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Contingent Business Interruption Coverage for Superstorm Sandy Losses

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Superstorm Sandy is a timely reminder of vulnerability. If recent reports by climatologists are correct, we can expect more and more such reminders, with damages and destruction to people, their property, and their businesses. The consequences of such large-scale climate events may be direct—as when a business's property is destroyed and it sustains an interruption of its business operations as a result—or indirect—as when there is damage to property and operations on which a business relies, such as damage to its suppliers, customers, or other property the operability of which the business relies on to continue operations.

At the moment of this writing, estimates of economic loss from Superstorm Sandy are as high as $50 billion.[2] As with claims associated with other major coastal storms, claims for coverage arising out of Superstorm Sandy will present a number of complex factual and legal issues for insurance coverage purposes, including the distinction between wind and flood damage,[3] the impact of transportation diversions and shutdowns, and the effect of power outages on otherwise unaffected business operations. Here we look at some of the issues that may arise with respect to contingent business interruption coverage. The centrality of the New York metropolitan area to so much of the country's commercial operations virtually guarantees that the impact on businesses functioning within that area will spread throughout the national economy, affecting other businesses and operations geographically distant from the site. That impact should be covered under the contingent business interruption insurance that is part of the property insurance policies that most businesses acquire.

Contingent Business Interruption Insurance

Business interruption insurance covers losses resulting from unavoidable interruptions, including slowdowns, of a policyholder's ordinary business operations that are caused by physical damage to the policyholder's property. One standard form for such coverage provides as follows:

We will pay for the actual loss of Business Income you sustain due to the necessary suspension of your "operations" during the "period of restoration". The suspension must be caused by direct physical loss of or damage to the property at the described premises. The loss or damage must be caused by or result from a Covered Cause of Loss.[4]

Such coverage may protect the policyholder against economic loss resulting from the interference with its own operations caused by covered damage to its own property but does not protect against economic loss caused by covered damage to others' property. The latter protection is provided by contingent business interruption coverage (CBI).[5]

CBI is intended to provide coverage for the policyholder's lost profits caused by loss to a key customer's or supplier's property or to other "dependent property," to use the term found in

many policies, not owned by the policyholder but relied on by the policyholder for its business operations. Typically, CBI requires the insurer

to pay for the actual loss of Business Income the insured sustains due to the necessary suspension of its operations during the “period of restoration.” The suspension must be caused by the direct physical loss of or damage to “dependent property.”[6]

Sometimes this coverage is provided only where the dependent property is identified in a schedule and where the cause of loss is identified as covered. But that need not be the case, and most policies define “dependent properties” generally to include contributing locations, recipient locations, manufacturing locations, and leader locations even if they are not specifically identified in the policy.[7] “Contributing locations” are locations where the insured’s suppliers operate. “Recipient locations” are locations where the insured’s customers operate. And a “leader location” is a magnet location that attracts customers to the insured’s business.

According to a widely used Insurance Services Office (ISO) form:

“Dependent property” means property operated by others whom you depend on to:
a. Deliver materials or services to you, or to others for your account (Contributing Locations). But any property which delivers any of the following services is not a Contributing Location with respect to such service;
(1) Water supply services;
(2) Power supply services; or
(3) Communication supply services, including services relating to internet access or access to any electronic network;
b. Accept your products or services (Recipient Locations).
c. Manufacture products for delivery to your customers under contract of sale (Manufacturing Locations); d. Attract customers to your business (Leader Locations).[8]

Dependent or Contributing Property What constitutes a dependent or contributing property has been the subject of some litigation over the years, and the issue was again addressed very recently in Millennium Inorganic Chemicals v. National Union Fire Insurance Co. of Pittsburgh.[9] There the policy language required insurers to cover loss resulting from damage to “direct contributing properties” that are “not operated by the insured.”[10]

In Millennium, the policyholder sought coverage for loss resulting from the shutdown of its titanium oxide manufacturing operations, located in Australia, after an explosion caused disruption of the insured’s supply of natural gas, a key component in the manufacture of its product. The loss of natural gas supply was caused by a massive explosion at a natural gas production facility on Varanus Island, off the coast of Western Australia, operated by a joint venture led by Apache Corporation. The explosion completely shut down Apache’s gas production on Varanus Island, which accounted for approximately 30 percent of the natural gas supply to all of Western Australia. Immediately after the explosion, the supply of natural gas to Millennium’s facilities was terminated, and, without natural gas, Millennium was forced to suspend production of titanium dioxide. Shortly after the explosion, Millennium submitted a claim to its insurers for coverage under the applicable policies. That claim was denied.

