

From Here to Infinity:  
A Brief Overview of the Connection Between Physical Damage  
and Business Interruption Coverage

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# **INTRODUCTION**

In the wake of September 11<sup>th</sup> and as a consequence of the increasing interdependence of individual businesses on other businesses or industries, both locally and globally, policyholders have become more assertive in presenting business interruption claims arising out of events more distant and remote than those traditionally envisioned in underwriting business interruption exposures.

This paper explores the current (December 2003) state of the law regarding the need for covered physical damage and the extension of coverage for denial of access caused by actions of civil authorities. The paper will not discuss Contingent Time Element provisions or cases, nor will it discuss Ingress/Egress provisions. It is not intended to be a comprehensive survey of the cases.

## **CONTRACT LANGUAGE**

There are a wide variety of clauses, many of them manuscript forms, in use. The ISO Business Income and Extra Expense Coverage Form<sup>1</sup> provides:

### **A. Coverage**

#### **1. Business Income**

...

We will pay for the actual loss of Business Income you sustain due to the necessary "suspension" of your "operations" during the "period of restoration". The "suspension" must be caused by direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations.

The current ISO form also includes "civil authority" coverage as an "Additional Coverage:"

We will pay for the actual loss of Business Income you sustain and necessary Extra Expense caused by action of civil authority that prohibits access to the described premises due to direct physical loss of or damage to property, other than at the described premises caused by or resulting from any Covered Cause of Loss.

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<sup>1</sup> ISO form CP 00 30 (4-02 ed.).

# THE BASICS

## 1. Something Has To Happen

Most policies contain language similar to that of the current ISO form which ties a duty to pay under business interruption coverage to the occurrence of covered physical damage to covered property. Most courts enforce that language. A traditional example is *Cleland Simpson Co. v. Firemen's Ins. Co. of Newark, N.J.*,<sup>2</sup> a 1958 decision from the Pennsylvania Supreme Court. Hurricane Diane in 1955 caused a flood which destroyed the municipal water system in Scranton, Pennsylvania. The City, fearing an outbreak of fire with no means to fight it, ordered all stores closed until water service was restored. Cleland Simpson owned a store which was closed for four days as a result. There were no fires.

The policy Cleland Simpson had purchased a named perils policy which covered fire and which included business interruption coverage, including civil authority coverage. The civil authority coverage applied only "when as a direct result of a peril insured against access to the premises described is prohibited by order of civil authority."

The Pennsylvania Supreme Court, adopting the opinion of the trial court, concluded that because no fire had occurred, the losses resulting from the forced closure of the business were not covered.

A more modern example is *Harry's Cadillac-Pontiac-GMC Truck Co., Inc. v. Motors Ins. Corp.*<sup>3</sup> There a snowstorm damaged the policyholder's automobile dealership. That snowstorm also made the dealership inaccessible for a week. The North Carolina appellate court rejected the policyholder's attempt to recover under its business interruption coverage for the week it was inaccessible. The court held:

Plaintiff neither alleged nor offered proof that its lost business income was due to damage to or the destruction of the property, rather all the evidence shows that the loss was proximately caused by plaintiff's inability to access the dealership due to the snowstorm. There was no suspension of business due to the roof damage or the repairs thereto. We hold that, under the language of the business interruption clause of the policy, coverage is provided only when loss results from suspension of operations due to damage to, or destruction of, the business property by reason of a peril insured against.<sup>4</sup>

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<sup>2</sup> 392 Pa. 67, 140 A.2d 41 (1958).

<sup>3</sup> 126 N.C. App. 698, 486 S.E.2d 249 (1997).

<sup>4</sup> 486 S.E.2d at 251-252.

In *Roundabout Theatre Co. v. Continental Casualty Co.*,<sup>5</sup> the insured did not buy coverage with the civil authority extension. The theatre was down the block in New York from the Conde Nast Building, then under construction. After a scaffolding on the Conde Nast Building collapsed into the street and adjacent buildings. The theatre suffered minor damage. After the collapse, the City of New York closed the street for almost a month. As a consequence of the street closure, but not the damage to the theatre, the insured had to cancel 35 performances. The court concluded "the language in the instant policy clearly and unambiguously provides coverage only where the insured's property suffers direct physical damage."<sup>6</sup>

