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Client Alert

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The Japanese Crisis and Business Interruption Insurance

"Companies facing potential BI or CBI losses arising from the crises in Japan should immediately review their property insurance policies."

In the wake of the tragic Japanese earthquake, tsunami and nuclear crisis, American and European companies with strong economic ties to Japan may find that their business interruption (BI) insurance coverage is a valuable financial asset. BI coverage is typically included in "all risk" property insurance policies and is acquired by corporations to offset lost profits and extra expense caused by damage to and loss of use of their property. Many policies also include contingent business interruption (CBI) insurance which allows recovery for lost profits resulting from a covered event at third-party premises.

The recent natural disasters in Japan have placed these often unnoticed provisions into the spotlight. When faced with incapacitation of critical suppliers or customers, businesses should closely examine their BI and CBI coverage. If potentially applicable, policyholders should promptly tender the claims to their insurance companies and immediately institute internal protocols to create and maintain evidence of damage and business losses.

Elements of a Business Interruption Claim

The most important step in determining insurance coverage is reviewing your policy's terms. Despite variations in wording, most BI and CBI insurance provisions have similar prerequisites. Coverage generally is triggered by (1) physical damage or property destruction at, or loss of use of, covered property, (2) caused by an insured peril, (3) which results in a suspension of the insured's operations and (4) an actual loss of business income.

1. Direct Physical Loss of or Damage to, or Loss of Use of, Described Property: The damage element typically requires direct physical loss of or damage to, or loss of use of, property described in the policy declarations, which could include property of the insured, their suppliers, their customers or other third parties. *See, e.g., Harry's Cadillac v. Motors Ins. Corp.*, 486 S.E. 2d 249 (N.C. Ct. App. 1997) (requiring physical damage to property at the insured's premises).

2. Covered Cause of Loss: For an insured to recover for losses, the damage at issue must have resulted from an insured cause of loss. For example, the policy may insure against earthquake, earth movement, flood or nuclear damage. Even if the policy contains earth movement, flood or nuclear exclusions, exceptions within the exclusions for specific losses — such as fires or explosions that arise out of the excluded events — may result in coverage.

3. Necessary Suspension of Operations During "Period of Restoration": Many insurance agreements explicitly define "necessary suspension of operations" as a slowdown or cessation of business activities. In the absence of a definition, some jurisdictions will allow claims for a slowdown of business activity (as opposed to an outright cessation) as long as the insured acts promptly to mitigate damages. *See, e.g., American Medical Imaging Corp. v. St. Paul Fire and Marine Ins. Co.*, 949 F.2d 690 (3d Cir. 1991) (insured set up temporary offices with reduced phone capacity after a fire and court concluded the insured was entitled to coverage, although without a complete cessation).

4. Actual Loss of Business Income: Finally, to determine covered business income under the policy, courts frequently consider both the net profit (or losses) that would have been realized and the continuing normal operating expenses incurred. Some jurisdictions view these two figures separately, whereby a business can recover ongoing operating expenses even if its business was operating on a net loss before the interruption. *See, e.g., Amerigraphics, Inc. v. Mercury Casualty Co.*, 182 Cal. App. 4th 1538, 1553 (Cal. Ct. App. 2010) (profitability not a prerequisite to coverage); *see also General Ins. Co. of America v. Pathfinder Petroleum Co.* 145 F.2d 368, 369 (9th Cir. 1944). Policies with a fixed payment for business interruption will ignore this calculus and typically pay the set amount. Some insurance agreements may also provide coverage for "extra expenses,"[1] such as relocation or increased labor costs.

Contingent Business Interruption Insurance

Policyholders also should examine their policies to determine if they cover lost profits and extra costs resulting from the interruption of the business of a supplier or customer. *See, e.g., Archer-Daniels-Midland Co. v. Phoenix Assurance Co.*, 936 F. Supp. 534 (S.D. Ill. 1996) (policy's CBI provision supported coverage for company's costs, which were incurred because of unprecedented flooding). For example, a policy's coverage may be triggered by physical loss of or damage to the following categories of "dependent properties:"

- *Contributing Locations* — Sites that deliver critical materials or services to insured
- *Recipient Locations* — Sites that accept products or services from insured
- *Manufacturing Locations* — Sites that produce goods for delivery to insured's customers
- *Leader Locations* — Sites that attract customers to the insured's business

In addition, some policies include broadly-worded general BI policy language that may provide a basis for recovering lost income arising from damage to property beyond that which is described in the policy declarations. For example, BI language that insures against "damage to property of a type insured under this policy," may extend coverage for interruption to a supplier's business, whereas language that merely insures against "damage to property at a premise described in the Declarations," may not. *See generally St. Mary's Foundry, Inc. v. Emplrs. Ins. of Wausau*, 332 F.3d 989, 992 (6th Cir. 2003) (noting the general presumption that when not clearly excluded from the operation of a contract, coverage is included in the operation thereof).

