TWO DEGREES OF SEPARATION

DEFINING YOUR **SUPPLY CHAIN** IS THE KEY TO DEFINING COVERAGE

BY DAVID F. KLEIN AND INESSA MIRKIN

IT is a well-worn truism that the answer you get depends on the question you ask.[1] This axiom could hardly be better illustrated than in the world of insurance—and within that world, no doubt the richest continent is the one wherein "contingent business interruption" dwells.

What is "contingent business interruption"? It depends on whom you ask. Whatever it is, insurance companies long have sold products to protect against it, whether in the guise of general, "all risks" coverage (first party, time element, business interruption), or specialized contingent business interruption policies or endorsements. In general terms, contingent business interruption (CBI) is the loss a policyholder suffers when some catastrophe prevents a key supplier from providing goods or services essential to the continuity of the policyholder's own business.[2] To cite just one example, it was reported that after the Japanese tsunami of 2011, numerous automobile manufacturers in the United States were forced to interrupt production of models in certain colors because the necessary pigments were supplied by a single Japanese manufacturer whose operations were interrupted by the disaster.[3] Given the increasingly interconnected nature of supply chains over the world, in a major corporate setting the potential supply chain risks may be too numerous to quantify and exceedingly difficult to assess. For their part, insurers struggle with understandably conflicting impulses to meet the increasing demand to cover these contingencies adequately while trying to define and cabin their unquantifiable and potentially infinite exposures.

When policyholders buy insurance, they are paying a premium in exchange for relief from uncertainty; and when they buy CBI coverage, they think they are buying security against the unanticipated risk that a catastrophe affecting someone—somewhere—will interrupt their *own* operations indirectly. But not all policies are the same. The emerging case law suggests that policyholders are too often disappointed to learn that—in a world where suppliers have suppliers and depend on services provided by entities altogether unknown to the policyholder—there is no coverage for a host of risks, perhaps the majority of risks, that may interrupt their own operations. In short, insurers have little sympathy for the "Kevin Bacon" argument. That is, unless you have negotiated the right terms and paid the right premium, insurers are not impressed to learn that you are only "six degrees of separation" from the supplier whose disaster has disrupted your own business.

At a glance, the emerging case law seems dizzyingly inconsistent. But it is our thesis that it actually illustrates a more or less consistent theme. The answer you get depends on the question you ask. Under your policy, what is a "supplier"? Policyholders are well advised to seek a definition broad enough to cover their needs. But first, they need to ask the right question. And they need to know the answer they want in return.

This article reviews some of the case law concerning CBI coverage that has emerged to date. It considers the case of "traditional" suppliers (you may think of them as "first-degree" suppliers); foreign suppliers; suppliers of computer-based services (itself an emerging market that is certain to spawn a host of new coverage issues); and suppliers of suppliers (second-, third-, and *n*th-degree suppliers, in the Kevin Bacon world). It suggests that policyholders can best limit their uncertainty by defining it—and the surest way to do that is to obtain a definition of "supplier" (or the equivalent policy term) broad enough to encompass the *entire* risk they are seeking to insure.

The First Degree: "Traditional" Suppliers

The most obvious place to start is with the traditional notion of a "supplier"—a direct supplier of goods or services to the insured. To restate a thesis from our introduction, the purpose of CBI coverage is to protect policyholders who experience loss as a result of damage to property of a supplier on whom the policyholder's business depends. Depending on the business context and the policy language, courts have diverged on just who a supplier might be.

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TIP

Know and understand each link in your client's supply chain and ensure that policy language is broad enough to cover any disruption along the chain that could significantly disrupt your client's business.

In one of the leading cases discussing CBI coverage, *Archer-Daniels-Midland Co. v. Phoenix Assurance Co. of New York*, the court interpreted the policy's broadly worded CBI provision to include an indirect supplier.[4] The CBI endorsement in that case covered damage to property of "*any* supplier of goods or services which results in the inability of such supplier to supply an insured locations [sic]."[5] The policyholder, a processor of farm products for domestic and international consumption, was unable to transport its goods via the Mississippi River system due to unprecedented flooding. Focusing on the "any supplier" language in the CBI endorsement, the court concluded that the United States Army Corps of Engineers and the United States Coast Guard, which operate and maintain the Mississippi River system, were "suppliers of goods and services" under the policies, despite the lack of a contractual relationship.[6] The court reasoned that "[f]unding the construction and maintenance of the physical infrastructure of the Mississippi River through the fuel taxes imposed on the users of that system easily brings the Corps and the Coast Guard within the plain meaning of the term 'any supplier of goods and services.'"[7]

