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## Selling Short: Is There Business Interruption Coverage For Losses Caused By The Global Chip Shortage?

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A prolific global crisis, originating overseas, causes supply chain disruptions limiting corporate activity for a period initially thought to be weeks, which stretches into more than a year. This is not a description of the COVID-19 pandemic. This is the global chip shortage. Microchips and semiconductors are not only essential to complex goods like cars, computers, phones, major appliances and industrial equipment, but even more mundane consumer products like toasters, toothbrushes and thermometers. According to analysts at Goldman Sachs, 169 U.S. industries embed semiconductors in their products.<sup>1</sup> And now, the brains of every smart device on the planet are in significantly short supply. The global microchip shortage will cause delays for car buyers and higher prices for smartphones and other products. It will also cost chip-dependent manufacturers billions of dollars in lost revenue.

Unfortunately, the shortage and its attendant losses cannot be cured, in the short run, just by making more microchips. Bringing additional manufacturing capacity online to meet current demand—particularly for the smallest, most sophisticated semiconductor wafers—requires proprietary intellectual property, extraordinary investment, and time. Capital expenditures for existing manufacturing equipment has surged, both domestically and abroad, even before the pandemic, but resources are limited. In the aggregate, “chipmakers increased spend on used equipment by 54% from 2019 to 2020.”<sup>2</sup> Despite these investments and increasing prices for semiconductor products of all types, by one estimate, demand will exceed supply for computer chips by an average of 20% until at least the fall of 2021, or perhaps early 2022.<sup>3</sup>

The shortfall in chip supply over this period will mean billions of dollars in lost revenues for affected industries. Ford Motor Company, for example, projects a reduction of \$2.5 billion in adjusted pretax profit this year from the shortage.<sup>4</sup> Other automakers and manufacturers will also sustain heavy losses as the dearth of chips continues.

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<sup>1</sup> Hanna Ziady, The global chip shortage is going from bad to worse. Here's why you should care, CNN (Apr. 29, 2021), available at <https://www.cnn.com/2021/04/29/business/chip-shortages-smartphones-consumer-goods/index.html>.

<sup>2</sup> Steven Zhou, The Global Chip Shortage: The Solution May Have Already Been Manufactured, Forbes (Apr. 28, 2021), available at <https://www.forbes.com/sites/forbestechcouncil/2021/04/28/the-global-chip-shortage-the-solution-may-have-already-been-manufactured/?sh=1518e9a971ea>.

<sup>3</sup> Hanna Ziady, The global chip shortage is going from bad to worse. Here's why you should care, CNN (Apr. 29, 2021), available at <https://www.cnn.com/2021/04/29/business/chip-shortages-smartphones-consumer-goods/index.html>.

<sup>4</sup> William Boston, Global Chip Shortage Set to Worsen for Car Makers, The Wall Street Journal (Apr. 29, 2021), available at <https://www.wsj.com/articles/global-chip-shortage-set-to-worsen-for-car-makers-11619708393>.

As major manufacturers limit production, upstream suppliers, downstream distributors and ancillary businesses will further magnify the loss of revenue resulting from the semiconductor shortfall.

With so much at stake for so many, what can be done? Traditional business interruption coverage insures lost business income, but only when resulting from physical loss or damage to the insured's own property. Contingent business interruption, also known as dependent business income coverage, on the other hand, insures lost profits caused by physical loss or damage to the property of others—specifically those upon whom the insured's business depends, including customers and suppliers.

While there has been much speculation about the role that the COVID-19 pandemic and various economic factors may have played in the chip shortage,<sup>5</sup> other causes are much more concrete and may provide a basis for seeking recovery from insurance. On March 19, a fire broke out at a semiconductor fabrication facility in Japan disrupting the operations of one of the world's largest manufacturers of automotive chips.<sup>6</sup> The plant was offline for repairs for a month, and a return to full production is not anticipated for up to 120 days.<sup>7</sup> Before this event, production at chip manufacturing facilities in Texas was suspended after freezing temperatures collapsed the state's power grid in February.<sup>8</sup> Adding to the crisis, historic drought conditions in Taiwan have devastated water supplies essential to chip production in that country.<sup>9</sup>