Millennium's policy provided CBI for loss caused by damage to "direct contributing properties,"[11] a phrase that was undefined in the policy. The insurer argued that Apache's Varanus Island facility was not a direct contributing property to Millennium's business because Millennium had no direct relationship with Apache.[12] Rather, as the insurers argued, because Millennium purchased its natural gas from a distributor named Alinta Sales Ltd., which in turn purchased the natural gas from Apache and other gas producers, Alinta was Millennium's direct supplier of natural gas and, hence, the only direct contributing property.[13]

The court found that the policy language was ambiguous.[14] After considering extrinsic evidence as to the parties' intent, the court was unable to resolve the ambiguity and applied the doctrine of contra preferentem. It concluded that Apache's property was, indeed, a direct contributing property for purposes of triggering CBI.[15] Thus, even though there was no direct contractual relationship between the insured and Apache, the court found that interruption of the insured's business resulting from damage to Apache's property was covered by CBI.

Before Millennium, the question of what constitutes a dependent or contributing property was addressed by a federal court in Illinois. It reached a similar conclusion, albeit under somewhat broader policy language. Archer-Daniels-Midland Co. v. Phoenix Assurance Co.[16] concerned losses resulting from the Mississippi River's "unprecedented flooding" in the summer of 1993, which affected 20 million acres of farmland in nine Midwestern states, causing $6.5 billion in crop damage.[17] Archer-Daniels-Midland (ADM), a global agribusiness, sustained over $50 million in losses due to the flooding and sought to recover under its CBI coverage.[18] ADM's CBI policies covered business interruption losses "caused by damage to or destruction of real or personal property . . . of any supplier of goods or services which results in the inability of such supplier to supply an insured locations [sic]."[19]

ADM contended that the farmers throughout the Midwest who grew the crops that it processed were "supplier[s] of goods or services" under the policies.[20] In contrast, its insurers contended that "the farmers are not suppliers because ADM does not contract for the purchase of grain from individual farmers. Rather, ADM purchases grain from licensed grain dealers," who in turn "either purchased the grain directly from farmers or from other dealers."[21] The court agreed with ADM's application of the policy language.

Unlike the parties in Millennium, neither side contended, and the court did not find, that the language of the policies was ambiguous. Rather, the court reasoned that the "key phrase for present purposes was 'any supplier of goods or services,'" and that under the "plain, ordinary, and popular meaning" of that phrase, derived from dictionary definitions of "any," "supply," and "supplier," the phrase "denotes an unrestricted group of those who furnish what is needed or desired."[22] Applying that construction, the Archer-Daniels-Midland court observed that the policies did "not state that coverage is limited to principal suppliers or suppliers with whom Archer-Daniels has a written contract, rather, they apply to 'any' supplier."[23] Thus, it reasoned that "the policy language does not limit coverage to those suppliers in direct contractual privity."[24] Moreover, the court rejected the insurers' argument that ADM's interpretation meant that the policies' coverage was essentially limitless, such that ADM could claim that its

"business was interrupted because of damage to a supplier of the farmers."[25] The court explained its reasoning as follows:

The goods at issue is the grain grown by the Midwest farmers. The grain is produced by the farmers and sold to grain dealers, who then sell it to ADM. The farmers may be an 'indirect' supplier of the grain, but they are a supplier nonetheless. Had either of the parties wanted to limit the coverage to 'direct' suppliers, they could easily have added language to that effect.[26]

