Insurance & Risk Management Update - Winter 2006

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BUSINESS INTERRUPTION COVERAGE - AN ESSENTIAL COMPONENT OF DISASTER PLANNING

Notwithstanding the relatively mild hurricane season this year, emergency planning and business continuity remains essential to every business regardless of size. Prior to any disaster, it is important to assess insurance as a risk mitigation tool. In that regard, Business Interruption (BI) coverage is essential. Yet, many companies do not have this type of coverage.

The purpose of BI insurance is to place the insured in the position it would have occupied had no interruption occurred. The traditional elements of BI insurance are:

- Actual loss of "business income"
- Due to a "necessary suspension" of the insured's "operations" during the "period of restoration"
- Suspension caused by direct physical loss of or damage to property
- Loss or damage must be caused by or result from a "covered cause loss"

"Business Income" is typically defined as net income (net profit or loss before income taxes) that would have been earned or incurred; and continuing normal operating expenses incurred, including payroll.

What constitutes "covered causes of loss" depends on the coverage form. There are generally two forms: Scheduled Perils (Basic and Broad Forms) and All Risk (Special Form). Under the All Risk Form, risks of "direct physical loss" are covered, unless the loss is excluded or limited.

There are a number of issues that come up under BI coverage. Some of these are:

- *Direct Physical Loss* - Term "direct physical loss" is not defined and there are frequently disputes as to what is and what is not a "direct physical loss".
- *Mixed Cause* - How the policy responds when there are included and excluded causes (e.g.,wind vs. rain).
- *Suspension of Operations* - Whether there must be a total suspension of all operations or whether a partial suspension is sufficient to trigger coverage.

- *Period of Restoration* - Whether the period of restoration ends on the date when the property should be repaired, rebuilt or replaced, the date when business is resumed at a new, permanent location, or some other date.

Where there are gaps in BI coverage, the insured needs to assess other types of insurance. In addition to the coverages in the standard form, there are various other coverage extensions, such as: Contingent Business Interruption; Service Interruption; and Ingress/Egress.

Disaster recovery/business continuity planning should include an evaluation of BI and related coverages. As with any insurance contract, the policyholder must read the policy and understand what is covered and what is not. In the event that there is a gap in coverage, the insured should take appropriate steps to fill those gaps, such a with coverage extensions or contractual risk allocation. Finally, the policyholder should keep good documentation and be able to access it in the event of a disaster.

MINNESOTA HIGH COURT RESOLVES REMAINING ISSUES REGARDING COVERAGE FOR CONTINUOUS PROPERTY DAMAGE

In the winter 2005/2006 edition of the Update, we discussed a split between two panels of the Minnesota Court of Appeals regarding how property damage occurring over successive policy periods would be allocated among primary and excess liability policies. *See Mold Cases Help Define Allocation of Property Damage Loss Across Excessive Policies* (GPM Insurance Law Update, Fall/Winter 2005). The Minnesota Supreme Court has now resolved that and several related issues in *Wooddale Builders, Inc. v. Maryland Cas. Co*., 722 N.W.2d 283 (October 5, 2006). Wooddale Builders involved claims for property damage made by homeowners against a construction company resulting from mold problems associated with stucco homes. The main issues before the court in Wooddale Builders were: (1) whether the insurer or insured was responsible for continuing property damages taking place after initial notice of the claim but before the problem had been fixed; and (2) how costs of defending the insured would be allocated among successive carriers.

First, in a very pro-insured ruling, the Minnesota Supreme Court held that continuous property damage is to be allocated from the commencement of "actual injury" to third-party property through the date when the insured receives notice of the damage. Id. at 292. The Court found this approach to be consistent with the "known loss" and "loss in progress" doctrines. Those doctrines are intended to prevent an insured from obtaining coverage for damages that it knows exist at the start of the policy. The Court reasoned that since the insured could not purchase coverage for known or ongoing losses, it would be inequitable to assign responsibility for post-notice losses to the insured.

Second, the court determined that defense costs would be allocated equally among all carriers whose policies are triggered by property damage during their policy periods. Importantly, the court noted that the duty to defend is broader that than duty to indemnify, and the insured need not tender the claim to all of its

carriers in order to receive a complete defense. Rather, the insured is entitled to a complete defense from every one of its carriers on the risk at the time potentially covered property damage is occurring. Id. at 302, citing *Jostens, Inc. v. Mission Ins. Co*., 387 N.W.2d 161, 167 (Minn. 1986) ("when no insurer undertakes the defense of an insured, the insured may recover its defense costs from any of its insurers") (emphasis original). The Wooddale Builders Court clarified that where several insurers have participated in the defense of their common insured, but at different levels, the defense costs should be re-apportioned equally to each of the carriers. The Court felt that this approach "encourages insurers to 'resolve promptly the duty to defend issue.'" Wooddale Builders, 722 N.W.2d at 304, citing Jostens, 387 N.W.2d at 167.

COURT FINDS COVERAGE FOR THIRD-PARTY PROPERTY DAMAGE CAUSED BY INSURED'S OWN FAULTY WORK

Typical commercial business liability policies exclude coverage for damage to the insured's own product or work, or simply for breaching a contract. Common examples of such exclusions include the "contractual liability," "your product," "your work," and "impaired property" exclusions. These exclusions are often equated with what is known as the "business risk" doctrine. Minnesota courts have held that to allow an insured to recover under those circumstances would be to create a disincentive for the insured to properly perform its contractual obligations. See *Wanzek Construction, Inc. v. Employers Ins. of Wausau*, 679 N.W.2d 322, 326 (Minn. 2004).

Business risk exclusions, however, may not apply where the insured's faulty product or work causes damage to property of a third party. This was the situation faced by the court in the *Corn Plus Co-op v. Continental Cas. Co.*, 444 F.Supp.2d 981 (D. Minn. 2006). A mechanical contractor, (Wanzek Construction) was hired to expand Corn Plus's ethanol processing facility. Wanzek was negligent in performing welds as part of the expansion project, causing damages including decreased ethanol production, costs to disinfect the corn mash and clean pipes, plant shutdowns and repair of defective welds. Corn Plus sued Wanzek for recovery of its losses. Wanzek and Corn Plus then entered into what is called a Miller-Shugart settlement agreement, under which Wanzek admitted its negligence and stipulated to entry of a $2.5 million judgment in favor of Corn Plus. Corn Plus, in turn agreed that it would only seek to satisfy the judgment through Wanzek's available insurance coverage.

Wanzek's carriers denied coverage, finding that the claim was barred in total by the business risk exclusions present in the insurance policies. The court held that the damages for repairing or replacing Wanzek's defective welds were barred by the "your work" exclusion. The court further held that the contaminated corn mash did not constitute "impaired property," because the corn mash could not be restored to use by repair or replacement of Wanzek's defective welds. As a result, the court found coverage for consequential damages to the corn mash, including costs of disinfecting the corn mash and cleaning the pipes, and lost income from plant shutdowns associated with those activities.

FOR MORE INFORMATION:

If you have additional questions on these or other insurance or risk management issues, please feel free to contact Nick Nierengarten or Rick Kubler.

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