## **2. With Civil Authority Coverage Access Must Be Denied**

An excellent recent example is *730 Bienville Partners v. Assurance Co. of America*<sup>7</sup> an unpublished decision from the Eastern District of Louisiana. There, the policyholder owned a hotel in New Orleans. After the September 11<sup>th</sup> attacks, the policyholder made a business interruption claim on the ground that the closure of U.S. airspace by the federal government on September 11<sup>th</sup> triggered coverage under the civil authority clause. The federal court in Louisiana concluded that the government's actions had not denied access to the hotel:

The terms of the policy are unambiguous. To recover for business losses under the Civil Authority Extension, the loss of business income and necessary expenses must be "caused by action of civil authority that prohibits access to your premises..." While the FAA's closure of the airports and cancellation of flights may have prevented many guests from getting to New Orleans and ultimately to plaintiff's hotels, the FAA hardly "prohibited" access to the hotels.

An even more recent, and published, case is *54<sup>th</sup> Street Limited Partners v. Fidelity and Guaranty Ins. Co.*<sup>8</sup> There, vehicular but not pedestrian, access to the policyholder's Manhattan restaurant was eliminated because of city closure of a street. The insured's employees, suppliers and customers still had access to the restaurant. The New York Court held there was no coverage on two grounds. First, access had not been eliminated. Second, there had not been a complete cessation of business at the insured location.

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<sup>5</sup> 302 A.D.2d 1, 751 N.Y.S.2d 4 (2002).

<sup>6</sup> 751 N.Y.S.2d at 8.

<sup>7</sup> 2002 WL 31996014 (E.D. La. 2002) *aff'd without opinion* 67 Fed. Appx. 248, 2003 WL 21145725 (5<sup>th</sup> Cir. 2003).

<sup>8</sup> 306 A.D.2d 67, 763 N.Y.S.2d 243 (2003).

# **HOW FAR CAN YOU GO WITHOUT LOSING COVERAGE?**

While there is divergent case law, there are areas of commonality regarding when property damage other than to the insured premises where the business interruption loss is sustained will or will not result in coverage for the business interruption loss.

## **1. Close Enough to Home: Damage to a Common Structure**

Damage to the structure occupied by the insured but not to the particular portion occupied by the insured will, when it results in a suspension of operations, support a business interruption claim.

The leading case is *Datatab, Inc. v. St. Paul Fire and Marine Ins. Co.*<sup>9</sup> There, the policyholder occupied two floors of a commercial building. The policy issued by St. Paul included business interruption coverage applicable to damage to the premises in which the insured property was located when that premises was "so damaged as to prevent access to such property." A water main broke in the basement of the building damaging the building's air conditioning system. As a consequence of the damage to the air conditioning system, the insured had to shut down its data processing and computer equipment.

The court found the words "access" and "premises" ambiguous in the fashion they were used in the policy. It held that the deprivation of the ability to use the computer equipment was a denial of access and that "premises" must be interpreted to mean the building as a whole.

## **2. So Near, Yet So Far: Things the Policyholder Failed to Insure**

Sometimes policyholders buy both physical loss coverage and business interruption coverage for only some of their property. The general rule, as illustrated by the following cases, is that if the source of the interruption of business at the insured location is damage to an uninsured (for business interruption) location, there is no coverage.

In *Swedish Crucible Steel Co. v. Travelers Indem. Co.*,<sup>10</sup> the insured operated a plastics and foundry manufacturing facility. The facility consisted of eight buildings. For reasons not explained in the opinion the insured purchased a separate business interruption policy for the foundry building, Building 1, from the business interruption policy it had purchased to cover the other seven buildings. There was a fire in Building 2 which damaged various molds, dies and patterns used in the operation of the foundry,

<sup>9</sup> 347 F. Supp. 36 (S.D.N.Y. 1972).

<sup>10</sup> 387 F. Supp. 231 (E.D. Mich. 1974).

Building 1. The insured sought to recover its business interruption losses for Building 1 from Travelers, who insured that building.

The court held that business interruption coverage under the Travelers policy was limited to interruptions caused by covered physical damage to Building 1, and interruption of business caused by damage to the uninsured (by Travelers) Building 2 was not covered by the Travelers policy. In reaching that conclusion, the court expressed the fear that finding coverage would encourage insureds to insure only their most important properties with the expectation that business interruption coverage on that property would provide them some protection regardless of which property was damaged.