In a related case, the court took a similarly broad view of the CBI endorsement, concluding that the policyholder did not have to specifically identify each particular grain supplier who was unable to supply it with grain.[8] As in the earlier *Archer-Daniels-Midland* case, the CBI endorsement referred to "any" supplier, which the court defined to include those farmers who supplied or *could have supplied* grain to the policyholder.[9]

The *Archer-Daniels-Midland* line of cases represents one of the broadest interpretations of "supplier," relieving policyholders from having to have a contractual relationship with each supplier and from having to name each individual supplier in the policy. In each case, the court drew upon the broad language the insurer had used in describing the coverage ("*any* supplier") and no doubt had in mind the reasonable expectations of an insured who has suffered an *actual* loss because of a disruption of goods and services necessary to conduct its business. However, today's market realities make it unlikely that such broad policy language would make it past the underwriting stage. And indeed, subsequent cases have taken a narrower view of the term "supplier."

In a more recent case, the Eighth Circuit interpreted the term "supplier" to mean companies in contractual privity with the policyholder. In *Pentair, Inc. v. American Guarantee & Liability Insurance Co.*, an earthquake disabled a substation that provided electric power to two Taiwanese factories.[10] As a result, the factories were unable to manufacture products they supplied to subsidiaries of the policyholder, Pentair. Rejecting Pentair's argument that the electric substation was a supplier within the meaning of the CBI provision in its policy, the Eighth Circuit concluded that the power company "was not a Pentair supplier . . . because it supplied no goods or services to Pentair, directly or indirectly."[11] Significantly, the CBI endorsement in *Pentair* provided coverage for losses incurred by Pentair as a result of damage to "property of a supplier of goods and/or services to the Insured."[12] The court read this language to limit coverage to "suppliers in direct contractual privity" with Pentair, unlike the policy at issue in *Archer-Daniels-Midland Co. v. Phoenix*. (Note that, unlike the language in *Archer-Daniels-Midland*, the policy did not extend to "any" supplier and was expressly limited to suppliers of "goods and/or services *to the Insured*.") Moreover, over the policyholder's protestation that a power outage constituted a loss of services, the court held that a power outage to the insured's supplier did not constitute either physical loss or damage to property, or a loss of services to the insured.[13]

How these differing interpretations of what constitutes a supplier for purposes of CBI coverage will impact businesses with modern-day supply chains is worthy of some examination.

The Second Degree: Foreign Suppliers, or the Limitations of Territorial Limits

As the turbulent events of the past year demonstrate, these days many large corporations purchase

David F. Klein *is a partner in the Washington, D.C., office of Orrick, Herrington & Sutcliffe LLP. He represents insurance policyholders in litigation, settlement negotiations, and alternative dispute resolution in coverage disputes involving business interruption, property damage, environmental liability, general commercial liability, directors' and officers' liability, and a range of other matters.* **Inessa Mirkin** *is an associate in the commercial litigation practice of the same firm. Her experience includes representing policyholders in insurance coverage disputes. They can be reached, respectively, at dklein@orrick.com and imirkin@orrick.com.*

necessary materials or products for their businesses overseas. The reasons are many, but it appears that to be competitive, companies engage in "global sourcing" more and more in order to reduce costs.[14] One need only look to the impacts of the devastating earthquake and tsunami in Japan or of the unprecedented massive flooding in Thailand to get a sense of the interconnectedness of today's economy.[15] In light of unfortunate events like these, policyholders rightly wonder whether they would be covered in the event of similar losses. The question boils down to whether suppliers in foreign countries are covered under CBI provisions.

As the *Archer-Daniels-Midland* and *Pentair* cases illustrate, policy wording is key. The broader the language, the more likely it is that losses resulting from damage to the property of a supplier—even one located thousands of miles away—will be covered.

