise cause damage to the suppliers' facilities. When production resumed, Pentair paid a premium of about $635,000 in air freight to expedite shipping of those component materials to the United States.[13]

Pentair's insurance policy extended business interruption coverage to losses incurred by Pentair as a result of "damage" to "property of any supplier of goods and/or services to the Insured" caused by a covered peril, which included earthquakes.[14] On appeal to the Eighth Circuit, Pentair left undisturbed the federal trial court's conclusion that direct physical loss or damage to the supplier's property was essential to trigger coverage under the CBI insuring agreement.[15]

The court concluded that Pentair was not entitled to coverage under its CBI policy, because the electric company whose substation had failed supplied power only to the Taiwanese factories. Affirmatively rejecting any analogy to the *ADM* case, the Eighth Circuit concluded that the Taiwanese power company did not supply a product or a service that was ultimately used by Pentair itself. Accordingly, because it supplied *Pentair* (the named insured) with neither goods nor services, the court held that the power company could not be deemed either a direct or an indirect Pentair supplier.[16]

The holdings in *ADM* and *Pentair* are products of their facts and the specific policy language at issue, but the conclusions represent opposite ends of the CBI coverage spectrum. Notably, in neither case did the court conclude that the policy language was ambiguous. But what happens if a court does reach that conclusion?

In *Millennium Inorganic Chemicals v. National Union*, the court considered a $10 million CBI claim that resulted from a natural gas explosion in Western Australia.[17] The insured had an Australian facility that produced a white pigment used in the manufacture of paint, plastics, and paper. In order to produce the pigment, the insured contracted for a constant supply of natural gas to its facility through a pipeline that also supplied Western Australia's major population centers. In June 2008, a massive explosion on an offshore island disrupted approximately 30% of the natural gas flow to Western Australia, resulting in a declaration of *force majeure* and the immediate termination of natural gas to the insured's facility, which remained offline for months.[18]

The coverage dispute turned on whether the natural gas producer could properly be deemed a "direct contributing property" to the insured's production facilities, or if the fact that the gas passed through a pipeline operated by a separate company – and the insured purchased the gas through that separate company – rendered the producer merely an "indirect" contributing property.[19] The court's task was complicated by the fact that the policy provision in issue stated only that it would cover business interruption losses "caused by damage to or the destruction of" contributing properties, while a separate clause in an endorsement contained the only reference to the term "direct supplier."[20]

Rejecting the parties' competing proffers of extrinsic evidence that the term "direct supplier" had a clear meaning, the court concluded that the policy language was ambiguous because it saw no evidence that the insurers communicated their understanding of the term to the insured when the policies were being negotiated, prior to the explosion.[21] Accordingly, the court applied the doctrine of *contra proferentem* and construed coverage in favor of the insured.[22] The court later went on to enter a stipulated judgment in favor of the insured, in the amount of $10.85 million.[23]

As we write this article, the time for the insurer in *Millennium* to take appeal has not yet expired. On a basic level, the *Millennium* court's holding is at variance with what other courts that have considered proffers of extrinsic evidence in the context of CBI coverage have concluded. *See generally*, *e.g.*, *Park Electrochemical Corp. v. Cont'l Cas. Co.*, No. 04-cv-4916 (ENV)(ARL), 2011 WL 703945 (E.D.N.Y. Feb. 18, 2011) (concluding that competing offers of extrinsic evidence to interpret meaning of "direct suppliers" created a question for the trier of fact). More fundamentally, though, the *Millennium* court's conclusion differs from the analysis employed by the *ADM* and *Pentair* courts, both of which refused to find any ambiguity in the relevant policy provisions.

III. Sandy-Related CBI Claims

In the coming weeks and months, business interests across the entire region affected by Superstorm Sandy will continue to tender business interruption claims to their insurers. Early estimates indicate that business interruption losses may comprise approximately 30% of the total insured losses for Sandy.[24] Many of these claims will likely include a CBI component. It will be absolutely essential, therefore, for both insurers and policyholders alike to review the terms of the coverage specified in each policy.

Whether CBI coverage attaches typically depends upon whether a third party sustained actual physical damage to its property, which in turn resulted in a disruption of the named insured's business. Damaged subways that resulted in employees being unable to get to work, flooded servers that brought down computer networks, and destroyed warehouses that prevented the fulfillment or orders are all likely to feature in various CBI claims. How each claim is adjusted will depend on the terms used in the policy applicable to each loss.

Endnotes

1. *See*, *e.g.*, *Zurich Am. Ins. Co. v. ABM Indus., Inc.*, 397 F.3d 158, 162 (2d Cir. 2005).

2. *See Pentair, Inc. v. Am. Guar. & Liab. Ins. Co.*, 400 F.3d 613, 615 fn.3 (8th Cir. 2005).

3. *See Millennium Inorganic Chemicals v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, ___ F.Supp.2d ___, 2012 WL 4480708, *5 (D.Md. Sept. 28, 2012).

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

5. *See id.*, at 536.

6. *See id.*, at 536, 540-41.

7. *See id.*, at 540.

8. *See id.*

9. *See id.*, at 541.

10. *See id.*, at 544.

11. *See id.*, at 543-44.

12. *See* note 2, *supra*.

13. *See id.*, at 614.

14. *See id.*

15. *See id.*, at 615.

16. *See id.* The court also went on to state that the mere loss of electrical power – without evidence of some affirmative damage to the property supplied by that electricity – did not constitute a direct physical loss within the meaning of the policy's plain language. *See id.*, at 616-18.

17. *See* note 3, *supra*.

18. *See id.*, at *1-*3, *8-*12.

19. *See id.*, at *2.

20. *See id.*, at *7.

21. *See id.*, at *35.

22. *See id.*, at *36, *39-*40.

23. *See Millennium Inorganic Chemicals v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, No. 1:09-cv-01893-ELH, Dkt. 177 (D.Md. Jan. 11, 2013).

24. *See, e.g.,* "Hurricane Sandy Business Interruption Losses Likened to Japan, Thailand, 9/11," *Business Ins.*, Nov. 4, 2012 (http://www.businessinsurance.com/article/20121104/NEWS06/311049977). ■

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