Insurance Coverage Litigation
FROM THE SECTION OF LITIGATION INSURANCE COVERAGE LITIGATION COMMITTEE

Is There Coverage for Time Element Losses Incurred or Ascertained (Arguably) Outside the Period of Recovery?

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Time element coverage provisions typically state that the policyholder can recover time element losses incurred during the period of recovery (also known as the period of indemnity, the period of interruption, or the period of restoration), which generally is defined as the period of time necessary to repair or to replace the covered property damage. Many policies also provide for an extended recovery period, which provides time element coverage for an additional period of time to allow the policyholder's operations to return to pre-loss levels. While this often is a relatively straightforward and non-controversial concept, disputes tend to arise when, due to the nature of the policyholder's business operations, a physical loss that interrupts the policyholder's business operations takes place during the recovery period but the directly associated revenue loss is not actually sustained or ascertained until after the recovery period has ended. For example, sometimes there is a substantial lag time between production of a product or a component part of a product and the policyholder's ultimate sale of or receipt of payment for the product or service it sells to others. In these situations, production losses during the recovery period can result in revenue losses outside of the recovery period. Additionally, for policyholders that sell goods or services through installment contracts, loss or damage during the recovery period can result in a loss of contracts that would have generated revenue during but also beyond the recovery period. Courts addressing these types of claims have split on whether such losses are covered.

Pennbarr Corp. v. Insurance Company of North America, 976 F.2d 145 (3d Cir. 1992), a case involving contingent business interruption coverage (or, as it turned out, the lack thereof), is a textbook example of a case illustrating the challenges created when there is a significant lag time between a supplier's production of a product and the ultimate sale of that product. In that case, the policyholder sold electromechanical typewriters that were manufactured at factories owned by two of its wholly-owned subsidiaries. Production of typewriters temporarily was suspended when two earthquakes struck one of the typewriter manufacturing facilities in November 1980 and January 1981. *Id.* at 148. The policyholder attempted to mitigate its losses by continuing to sell typewriters until its inventory was depleted. After the typewriter factory resumed normal operations, the policyholder lost sales due to its depleted inventory and submitted an insurance claim for losses arising from physical damage to a contributing property. *Id.* at 147-48. The carrier denied coverage because the losses were not incurred until after the typewriter factory had resumed operations, and litigation ensued. *Id.* at 148.

The district court denied the carrier's motion for summary judgment, finding that the policy's period of indemnity provision was ambiguous. *Id.* at 149. The district court based its conclusion on "the unique nature of [the policyholder's] typewriter business: a long production pipeline and shipping time which resulted in a significant lag time between production and sales and necessitated the maintenance of a substantial inventory." The district court thus found it reasonable to interpret the indemnity period as beginning with the interruption of the sale of typewriters, rather than at the point of interruption of the supply of the contributing plants.

The Third Circuit reversed, endorsing the carrier's position that, in order to be covered, the lost sales must occur simultaneously with the interruption of manufacturing activity. *Id.* at 150, 152. The court further noted that the policy's "resumption of operations" clause required the policyholder to use supplemental inventory acquired from other sources to mitigate its losses (*id.* at 152), a requirement that arguably created a Catch-22 for the policyholder: failing to use extra inventory to meet sales orders could be deemed a failure to mitigate or a failure to satisfy a condition precedent, thereby resulting in a forfeiture of coverage. On the other hand, using extra inventory to fill sales orders until the policyholder depleted its inventory deferred the policyholder's losses until after the period of indemnity had expired.

By contrast, in *National Union Fire Insurance Co. v. TransCanada Energy USA, Inc.,* 28 N.Y.S.3d 800, 52 Misc.3d 455 (2016) , the court held that the policyholder was entitled to coverage for business interruption losses caused by a loss of production during the recovery period even though the amount of the related revenue loss was not ascertained until after the period of liability. In that case, a turbine at one of TransCanada's electricity generating facilities was taken out of service for approximately eight months— from September 12, 2008, through May 18, 2009—to repair a crack in its rotor that had expanded, caused excessive vibrations, and caused a mechanical breakdown. *Id.* at 457. This particular turbine generated approximately 39% of the facility's capacity. *Id.* at 458. The facility's capacity to produce electricity is sold to utilities at auctions, and the amount that TransCanada receives from an auction is based on the auction price and the amount of capacity sold. Thus, TransCanada did not realize or ascertain its payments for capacity sold at auction until the sale occurred, which was after the May 18, 2009, end of the period of liability. TransCanada sought coverage for more than $48 million in lost sales of capacity resulting from the lost capacity sustained during the eight-month period that the turbine was out of service. *Id.* at 457.