In a recent case examining this scenario, the U.S. District Court for the Eastern District of New York considered an insurer's argument that, to be covered under the CBI provision in its policy, physical property damage and the loss of business must have occurred within the policy's territorial limits.[16] In *Park Electrochemical*, the policyholder operated two subsidiaries that manufactured certain products used in circuit boards and other materials in the telecommunications, computing, and aerospace sectors. An explosion at the Singapore-based subsidiary left the Arizona-based subsidiary without supply of a crucial component for one of its products. The CBI endorsement in the policy provided:

> [Continental] will pay for the loss resulting from necessary interruption of business conducted at Locations occupied by the Insured and covered in this policy, caused by direct physical damage or destruction to:
>
> a. any real or personal property of direct suppliers which wholly or partially prevents the delivery of materials to the Insured or to others for the account of the Insured . . . .[17]

The policy identified 15 "Named Locations" within the United States. In addition, the coverage territory of the policy was limited to "[t]he United States of America, including its territories and possessions, and Canada."[18]

Park Electrochemical submitted a claim under the CBI provision seeking coverage for the Arizona subsidiary's lost sales. The insurer denied coverage, arguing that the Singapore facility was not a covered location and was excluded by the policy's territorial limits. The court rejected this argument, reasoning that the "loss covered is not physical damage to property but a financial shortfall, and that shortfall must occur within the territorial limits of the policy."[19] And so it did. The policy provided merely that the financial losses must be "caused by direct physical damage or destruction to . . . any real or personal property of direct suppliers."[20] It did not place a territorial limitation on where the "direct physical damage or destruction" must occur. Therefore, the court concluded that the business interruption loss occurred in Arizona, where the financial shortfall took place. This was within the policy's territorial limits, even though it was caused by direct physical damage to a direct supplier located in Singapore.[21]

Park Electrochemical suggests that suppliers in foreign countries may indeed be "suppliers" for purposes of CBI coverage. But policyholders should also recognize in this decision the cautionary note that there was nothing to stop the insurer from placing a territorial limitation on where "direct suppliers" must be located for coverage to attach.[22] Absent any *explicit* language to the contrary, there is likely nothing preventing losses resulting from damage to a foreign supplier from coming within CBI coverage.[23] However, insurers are likely to place more stringent territorial limitations in their policies and—unlike in the *Park Electrochemical* case—define the term "direct suppliers" as narrowly as possible to limit exposure to uncertainties in foreign countries. The constant refrain in CBI cases addressing the supplier issue is thus, "Beware! Policy language is key. Remember to ask the right question."

A Degree Apart: Suppliers of Computer-Based Services

To date, no cases have addressed coverage for losses resulting from cybersecurity-based business interruptions of a supplier of computer services, such as cloud providers or network hosts. But the issue is a ripe one, in light of recent cyber attacks at numerous major corporations and inevitable periodic system outages that bring business to a halt.[24] While several cases suggest that such suppliers would come within CBI coverage, one case suggests that whether general liability and other standard form insurance policies cover cyber attacks and other data breaches is likely to be a source of contentious litigation.

In *Southeast Mental Health Center, Inc. v. Pacific Insurance Co.*, the policyholder's computer was corrupted as a result of an electricity outage.[25] The policyholder filed a claim under its business interruption policy for loss of income that resulted from its inability to use its computer system to conduct its business, including setting patient appointments and filling prescriptions. The insurer declined coverage on the grounds that the policyholder's losses were "not caused by direct physical loss of or damage to the insured property."[26] In other words, the insurer contended that the losses did not come within the policy's coverage because there was no direct physical damage *to the computer*. The court rejected this argument, holding that "the corruption of the pharmacy computer constitutes 'direct physical loss of or damage to property' under the business interruption policy."[27]

Another court came to the same conclusion several years before *Southeast Mental Health Center*. In *American Guarantee & Liability Insurance Co. v. Ingram Micro, Inc.*, Ingram lost power at its data center.[28] Although power was restored a short time later, the systems in the data center had to be reprogrammed in order to restore full functionality—a process that took eight hours. As in *Southeast Mental Health Center*, the insurer denied coverage for Ingram's resulting financial losses, arguing that Ingram's computer system was not "physically damaged" as a result of the power outage.[29] This, too, was rejected by the court. Indeed, the court concluded that the term "'physical damage' is not restricted to the physical destruction or harm of computer circuitry but includes loss of access, loss of use, and loss of functionality."[30]