In addition, ADM argued that the Army Corps of Engineers and the United States Coast Guard were suppliers on which ADM depended because they operated and maintained the Mississippi River, on which ADM depended as a means of shipment of the material it processed. A large part of ADM's raw materials traveled by barge on the Mississippi River, and barge traffic was halted by the Coast Guard and the Corps because of the flooding. This forced ADM to use more expensive transport systems, and it sought to recover its increased shipping costs from its insurers. The insurers argued that the Corps of Engineers and the Coast Guard were actually serving a regulatory role, but the court disagreed, finding that they supplied ADM with needed transportation services and that, when these services were interrupted, they interrupted ADM's business operations, entitling it to recover its increased costs from its insurers.

The reasoning of the Archer-Daniels-Midland and Millennium decisions suggests a broad reading of CBI coverage, one that may be triggered by any operations of others on which the insured business depends. This includes the operations not only of those with whom policyholders have a direct contractual relationship but also third parties who provide product to policyholders through others and even public entities such as governmental entities that operate transportation systems and other infrastructure. By the same token, policyholders whose operations were adversely affected by Superstorm Sandy's interference with operations of suppliers and customers in the New York and New Jersey area should be able to recover under CBI even if their own property was not harmed by the storm.

The contributing property issue also was addressed by the Eighth Circuit Court of Appeals in Pentair, Inc. v. American Guarantee & Liability Insurance Co.[27] In Pentair, an earthquake in Taiwan disabled a substation that provided electric power to two Taiwanese factories. Without power, the factories could not manufacture products they were supplying to a subsidiary of Pentair. When production at the power plants resumed two weeks later, Pentair shipped orders from Taiwan via airfreight to meet its customers' needs for the Christmas season, resulting in shipping costs in excess of the costs it would have incurred had the earthquake not occurred and the shipments been made earlier.[28]

Pentair sought to recover its additional shipping costs under its CBI policy, which insured against "losses incurred by Pentair as the result of 'damage' to 'property of a supplier of goods and/or services to the Insured' that is caused by a covered peril, here, an earthquake."[29] Relying on Archer-Daniels-Midland, Pentair argued that the Taiwanese power substation was one of Pentair's suppliers within the meaning of the policy because it supplied power to the individual factories of Pentair's suppliers.[30]

The Eighth Circuit held that the "power substation was not 'a supplier of goods and/or services' to Pentair within the plain meaning" of the policy.[31] Rejecting the analogy between the power substation and the farmers in Archer-Daniels-Midland as "inapt," the court reasoned as follows:

In [Archer-Daniels-Midland], each farmer supplied a product (grain) that a dealer then resold to the insured, ADM. . . . Here, on the other hand, though the substation supplied power to the Taiwanese factories, the Taiwanese power company did not supply a product or service ultimately used by Pentair. Thus, it was not a Pentair supplier for purposes of [the policy] because it supplied no goods or services to Pentair, directly or indirectly.[32]

As the cases addressing the dependent or contributing property issue illustrate, whether a loss will be found to result from loss or damage to a qualifying dependent or contributing property will depend on an analysis of the policyholder's operations and the manner in which they were adversely affected. Where there is some relational nexus between the policyholder and the affected third-party's operations, courts will find CBI triggered. As in Archer-Daniels-Midland, that may include the operations of public entities that provide services, such as transportation, on which the policyholder's operations rely.

Total or Partial Cessation of Operations

Under the provisions of most modern policies, it is not necessary that the policyholder's business operations cease in order to trigger CBI. Rather, a slowdown, or a partial loss of profits, is sufficient to trigger coverage under most policies.[33] Since at least 2000, for example, policies written using the ISO business interruption form have defined a suspension of operations to include a business "slowdown":

"Suspension" means:

… [t]he slowdown or cessation of your business….[34]

Thus, even a slowdown of business, irrespective of whether or not business operations actually cease, counts as a "suspension" of business for purposes of triggering CBI, as well as other time element coverages.

