

Gilbert LLP (United States)
Covering The Ripple Effect: How Insurance Can Help Offset
Auto Industry Losses From The Recent Earthquake And
Tsunami In Japan
16 May 2011

By Mr. Barry Buchman

Although the media properly has focused primarily on the human tragedy caused by the recent earthquake and tsunami in Japan, much also has been written about the potential economic ripple effect of those events, particularly within the auto industry. The auto industry is particularly susceptible to losses caused by supply chain disruptions in Japan because of the industry's reliance on imports of component parts from that country. The scope of potential auto industry losses is currently unknown due to the fluid nature of the situation, and commentators are not unanimous in their assessments. They generally agree, however, that the ripple effect could last for a while.¹

Auto industry companies may be able to protect themselves from at least some of these losses by accessing various types of coverage that likely are included within their "first-party" property damage policies.² Significantly, these policies often can provide coverage for much more than physical damage to property, such as lost profits; indeed, companies may be able to obtain coverage even if they did not sustain any damage to their own facilities, if they have experienced, or experience in the future, an interruption of their business due to property damage sustained by a supplier or customer.³

This article briefly summarizes the main categories of losses that may be covered under typical property damage policies, and it previews some of the coverage disputes that may arise. The article also identifies steps that companies should take now to preserve their right to pursue an insurance claim later if necessary.⁴

Types of Potentially Insured Losses

The most basic type of loss that may be covered by insurance is property damage to facilities in Japan. Some domestic auto industry companies, for example, have facilities in Japan; those facilities may have sustained structural damage due to the earthquake, or sustained water damage from the tsunami, or been damaged in fires precipitated by the earthquake or tsunami. A typical property policy would cover the cost of rebuilding or repairing such a facility, if the facility is a "covered property" and if the event giving rise to the damage is a "covered cause of loss."

Another type of potentially covered loss is lost profits caused by property damage in Japan, whether the damage is to a company's own facilities or to the facilities of its suppliers and/or customers. These

types of losses generally fall into one of two categories of coverage: coverage for “business interruption” losses and coverage for “contingent business interruption” losses. “Business interruption” losses occur when a company loses profits due to damage to its own facilities. “Contingent business interruption” losses occur when a company loses profits due to the inability to get materials from a supplier or to sell its products to a customer, due to property damage sustained by that supplier or customer at one or more of its facilities.

A third category of loss that may be covered consists of additional expenses that companies incur in order to address the impact to their business of the disaster in Japan. These types of losses often fall under the “extra expense” coverage of a typical property policy. Companies, for example, may incur expenses to shift production away from damaged plants to other facilities. Companies also may incur “extra expense” if, during the period that their normal suppliers cannot operate, the companies have to use more expensive suppliers. Further, property policies also may cover costs incurred to repair damaged property, and fees for professional services, e.g., from accounting firms and consultants, that are necessary to help companies address the impact of the disaster.

Potential Coverage Disputes

One dispute that often arises under property policies is whether there has been physical damage to insured property, which, as noted, typically is required for business interruption and contingent business interruption claims. For example, an insured company or its supplier may not have sustained physical damage to its factory, but because of contamination of the building caused by the aftermath of a disaster, and/or because of a lack of power or an inability to get people and items in and out of the property, the company or supplier cannot use the facility.

Auto industry companies have several tools at their disposal to address such disputes. There are some court decisions, for example, that equate physical property damage with loss of use of a facility due to contamination. Further, even if neither an insured company nor its direct suppliers have sustained physical property damage, some courts have interpreted the term “supplier,” for contingent business interruption purposes, to include more than direct suppliers, e.g., suppliers of direct suppliers, and those indirect suppliers may have sustained physical property damage. Many property policies also provide “civil authority” coverage, which typically covers business interruption losses caused by an order, such as a curfew or an airport closure, that prevents use of one or more insured facilities. Although such provisions often provide coverage only when the civil authority order results from property damage, civil authority provisions tend to vary materially between policies, and not always in obvious ways, so a careful examination of the precise language is critical. For example, after the terrorist attacks of September 11, 2001, U.S. Airways and United Airlines each litigated with their insurers over whether their civil authority coverage provisions applied to losses caused by the closure of Reagan National Airport. U.S. Airways won, and United lost, the merits of that coverage dispute, based on nuanced differences in the language of their civil authority provisions.⁵

Another dispute that often arises under property policies, and that likely will arise in the context of the disaster in Japan, is whether property damage and business interruptions have been caused by a covered peril or instead by an excluded one. Property policies, for example, may provide coverage for floods but exclude earthquakes, or vice versa. And virtually all policies have an exclusion for damage and losses arising from nuclear radiation.⁶

Thus, there may be disputes about whether damage and business losses were caused primarily by the earthquake, the tsunami, or the radiation leaks from the nuclear power plants. Insurance law doctrines such as the “efficient proximate cause” doctrine and the “concurrent causation” doctrine may allow policyholders to overcome insurance company efforts to rely on exclusions like the ones just referenced. For example, if the facility of an insured company or its supplier was damaged by a fire precipitated by the earthquake, and the company’s policy excludes earthquakes but covers fires, the company may be entitled to coverage under these doctrines. The insurance industry has attempted to contract around these causation doctrines through the use of so-called “anti-concurrent causation clauses.” Courts have taken differing approaches to these causation doctrines and to anti-concurrent causation clauses; thus, as in many insurance disputes, the issue of which jurisdiction’s law applies to these issues will be important.

There is another reason why insurers and policyholders may dispute which event was the primary cause of damage and losses: property policies often provide different sub-limits of coverage for different types of events, e.g., different policy limits for earthquake coverage and for flood coverage. Thus, there may be issues about how to characterize a particular loss and claim.