Although both of these cases address coverage issues under standard business interruption provisions—not CBI policies—they are instructive in the way they construe the term "physical damage." If physical damage includes loss of access, use, or functionality, then it stands to reason that companies that provide these services may be considered "suppliers" for purposes of CBI coverage. However, in a recent lawsuit filed by Zurich American Insurance against Sony in connection with hacking incidents at Sony, Zurich sought a declaratory judgment finding that it is not obligated to defend or indemnify Sony for claims asserted against Sony as a result of the cyber attacks.[31] Specifically, Zurich argues in part that the claims against Sony did not arise out of "bodily injury," "property damage," or "personal and advertising injury," as provided in Sony's general commercial liability policy.[32] While the lawsuit does not directly address any CBI claims, this case may ultimately determine whether hacking incidents and cyber attacks would come within CBI coverage.[33]

It bears emphasizing once again that policy language is key, particularly when dealing with cybersecurity issues. Some policies may specifically exclude incidents like cyber attacks from coverage. In addition, policyholders with nontraditional "suppliers" like network hosts, cybersecurity providers, and cloud providers may opt to add cyber insurance policies that cover cyber attacks and other computer-based incidents.[34]

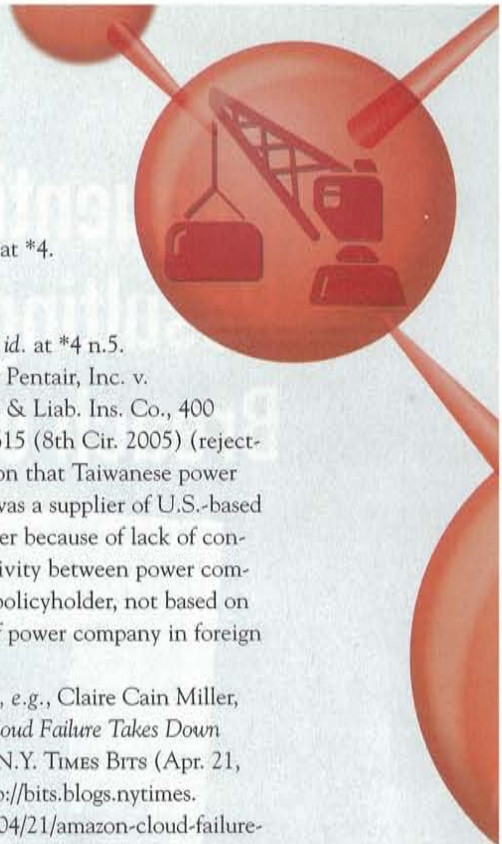
The *N*th Degree: Suppliers of Suppliers

A related consideration in determining whether a particular loss comes within a CBI policy is whether damage to the supplier of a supplier is covered. Most typically—and as in many of the cases already discussed—this occurs when a supplier experiences a loss of power. Although the *Archer-Daniels-Midland* cases held that the broadly worded policies included indirect suppliers like the Army Corps of Engineers and Coast Guard, subsequent cases have taken a narrower approach. Looking once again to *Pentair*, the court in that case concluded that the policy was limited to "suppliers in direct contractual privity" with Pentair.[35] Moreover, the Eighth Circuit held that the supplier's inability to function after a loss of power did not constitute "direct physical loss or damage" to goods produced by the supplier.[36] Thus, "a power outage alone [does not] constitute[] physical loss or damage to property."[37]

Although the Eighth Circuit's interpretation of the term "physical damage" conflicts with the interpretation of this term in *American Guarantee & Liability Insurance Co.*, the court's narrow construction of the term "supplier" may stick. No court since the *Archer-Daniels-Midland* cases has held that indirect suppliers come within CBI coverage, absent identical policy language. Since those cases were decided, CBI coverage has evolved, and supply chains, too, have become more and more complex. Again, it depends on the wording of the specific policy involved, but it is unlikely that a court would take a similarly broad approach, particularly in light of the more modern *Pentair* precedent.

Conclusion

Anyone who has used LinkedIn or one of its equivalents has learned that the Kevin Bacon phenomenon



is real. It is often amazing to learn who is within a degree or two of separation in our chain of acquaintances. A corollary to the Kevin Bacon phenomenon holds sway in the business world. Every company is within six degrees of separation from every other. And just as the political world justified the auto bailout by reference to the domino effects of business failure—just as the 2011 tsunami appears to have had profound ripple effects throughout the global economy—so every business enterprise is connected with and interdependent with every other for its continuity and survival.

Policyholders should be asking the right questions: How much of my risk is really insured? At its core, how broadly does the policy define my supply chain? What is a supplier? Policyholders should look closely at their coverage to make sure it meets their expectations.