TransCanada's carriers denied coverage in part on the ground that "most of TransCanada's approximately $48 million claimed loss of capacity sales were only realized at auctions of capacity held after May 18, 2009," and thus were "incurred after the period of liability ended." *Id.* at 465. The carriers also denied coverage on the grounds that a crack in the turbine formed before the policy incepted, and the policy's capacity payments exclusion applied. *Id.* at 462-65 and 469-70. The court rejected these arguments as well. TransCanada argued that "because capacity revenues are calculated and paid at subsequent auctions, the total amount of its loss includes decreased capacity revenues resulting from the forced outage while [the turbine] was being repaired which were earned or sustained during the period of liability, even though not paid until the auctions were held." The court agreed with TransCanada, finding that its loss of capacity sales after May 18, 2009, constituted an "actual loss sustained during the period of liability." *Id.* at 467-69.

As an initial matter, the court explained that one "purpose of business interruption insurance is to 'return to the insured that amount of profit that would have been earned during the period of interruption had a casualty not occurred.'" *Id.* at 466 (citing *Pennbarr Corp. v. Ins. Co. of N. Am.*, 976 F.2d 145, 154 (3d Cir. 1992)). The court then reasoned that there was no dispute that the physical loss or damage between September 12, 2008, and May 18, 2009, prevented TransCanada from generating any or its usual amount of electricity, and that "when it sold those months of electricity capacity at auctions held after May 18, 2009, it did so at a decreased amount due to its decreased capacity." TransCanada's loss, *i.e.*, the decreased capacity, thus "was not manifest or realized until the auctions were held." The court concluded: "[T]he loss at issue here is the decreased capacity sustained during the period of liability, even though the amount of the loss was not ascertained until after the period of liability when the auctions were held." The court further reasoned that "[a]cceptance of the [carriers'] interpretation of the policy would result in a windfall to them," because they would be relieved of their coverage obligations despite the fact that TransCanada's business was interrupted for months simply because TransCanada did not sustain the revenue loss until months after the repairs to the turbine were made.

In so ruling, the court discussed and relied on two analogous cases (*Nonpareil Corp. v. Hartford Cas. Ins. Co.*, No. 4:10-CV-00500-EJL, 2014 U.S. Dist. LEXIS 35461 (D. Idaho, Mar. 17, 2014) , and *Gates v. State Auto. Mut. Ins. Co.*, 196 S.W. 3d 761 (Tenn. 2005) in which, due to the nature of the policyholders' business models, the policyholders incurred revenue losses outside the recovery period as a direct result of physical losses incurred, and an ensuing business interruption, during the recovery period. *Id.* at 467-68 (citing and discussing *Nonpareil Corp. v. Hartford Cas. Ins. Co.*, No. 4:10-CV-00500-EJL, 2014 U.S. Dist. LEXIS 35461 (D. Idaho, Mar. 17, 2014), and *Gates v. State Auto. Mut. Ins. Co.*, 196 S.W. 3d 761 (Tenn. 2005)). In those cases, the court had found that the losses were covered, reasoning that the revenue losses incurred outside the recovery period would not have been incurred but for the property damage and resulting business interruption that had occurred during the recovery period. One court also had based its conclusion on the nature of the policyholder's business and the purpose of business interruption insurance. It reasoned that the "the insurer's interpretation of the term 'actual loss of business income,' considered with the nature of the insured's business, would defeat the purpose of business interruption insurance, which was to place the insured in the position it would have occupied had the interruption not occurred." *Id.* at 468 (citing *Gates*, 196 S.W.3d at 765). *Cf. Northrop Grumman Corp. v. Factory Mu. Ins.Co.*, No. CV 05-08444 DDP (PLAx), 2013 WL 3946103 at **12, 13 (C.D. Cal., Jul. 31, 2013) (holding that carrier's interpretation of policy's "actual loss sustained" requirement did not "take into account the nature of the contracts in question, namely, long-term ship-building contracts," which "call for an accounting method that takes into account the long term nature of the contracts," such as the percentage of completion accounting method, and explaining that carrier's proposed calculation methodology "would effectively nullify the business interruption insurance that Northrop purchased.").

At the end of the day, regardless of what side of the proverbial "v." you are on, these cases highlight the additional complexities that are presented, and protracted disputes that arise, when a policyholder's business model is one in which there necessarily is a delay between the time that a physical loss or damage interrupts a policyholder's business and the time that revenue losses directly caused thereby are sustained or ascertained.

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