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Lawyer Insights

Insurance Coverage for Supply Chain Interruptions

By Michael Levine, P. Watson Seaman, Joseph Niczky
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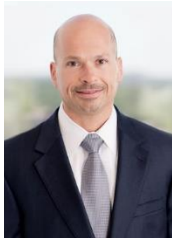

Supply chain disruptions and logistical issues over the course of the past year have left many retailers and manufacturers unable to obtain products to stock their shelves and unable to obtain the components they need to manufacture their products. These disruptions and other issues have caused significant financial loss for affected businesses. Fortunately, insurance coverage may be available to help ease the disruptions.

Most commercial property insurance policies include coverage for supply chain disruptions. This coverage may be available under the affected company's policy as well as insurance policies held by business affiliates, suppliers, logistics companies and transportation suppliers, among others, where the affected company may be an additional insured. An affected company, therefore, should check its own policy for coverage applicable to supply chain disruptions and also policies issued to its suppliers or customers. Vendor and outsourcing agreements with third parties, like suppliers, customers and transporters often include provisions that specify whether a customer should be included as an additional insured. These agreements thus provide an excellent first resource when trying to identify potentially applicable coverages.

Where available, the primary coverages applicable to a supply chain disruption are contingent time element coverages, which typically include contingent business interruption coverage and contingent extra expense coverage. Unlike direct time element coverage, which covers the policyholder's lost business income and extra expense where physical loss or damage occurs to *the insured's own* property, contingent time element and contingent extra expense coverage apply when the damaged property belongs to a *supplier or customer*.

As a general matter, most of the coverages found in a commercial property policy—including the contingent time element and contingent extra expense provisions—are triggered by some variant of "physical loss or damage to insured property." Despite decades of debate and litigation over the meaning of the coverage-triggering language, insurers have left this pivotal phrase undefined, so courts have stepped in to fill the void. This has led to a broad spectrum of meanings across jurisdictions. Generally, the presence of a physical condition on the property that renders it unusable, such as contamination, is enough to trigger coverage in many jurisdictions.

As with many included coverages, different insurance policies provide different contingent time element and contingent extra expense coverage, and it is important for a policyholder to understand the scope of coverage before purchasing a policy to ensure that it is purchasing the policy that best meets its needs. Most significantly, some policies provide coverage only if the damage is to property owned by a *direct* supplier, while others also provide coverage if the damage is to property owned by an *indirect* supplier. These terms, which set the scope of the contingent time element coverage, often are defined in the policy. Other policies also include direct or indirect customers.

For example, Factory Mutual's standard policy form provides coverage if the physical loss or damage occurs at:

A. any location: 1) of a direct customer, supplier, contract manufacturer or contract service provider to the insured; 2) of any company under a royalty, licensing fee or commission agreement with the insured;

B. any location of a company that is a direct or indirect customer, supplier, contract manufacturer or contract service provider to a location described in A1 above, not including locations of any company directly or indirectly supplying to, or receiving from, the insured, electricity, fuel, gas, water, steam, refrigeration, sewage, voice, data or video.

Sublimits and deductibles also may differ depending on if the damage was at the property of a direct or indirect supplier. When purchasing coverage, a company should consider its supply chain vulnerabilities and risk appetite to ensure that the coverage obtained is appropriate for the insured operations. In the modern interconnected economy, nearly every company has both indirect suppliers and customers and would benefit from having coverage for damage to the property of both. Thus, if a business is dependent upon certain components or materials that are known to have limited sources or long lead times, contingent time element coverage may be tailored to specifically contemplate a disruption in supply of that component or material. On the other hand, if a business utilizes common components and materials that can be sourced on short notice from multiple vendors, lower contingent time element limits may be sufficient.

The recent and ongoing microchip shortage provides a timely illustration. A fire at a microchip manufacturing facility causes a closure of the factory. The microchip manufacturer would typically be covered under standard time element coverage for the loss of business income sustained during the period that the factory is closed due to the fire.

But, what about the manufacturer's customers (and its suppliers of raw and component materials), all of whom depend on the steady supply of microchips from the affected facility? Following the repercussions of the fire down the supply chain, many industries are affected, including consumer electronics manufacturers, suppliers and retailers, automobile manufacturers, transporters and dealerships. Virtually every industry is affected in today's economy because they all rely on microchip-based products to conduct business. Whether, and to what degree, resulting business income losses may be covered will depend on the breadth and extent of each impacted businesses' contingent time element insurance coverage.

The current supply chain crunch has many causes, but many of those are the result of covered physical loss or damage, whether from natural disasters, factory fires, crime and theft, or cyber and ransomware attacks. Labor shortages and the COVID-19 pandemic were also major causes of supply chain disruptions in 2021.

Given that multiple events may contribute to a single supply chain disruption, issues of causation will likely be key to determining if there is coverage. It is important for policyholders to investigate all possible causes of their loss in order to put forward the strongest possible claim.

Michael S. Levine *is a Partner in the firm's insurance coverage group in the firm's Washington office. Mike is a Legal 500 and Chambers USA-ranked lawyer with more than 25 years of experience litigating insurance disputes and advising clients on insurance coverage matters. He can be reached at +1 (202) 955-1857 or mlevine@HuntonAK.com.*

P. Watson Seaman *is a Partner in the firm's Global Technology, Outsourcing & Privacy group in the firm's Richmond office. Watson understands corporate clients' budgets and need for solid legal solutions that are practical and cost-effective. He can be reached at +1 (804) 788-7376 or wseaman@HuntonAK.com.*

Joseph Niczky *is an Associate in the firm's Insurance Coverage group in the firm's New York office. Joseph's practice focuses on complex insurance disputes, bad faith litigation, and advising policyholders on coverage issues. He can be reached at +1 (212) 309-1359 or jniczky@HuntonAK.com.*