Each of these underlying events—a fire, a power outage and drought—may provide the predicate physical loss or damage to chip suppliers necessary to trigger contingent business interruption/dependent property coverage potentially available to manufacturers reliant on these suppliers. Tangible, structural injury caused by fire is unquestionably “physical loss or damage” for purposes of contingent business interruption coverage. See, e.g., *Phila. Parking Auth. v. Fed. Ins. Co.*, 385 F. Supp. 2d 280, 288 (S.D.N.Y. 2005) (“[I]f an insured business had to temporarily close its store because of structural damage caused by a fire, the Business Income and Extra Expense Provision would clearly cover the resulting losses. In that instance, the ‘direct physical loss or damage’ would be the structural damage, and the ‘covered cause of loss’ would be the fire.”).

Courts have also found that the loss of functionality, resulting from the lack of critical inputs like electricity, can qualify as “physical loss” for purposes of commercial property coverage. For example, in response to arguments that a power outage rendered computers unusable, justifying recovery of business interruption loss, the court in

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<sup>5</sup> Vildana Hajric, Intel CEO says chip shortage to last ‘couple of years’, *The Detroit News* (May 2, 2021), available at <https://www.detroitnews.com/story/tech/2021/05/02/intel-ceo-says-chip-shortage-last-couple-years/115948508/>.

<sup>6</sup> Kana Inagaki, Renesas warns of hit to global chip supply after factory fire, *Financial Times* (Mar. 21, 2021), available at <https://www.ft.com/content/51762983-00bc-4017-aeab-12be802c3cc5>.

<sup>7</sup> Renesas resumes production at plant hit by blaze: reports, *Taipei Times* (Apr. 19, 2021), available at <https://www.taipeitimes.com/News/biz/archives/2021/04/19/2003755937>

<sup>8</sup> Texas freeze shuts chip factories amid shortages, *BBC News* (Feb. 18, 2021), available at <https://www.bbc.com/news/technology-56114503>.

<sup>9</sup> Stephanie Yang, The Chip Shortage Is Bad. Taiwan's Drought Threatens to Make It Worse, *The Wall Street Journal* (Apr. 16, 2021), available at <https://www.wsj.com/articles/the-chip-shortage-is-bad-taiwans-drought-threatens-to-make-it-worse-11618565400>.

*American Guarantee & Liability Insurance Company. v. Ingram Micro, Inc.*, concluded that “‘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.” 2000 U.S. Dist. LEXIS 7299, \*6 (D. Ariz. Apr. 18, 2000); *see also Wakefern Food Corp. v. Liberty Mut. Fire Ins. Co.*, 406 N.J. Super. 524, 538 (App. Div. 2009) (“In the context of this case, the electrical grid was ‘physically damaged’ because, due to a physical incident or series of incidents, the grid and its component generators and transmission lines were physically incapable of performing their essential function of providing electricity.”).

More recently, in the context of the COVID-19 pandemic, courts have been called upon again to determine whether the loss of functionality and utility of tangible property, absent structural injury, constitutes “physical loss or damage.” The resulting opinions have been mixed. *See, e.g., Blue Springs Dental Care, LLC v. Owners Ins. Co.*, 488 F. Supp. 3d 867, 876-77 (W.D. Mo. 2020) (denying an insurer’s motion to dismiss for lack of “physical loss” because the insured’s complaint alleged that “COVID-19 had physically occupied and contaminated their dental clinics,” rendering the insured property unusable); *compare, e.g., Tria WS LLC v. Am. Auto. Ins. Co.*, 2021 U.S. Dist. LEXIS 60500, \*12 (concluding that “Plaintiffs’ ‘loss of use’ theory is clearly untenable”).

In addition to considering these authorities, corporate policyholders should also be aware of potential limitations in the specific terms of the contingent business interruption/dependent property coverage granted in a given policy. Some policies include schedules identifying covered dependent properties by specific location. Some policies include terms requiring a “direct” connection between the damage to a dependent property and the insured’s loss of income. Other policies are not so limited.

To the extent that policyholders experiencing lost income from the chip shortage have contingent business interruption/dependent property coverage and can trace their impaired revenues to physical loss or damage to a supplier, there may be some potential for insurance recovery. At a minimum, corporate policyholders with chip-related losses should explore whether some coverage may be available to offset lost profits relating to the semiconductor shortage.