In *Gregory v. Continental Ins. Co.*,<sup>11</sup> the insured operated a golf course. The insured purchased a property policy covering the course office, pro shop and restaurant which included business interruption coverage for that structure (other structures were also insured, apparently without business interruption coverage). A hurricane seriously damaged the office/pro shop/restaurant building. More importantly to the insured's business, it blew trees and other debris onto the course. The course was closed for about two weeks while the course was cleared. The insured sought to recover business interruption losses not only for the pro shop and restaurant, but also for the course as a whole. The Mississippi Supreme Court held the business interruption coverage on the office/pro shop/restaurant did not extend to losses caused by the entire golf course being shut down.

In *St. Mary's Foundry, Inc. v. Employers Ins. of Wausau*,<sup>12</sup> patterns owned by the insured's customers but necessary to the insured's business burned. Although the building in which they were stored was a covered location, the patterns themselves were not insured property. The Sixth Circuit held that because the patterns were uninsured, their loss was not a covered loss which would entitle the insured to payment for its business interruption loss.

### **3. Mutually Beneficial Relationship or Mutual Dependency?**

A 1931 decision of the New Hampshire Supreme Court, *Studley Box and Lumber Co. v. National Fire Ins. Co.*,<sup>13</sup> has inspired more policyholder attorneys than courts in recent years. Studley Box occupied a series of more or less adjacent buildings as part of its box factory and mill. Portions of the facility were horse powered. The stable and some of the horses were destroyed in a fire. The insured sought to recover for the additional expense of hiring horses to operate the mill until it could replace those which it had lost. National Fire issued a business interruption policy which described the principal structures at the facility in general terms, but did not identify various secondary structures, including the stable. The court held that the policy's description of the insured property was general only and extended to the entirety of the insured's facilities.

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<sup>11</sup> 575 So.2d 534 (Miss. 1991).

<sup>12</sup> 332 F.3d 989 (6<sup>th</sup> Cir. 2003).

<sup>13</sup> 85 N.H. 96, 154 A. 337 (1931).

More importantly, the New Hampshire court also held that the various structures were mutually dependent so that business interruption losses at all of them could be recovered on account of damage to a single insured structure.

Modern courts have distinguished *Studley*. The leading case is *Ramada Inn Ramogreen, Inc. v. Travelers Indem. Co.*<sup>14</sup> There, the Eleventh Circuit, applying Florida law, held that a hotel owner could not recover under its business interruption coverage for reductions in its hotel room occupancy occasioned by the destruction of the on premises restaurant. The hotel and restaurant had been insured by a single policy, but with different limits for each. The court rejected the policyholder's argument that the mutual dependency doctrine of *Studley* should be applied. In doing so it looked to the structure of the policy observing that the restaurant was insured with a separate limit of liability. It also noted that the insured had failed to rebuild the restaurant after the fire, which it took as evidence that there was no mutual dependency between it and the hotel.

The Eleventh Circuit relied heavily on *Hotel Properties Ltd. v. Heritage Ins. Co.*<sup>15</sup> in deciding *Ramada Ramogreen*. *Hotel Properties* also involved damage to a hotel restaurant, but it did not address the mutual dependency issue. There, the restaurant was operated by a tenant of the insured. The insured claimed a business interruption loss based on the reduction in occupancy of the hotel after the closure of the restaurant. The Court of Appeals of Florida held that the business interruption policy did not cover a diminution in volume of the insured's business and thus found no coverage.

The insured fared even more poorly in *Royal Indem. Ins. Co. v. Mikob Properties, Inc.*<sup>16</sup> There the insured property was a three building waterfront apartment complex near Houston. The building closest to the water burned. Asbestos was discovered in the debris and access to the waterfront amenities disappeared for an extended period of time. Not surprisingly, the complex in its post-loss condition was less attractive to tenants and occupancy rates in the two undamaged buildings dropped significantly in the months following the fire. The insured sought to recover for the diminution in its business in the two undamaged buildings. The district court, applying Texas law, held there was no mutual dependency and no covered loss because operations in the undamaged buildings were not suspended.

#### **4. Not In My Backyard: Civil Authority Claims and Moderately Distant Damage**

In *Syufy Enterprises v. Home Ins. Co. of Indiana*,<sup>17</sup> the policy's civil authority coverage extended to losses "as a direct result of damage to or destruction of property adjacent to the premises herein described by the peril(s) insured against, access to such described premises is specifically prohibited by order of civil authority." Syufy, a

<sup>14</sup> 835 F.2d 812 (11<sup>th</sup> Cir. 1988).