This fact is of particular importance. Oftentimes, the loss of a customer or set of customers, for instance, doesn't mean that the entire business's operations cease. Instead, such a loss may mean merely that the business slows down, with profits diminishing more than they might but for the loss of that customer or set of customers. The fact that a slowdown of business constitutes a suspension for coverage purposes means that CBI will be available for profits lost as a result, even if sales continue to other customers. So, for instance, if a manufacturer sells a product to retailers across the nation and if, say, 10 percent of those retailers are located in the northeast and their orders fall because of the effects of Sandy, there will be coverage for the slowdown in the manufacturer's profits, even if sales for the other 90 percent of its customers have continued unaffected.

What Is Covered?

In addition to lost profits, CBI coverage generally includes coverage for extra expense triggered by the damage to dependent, or otherwise applicable, properties. This can be especially important in the context of extended business interruption, as it should include extra shipping expense caused by disruptions, as well as other increased costs associated with damage to the property within CBI.[35]

For example, in Pentair, Inc. v. American Guarantee & Liability Insurance Co.,[36] discussed above, an earthquake disrupted the insured's supply of components for its manufacturing operation due to the interruption of electrical power to the plants of the manufacturer of the components. When production resumed, Pentair shipped orders from Taiwan via airfreight to meet its customers' needs for the Christmas season, resulting in substantial additional shipping costs. Pentair sought to recover its loss under the CBI provision of its all-risk property insurance policy. Although the court in Pentair ultimately found that Pentair's loss was not covered, the decision illustrates that under the correct circumstances (e.g., where the increased expense is caused by direct physical loss to a dependent or contributing property), CBI should be available for increased operating expenses and other extra expense.

Archer-Daniels-Midland,[37] discussed above in the context of contributing property, offers another example of the types of categories of loss that may be covered under CBI. ADM processed farm products and sustained losses caused by damage to farm property owned by farmers that sold grain to ADM's suppliers, as well as damage due to the failed flood control efforts of the Army Corps of Engineers, which provided navigable waterways for grain shipments. The court held that there was CBI coverage. Even though there was no direct contractual relationship between the insured and either the Army Corps of Engineers or the farmers, the court held that because these entities were suppliers of services and products upon which ADM relied, damage to their property was covered by CBI.

Other coverages typically found in first-party property policies, such as coverage for loss resulting from an order of a civil authority, may also assist policyholders in recovering for CBI losses. For example, a circuit court in Virginia found that U.S. Airways could recover a business interruption loss that resulted from ground stop orders issued by the Federal Aviation Administration and the closing of Reagan National Airport after the 9/11 terrorist attack.[38] Thus, the scope of damage triggering CBI coverage is much broader than merely damage to the policyholder's suppliers' and customers' property, but it can extend as well to extra expenses incurred and profits lost resulting from damage to others that supply goods and services—directly or indirectly—on which the policyholder relies for its operations.

Physical Loss Required

Perhaps the most difficult aspect of triggering CBI coverage is meeting the requirement of showing that the dependent location sustained "physical loss or damage." This difficulty was experienced firsthand by the policyholder in Pentair, in which the Eighth Circuit affirmed the district court's finding that the loss of electrical power to Pentair's parts suppliers did not

constitute “direct physical loss” when power outages rendered the suppliers’ factories unable to perform their “intended function” of manufacturing products for Pentair.[39]

There are, however, some recent cases that support the proposition that a broader view of the physical loss requirement is appropriate. In particular, the interruption of information and communication systems during and after Superstorm Sandy could and arguably should be treated as physical loss within the meaning of CBI coverage. If failures of those systems adversely affected the operations of an insured’s suppliers or customers, CBI may very well be triggered.