Length of Coverage

Coverage typically is provided for loss occurring during the "period of restoration." The "period of restoration" is a theoretical measure — for example, the time necessary, "with reasonable speed" or "with due diligence and dispatch," to rebuild, repair or replace the damaged, dependant property.

The current ISO form[2] defines the period of restoration as commencing 72 hours after the damage incepts and ending either when the damaged property "should be repaired, rebuilt or replaced with reasonable speed and similar quality" or when "the business is resumed at a new permanent location," whichever comes first. With respect to widespread disasters, the period of restoration should account for delays caused by limited materials or resources necessary to restore property and operations. Note that some policies limit covered losses to those incurred within a certain timeframe, such as one year. Many policyholders also purchase an extended period of indemnity which extends the loss period beyond the period of restoration and provides insureds with additional time to restore their operations to pre-loss levels.

Potential Limitations on Coverage

An essential question in determining potential coverage for the Japanese crisis is whether the policy has earthquake, earth movement, flood and nuclear exclusions. The existence of such exclusions in the policy, however, does not end the inquiry. In many instances, the damage to the premises can be caused in part by other covered perils. Likewise, the wording of such exclusions may limit or negate their application.

Another issue is whether the collateral harm caused by the disaster is covered. The Japanese earthquake and tsunami caused extensive damage to the country's infrastructure. Thus, facilities that were unharmed directly by the earthquake may be unable to operate due to a loss of power, lack of other basic utilities, or government closures of roads or airports. When governmental and other functions are impeded, collateral damage to a facility also may occur, thus triggering coverage. Businesses therefore should determine if their property policy includes computer interruption, ingress/egress obstruction, service interruption, civil authority interruption and/or disruption due to a nuclear crisis as covered risks. Property policies may include these additional coverages or the coverage may have been specifically added by endorsement. *See, e.g., Penton Media v. Affiliated FM Ins. Co.*, 245 Fed. Appx. 495 (6th Cir. 2007) (relying on civil authority endorsement language to decide coverage as to the particular convention center location at issue).

It is important that the policyholder take proactive steps to contemporaneously investigate and preserve critical evidence of damage. Policyholders should not assume that an insurer's alleged defenses will defeat insurance coverage, but rather may want to consider retaining insurance counsel to investigate the applicable law, facts and coverages relevant to a claim.

Conclusion

Companies facing potential BI or CBI losses arising from the crises in Japan should immediately review their property insurance policies. In circumstances where coverage may be available, an insured's next steps should include assembling their internal and external insurance coverage team, as well as timely and prompt notice of all potential claims. Businesses also should determine if their policy portfolio includes computer interruption, service interruption, civil authority interruption and/or disruption from a nuclear reactor crisis as covered risks.

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Latham's Preeminent Insurance Coverage Practice

Latham & Watkins has a preeminent insurance coverage group and is one of the only global law firms that exclusively represent policyholders in coverage disputes. Latham has extensive experience with business interruption policies and has represented many corporations in pursuing insurance coverage after natural disasters.

Endnotes

1 "'Extra Expense' is defined in this policy to mean necessary expenses you incur during the 'period of restoration' that you would not have incurred if there had been no direct physical loss or damage to property caused by or resulting from a Covered Cause of Loss." See Insurance Services Office, Inc. (ISO) Business Income (and Extra Expense) Coverage Form, CP 00 30 04 02, ¶ A.2.

2 Insurance Services Office, Inc. (ISO) is a nonprofit trade association that provides rating, statistical, and actuarial policy forms and related drafting services to property and casualty insurers across the country. ISO develops standardized forms of certain types of insurance policies. Once these forms are approved by ISO's constituent members and submitted for state agency review, the standardized language is available for use throughout the insurance industry.

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