Insurers, too, should be asking questions: How many degrees of separation are insurable, or appropriate to insure? At what point does it become impossible to know the answer? Insurer balance sheets have reflected the consequences before, when the answers to precisely these questions were either unknown or imperfectly understood.

The answer you get depends on the question you ask. First, you need to ask the right question. And you need to know the answer you want in return. ■

Notes

1. Arguably this is a corollary to the trial lawyer's maxim: "Never ask a question if you don't already know the answer."

2. There is also a limited market for insurance for the loss a policyholder experiences when some catastrophe interrupts the *market* for the policyholder's goods or services, by disrupting its *customer's* business. Policyholders should not assume this is within the coverage of their CBI policy. If they are seeking such coverage, they should discuss with their brokers the possibility of endorsing the policy to provide explicit loss of market coverage.

3. *See, e.g.*, Keith Naughton, *Ford Curbs Black, Red Paint Use amid Japan Quake Shortage*, Bloomberg (Mar. 24, 2011), http://www.bloomberg.com/news/2011-03-24/ford-limits-use-of-black-red-paints-amid-japan-quake-shortage.html.

4. 936 F. Supp. 534 (S.D. Ill. 1996).

5. *Id.* at 540 (emphasis added).

6. *Id.* at 541.

7. *Id.* at 542.

8. Archer Daniels Midland Co. v. Aon Risk Servs. of Minn., No. Civ. 97-2185 JRT/FLN, 2002 WL 31185884 (D. Minn. Sept. 27, 2002).

9. *Id.* at *3.

10. 400 F.3d 613 (8th Cir. 2005).

11. *Id.* at 615.

12. *Id.* at 614.

13. *Id.* at 617.

14. *See, e.g.*, John Brockwell, *Global Sourcing: Is It Really Worth It?*, Supply & Demand Chain Executive (Mar. 17, 2008), http://www.sdcexec.com/article/10289618/global-sourcing-is-it-really-worth-it; Shawn Casemore, *Five Ways to Revitalize Your Supply Chain*, CFO (Dec. 12, 2011), http://www3.cfo.com/article/2011/12/procurement_supply-chain-growth-casemore-2012.

15. *See* Bill Powell, *The Global Supply Chain: So Very Fragile*, CNN Money (Dec. 12, 2011), http://tech.fortune.cnn.com/2011/12/12/supply-chain-distasters-disruptions/.

16. Park Electrochemical Corp. v. Cont'l Cas. Co., No. 04-CV-4916 (ENV)(ARL), 2011 WL 703945, at *4 (E.D.N.Y. Feb. 18, 2011).

17. *Id.* at *2 (alteration in original).

18. *Id.* at *1.

19. *Id.* at *4.

20. *Id.*

21. *Id.*

22. *See id.* at *4 n.5.

23. *See* Pentair, Inc. v. Am. Guar. & Liab. Ins. Co., 400 F.3d 613, 615 (8th Cir. 2005) (rejecting assertion that Taiwanese power company was a supplier of U.S.-based policyholder because of lack of contractual privity between power company and policyholder, not based on location of power company in foreign country).

24. *See, e.g.*, Claire Cain Miller, *Amazon Cloud Failure Takes Down Web Sites*, N.Y. Times Bits (Apr. 21, 2011), http://bits.blogs.nytimes.com/2011/04/21/amazon-cloud-failure-takes-down-web-sites/.

25. 439 F. Supp. 2d 831 (W.D. Tenn. 2006).

26. *Id.* at 834.

27. *Id.* at 837.

28. No. 99-185 TUC ACM, 2000 WL 726789 (D. Ariz. Apr. 18, 2000).

29. *Id.* at *2.

30. *Id.*

31. *See* Complaint for Declaratory Judgment, Zurich Am. Ins. Co. v. Sony Corp. of Am., Index No. 651982/2011 (N.Y. Sup. Ct. July 20, 2011).

32. *See* Roxanne Palmer, *Zurich Sues Sony over PlayStation Hacking Coverage*, Law360 (July 20, 2011), http://www.law360.com/articles/259448.

33. As of May 2012, the lawsuit was still pending and the coverage issues remained unresolved.

34. *See* Nicole Perlroth, *Insurance against Cyber Attacks Expected to Boom*, N.Y. Times Bits (Dec. 23, 2011), http://bits.blogs.nytimes.com/2011/12/23/insurance-against-cyber-attacks-expected-to-boom/.

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

36. *Id.* at 617.

37. *Id.*