For example, in Southeast Mental Health Center, Inc. v. Pacific Insurance Co., Ltd.,[40] the court rejected an insurer’s contention that there was no coverage for its policyholder’s loss of business income resulting from the corruption of data on a computer. Hurricane Elvis destroyed power and utility poles, causing the insured to lose electricity and telephone service, which according to the insured, in turn damaged its computer and caused the loss of data. Consequently, the policyholder lost significant business income. The insurer contended that the loss of data did not constitute a physical loss covered by the policy.[41] The district court disagreed, holding that “corruption of the [policyholder’s] computer constitutes ‘direct physical loss of or damage to property’ under the business interruption policy.”[42] The court found, citing the reasoning adopted in an earlier computer failure case, that “[t]he computer[] ‘physically lost programming information and custom configurations necessary for [it] to function’ when [it] was damaged by the power outage,” entitling the insured to business interruption coverage.[43] Thus, interruption of a policyholder’s supplier’s business or a customer’s orders due to the destruction or corruption of data in its information systems may also trigger an insured’s CBI coverage.

Similarly, the interference with communications infrastructure during and after Superstorm Sandy may trigger CBI coverage, as the reasoning in Wakefern Food Corp. v. Liberty Mutual Fire Insurance Co.[44] demonstrates. There, the policyholder operated supermarkets in the northeastern United States. Its policy insured against consequential loss or damage resulting from an interruption of electrical power caused by “physical damage.” In August 2003, there was a massive power outage in the northeast, in which “[a]t least 265 power plants with more than 508 individual generating units . . . shut down,” in some locations for as long as four days. As a result, the insured food company’s inventory was spoiled, and it sustained consequential losses.[45] The insurer denied coverage, however, contending that the power lines were not physically damaged because once certain safety devices were adjusted, the lines would function as before. The New Jersey court rejected that argument, reasoning that “from the perspective of the millions of customers deprived of electric power for several days, the system certainly suffered physical damage, because it was incapable of providing electricity.”[46] The court cited with approval Southeast Mental Health Center’s finding that “‘physical damage’ could include loss of ‘functionality’ even if the affected machinery remained intact.”[47]

By the same token, from the perspective of insureds, customers or suppliers who were unable to place orders or provide material due to storm-related interference with their communication systems suffered physical damage that may likewise trigger CBI coverage. Whether there is physical damage is determined by reference to the viewpoint of the insured. A customer that is unable to place orders or a supplier that is unable to provide material because a catastrophic

weather event caused an interruption of its communications systems has arguably sustained physical damage from the perspective of the insured even if the systems, in and of themselves, were not harmed.

Conclusion

Policyholders need to look carefully at the impact a storm such as Superstorm Sandy has, not only on their own operations, but on the operations of their customers and suppliers as well as the operations of other businesses and entities on which they depend. Even if the Storm did not directly damage insured property, thus adversely affecting the policyholder's business operations, if it caused damage to the property of suppliers or customers or otherwise disrupted their capacity to provide materials or receive products from the policyholder, which in turn had an adverse impact on the policyholder's operations, CBI coverage may be an available and extremely valuable asset.

Keywords: contributing property, dependent property, cessation of operations, physical loss, time element coverage, extra expense

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[2] EQECAT, Inc., Post-Landfall Loss Estimates for Superstorm Sandy Released (Nov. 1, 2012).
[3] See, e.g., Walter J. Andrews & Michael S. Levine, "A Flood of Uncertainty: Contractual Erosion in the Wake of Hurricane Katrina and the Eastern District of Louisiana's Rulings in In re Katrina Canal Breaches Consolidated Litigation," 81 Tul. L. Rev. 1277 (2006–2007) (discussing, among other things, the confusion raised in the wake of Hurricane Katrina in the context of whether damage was "caused" by wind or flood).
[4] Insurance Service Office (ISO) Form BP 00 02 12 99, p. 4 of 23.
[5] Also, businesses may have coverage for loss resulting from evacuation by order of civil authority, triggered when authorities close off access to a damaged area within which the business is located.
[6] This language is adopted from the Insurance Service Office's Business Income from Dependent Properties—Broad Form.
[7] ISO Form CP 15 08 06 07, p. 2 of 2.
[8] ISO Form CP 15 08 06 07, p. 2 of 2.
[9] No. ELH-09-1893, 2012 U.S. Dist. LEXIS 140257 (D. Md. Sept. 28, 2012).
[10] Millennium, 2012 U.S. Dist. LEXIS 140257, at *11.
[11] Millennium, 2012 U.S. Dist. LEXIS 140257, at *11.
[12] Millennium, 2012 U.S. Dist. LEXIS 140257, at *18.
[13] Millennium, 2012 U.S. Dist. LEXIS 140257, at *39.
[14] Millennium, 2012 U.S. Dist. LEXIS 140257, at *48–49.
[15] Millennium, 2012 U.S. Dist. LEXIS 140257, at *61.