Insurers also may challenge the efficacy of loss mitigation measures that auto industry companies adopt to address the ripple effects of the disaster. Typical property policies require policyholders to undertake such measures. Insurer challenges to such measures, unfortunately, are not uncommon. For example, in a case involving insurance coverage for residual value losses on a large portfolio of automobile leases, the insurer attacked the leasing company’s lease-termination practices, such as its protocols for collecting excess damage, and its remarketing practices, such as its use of alternate sales channels in addition to auctions.⁷ Fortunately, the insurer’s attacks were unsuccessful. Insurers do not know how to manage automotive businesses as well as the industry companies that actually run them, so policyholders should be prepared to defend their business decisions. Further, under many property policies, policyholders may be able to recover expenses incurred in order to mitigate loss.

Finally, there may be disputes about how many “occurrences” transpired during the disaster in Japan. This issue may arise because some policies treat earthquakes, floods, and fires all as covered “occurrences”, and the policies have only “per occurrence” policy limits; they do not have aggregate policy limits that apply regardless of the number of “occurrences.” Thus, a policyholder may be able to obtain additional coverage if more than one “occurrence” contributed to its losses.

Practical Pointers for Preserving Insurance Rights

It is critical that companies act proactively to protect their rights by promptly giving at least precautionary notice, absent business reasons to refrain from doing so. Moreover, companies should consider approaching their insurers about postponing, or “tolling,” the referenced proof of loss and lawsuit deadlines, by agreement. Insurance companies often are willing to do so in fluid situations like the one arising out of the disaster in Japan. Note, however, that some jurisdictions differ in their rules regarding the extent to which parties can enter into such “tolling” agreements, and thus an examination of the applicable law is necessary.

Third, companies should carefully document their property damage, lost revenues, and additional expenses, and they also should set up protocols for communicating both internally and externally

about any losses and insurance issues. Because of the fluid nature of the situation, and because of the nuances in the coverage issues raised, such protocols are important to help protect against inadvertent characterizations regarding the nature or cause of losses, for example, that insurance companies might use later if a coverage dispute arises. Thus, companies should consider involving their legal departments in such communications.

Finally, because of the complicated coverage questions and potential procedural traps previewed here, companies should consider consulting with experienced professionals, such as insurance brokers, accounting consultants, and coverage counsel, who can help prepare for a potential coverage claim.

Conclusion

The coverage provided by an automotive company's insurance policies can be an extremely valuable business asset. Companies can maximize the benefits of that asset, and minimize the chances of protracted disputes later, by acting proactively now to assess and preserve their rights.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

Mr Barry Buchman
Gilbert LLP
1100 New York Avenue, NW, Suite 700
Washington, DC
20005
UNITED STATES
Tel: 2027721960
Fax: 2027721933
[E-mail: katkine@gotofirm.com](mailto:katkine@gotofirm.com)
[URL: www.gotofirm.com](http://www.gotofirm.com)

(c) Mondaq Ltd, 2011 - Tel. +44 (0)20 8544 8300 - <http://www.mondaq.com>

¹ See Susan Aluise, *Auto Supply Chain Broken By Japan Woes*, InvestorPlace, Apr. 14, 2011; David Sedgwick, *Japan Parts Shortage Looming, Suppliers Say*, Automotive News, Apr. 12, 2011; Avi Salzman, *Toyota To Close Plants, Supply Shortages Spreading Through Auto Industry*, Barron's, Apr. 5, 2011; Peter Valdes-Dapena, *Japan Earthquake Impact Hits U.S. Auto Plants*, CNNMoney.com, Mar. 30, 2011; Hans Greimel, *Japan Production Shutdowns, Slowdowns To Go Well Into April*, Automotive News, Mar. 30, 2011; Peter Valdes-Dapena, *Ford, Chrysler Restrict Colors for New Cars*, CNNMoney.com, Mar. 28, 2011; John Reed and Bernard Simon, *Car Components Hit By Japan Aftershock*, Financial Times, Mar. 28, 2011; Elaine Kurtenbach and Sharon Silke Carty, *With Shortages Looming At Car Dealerships and Factories, The Global Auto Crisis Deepens*, The Washington Post, Mar. 28, 2011; *Chip Shortage: Auto Makers' Biggest Threat?*, The Wall St. J., Mar. 28, 2011; Mike Ramsey, *Parts Shortages Will Impact U.S. Auto Makers for Months*, The Wall St. J., Mar. 23, 2011.

² "First-party" policies typically cover losses sustained directly by an insured business, e.g., damage to its facilities and any resulting loss of profits. "Third-party" liability insurance typically covers litigation costs and any

ultimate judgments or settlements that an insured company incurs in defending claims made against it by third parties.

³ See, e.g., *GM Puts Insurers On Notice of Potential \$1bn CBI Claim*, The Insurance Insider, Apr. 12, 2011.

⁴ This article provides an overview of general principles and a non-exhaustive set of examples of the issues and arguments that may arise. Actual legal advice should be based upon an evaluation of all facts and circumstances, including specific policy language and the law of the pertinent jurisdiction(s).

⁵ U.S. Airways' victory was later vacated on appeal, on grounds independent of the merits of the policy interpretation dispute between U.S. Airways and its insurer.

⁶ Most property policies fall into one of two categories: "all risk" policies cover damage to covered property and any corresponding business interruption that are caused by perils not specifically excluded; "named peril" policies covers property damage and business interruption caused only by those peril specifically identified. Exclusions are particularly important in "all risk" policies, but even "named peril" policies may have exclusions for certain losses caused by an otherwise covered peril.

⁷ The author and his firm were counsel for the automotive leasing and finance company that brought the residual value insurance case.