<sup>15</sup> 456 So.2d 1249 (Fla. Ct. App. 1984).

<sup>16</sup> 940 F. Supp. 155 (S. D. Tex. 1996).

<sup>17</sup> 1995 WL 129229 (N.D. Cal. 1995) (unpublished disposition).

major theater operator in the western states owned theaters in Las Vegas, Los Angeles and San Francisco which were closed as a result of curfews imposed after the Rodney King riots in 1992. Although no civil authority ever specifically prohibited access to an insured location and no property damage occurred adjacent to or even within two blocks of a Syufy theater, Syufy sought to recover its losses under the civil authority coverage. The district court held there was no coverage because no civil authority ever specifically denied access to any of the insured's theaters.

## **5. For the Want of a Nail: Damage to Suppliers**

Here, much depends on the language of the policy. Some policies cover losses resulting from damage to supplier facilities while others do not. Even when damage to supplier facilities is covered, whether there is coverage depends on the relationship between the insured and the entity claimed to be a supplier. Physical distance is less important than the actual policy language.

The best known modern case is *Archer-Daniels-Midland Co. v. Phoenix Assurance Co. of New York*.<sup>18</sup> ADM involved the 1993 Mississippi River floods which disrupted the supply chain for ADM. ADM incurred extra expenses transporting goods and for raw materials which it could not obtain due to the halting of barge traffic on the Mississippi and its tributaries. In addition to analyzing the particular language of the policies with respect to the property damage requirement (it found that language ambiguous), the district court also analyzed whether Midwestern farmers and federal agencies were suppliers within the meaning of a clause extending coverage for losses resulting from damage to real or personal property of "any supplier of goods or services."

The district court held that both the Army Corps of Engineers (responsible for the locks on the rivers) and the Coast Guard (responsible for aids to vessel navigation) were suppliers to ADM. It also held that farmers who were indirect suppliers to ADM because title to their products passed through grain dealers enroute to ADM, nonetheless were suppliers for purposes of the policy.

*Pentair Inc. v. American Guarantee and Liability Ins. Co.*,<sup>19</sup> an unpublished decision from the District of Minnesota, arose out of an earthquake in Taiwan which resulted in the cutting off of electrical power to one of the insured's suppliers there, thus stopping the supplier's production temporarily. The insured claimed that because of the delay in production, it incurred additional transportation costs air freighting goods from Taiwan. The court concluded there was no coverage because there had been no direct physical loss to the supplier; the loss had damaged the electrical utility who was a supplier of the Taiwanese supplier. It held that physical damage to the electrical

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<sup>18</sup> 936 F. Supp. 534 (S.D. Ill. 1996). This opinion is but one of many associated with ADM's lengthy set of efforts to find someone to pay its losses resulting from the 1993 flood. See also, 975 F. Supp. 1124 (S.D. Ill. 1997), 975 F. Supp. 1129 (S.D. Ill. 1997), 975 F. Supp. 1137 (S.D. Ill. 1997), *Archer Daniels Midland Co. v. Hartford Fire Ins. Co.*, 243 F.3d 369 (7<sup>th</sup> Cir. 2001) and *Archer Daniels Midland Co. v. Aon Risk Services*, 2002 WL 31185884 (D. Minn. 2002).

<sup>19</sup> 2003 WL 21804874 (D. Minn. 2003).

substations in Taiwan was "too remote to entitle Pentair to coverage." *Id.* The court distinguished *ADM* on the basis that the policy language in the American Guarantee policy was more narrow. That policy provided coverage when there was damage by covered perils to "property of a supplier of goods and/or services to the Insured." In contrast, the *ADM* policy applied to "any supplier of goods or services" and did not include the "to the Insured" limiting language of the American Guarantee policy.

## **CONCLUSION**

While there are circumstances in which losses which might not be covered under most policies are covered as a consequence of unusual policy language, and there are instances in which result-oriented jurisprudence prevails over contractual language and majority precedent, as a general proposition, the physical damage requirement is alive and well. At this writing, however, there remain of cases pending arising out of the events of September 11, 2001, in which the physical damage requirement and/or the denial of access requirement of the civil authority extension will be tested.

Today, we live in an interdependent world in which events happening thousands of miles away to perfect strangers can affect businesses to a significant degree. The existence of a causal relationship between distant events and business slowdowns or closures. Policyholders cannot substitute the often infinite results of causation analysis for finite contractual conditions precedent. Commercial property insurance is not financial guarantee insurance.