[16] 936 F. Supp. 534 (S.D. Ill. 1996).
[17] Archer-Daniels-Midland Co., 936 F. Supp. at 536.
[18] Archer-Daniels-Midland Co., 936 F. Supp. at 536.
[19] Archer-Daniels-Midland Co., 936 F. Supp. at 540 (quoting policies) (emphasis added).
[20] See Archer-Daniels-Midland Co., 936 F. Supp. at 543.
[21] See Archer-Daniels-Midland Co., 936 F. Supp. at 543–44.
[22] See Archer-Daniels-Midland Co., 936 F. Supp. at 541.
[23] See Archer-Daniels-Midland Co., 936 F. Supp. at 543.
[24] See Archer-Daniels-Midland Co., 936 F. Supp. at 544.
[25] See Archer-Daniels-Midland Co., 936 F. Supp. at 544.
[26] See Archer-Daniels-Midland Co., 936 F. Supp. at 544.
[27] 400 F.3d 613 (8th Cir. 2005).
[28] Pentair Inc., 400 F.3d 613.
[29] Pentair Inc., 400 F.3d at 614 (quoting policy).
[30] See Pentair Inc., 400 F.3d at 615.
[31] See Pentair Inc., 400 F.3d at 615 (emphasis in original).
[32] See Pentair Inc., 400 F.3d at 615.
[33] See, e.g., Archer-Daniels-Midland Co. v. Phoenix Assurance Co., 936 F. Supp. 534 (S.D. Ill. 1996) (finding CBI coverage where flooding caused slow down and loss of income but did not result in a total suspension of the insured's operations).
[34] ISO Form CP 00 30 10 00.
[35] See, e.g., Pentair, Inc. v. Am. Guarantee & Liab. Ins. Co., 400 F.3d 613 (8th Cir. 2005) (finding that CBI for increased cost of shipping would not be available because damaged electrical substation "was not 'a supplier of goods and/or services' to Pentair within the plain meaning of [Pentair's policy]" and the loss of power to Pentair's supplier was not a "direct physical loss").
[36] Pentair, Inc., 400 F.3d 613 (8th Cir. 2005).
[37] Archer-Daniels Midland Co. v. Phoenix Assurance Co. of N.Y., 936 F. Supp. 534 (S.D. Ill. 1996).
[38] U.S. Airways v. Commonwealth Ins., No. 03-587, 2004 Va. Cir. LEXIS 121 (July 23, 2004), overruled on other grounds, PMA Capital Ins. Co. v. US Airways, Inc., 271 Va. 352, 626 S.E.2d 369 (2006) .
[39] Pentair, Inc., 400 F.3d at 615.
[40] 439 F. Supp. 2d 831 (W.D. Tenn. 2006).
[41] Southeast Mental Health Center, 439 F. Supp. 2d at 837.
[42] Southeast Mental Health Center, 439 F. Supp. 2d at 837–38.
[43] Southeast Mental Health Center, 439 F. Supp. 2d at 838 (citing Am. Guarantee Liab. Ins. v. Ingram Micro, Inc., No. 99-185, 2000 U.S. Dist. LEXIS 7299 (D. Ariz. Apr. 18, 2000)).
[44] 968 A.2d 724 (N.J. Super. Ct. App. Div. 2009).
[45] Wakefern Food, 968 A.2d at 728–29.
[46] Wakefern Food, 968 A.2d at 736.
[47] Wakefern Food, 968 A.2d at 736.