

A Bridge Over Troubled Water: Service Interruption Coverage and The Water Crisis

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PRACTICES Insurance Recovery

Despite the extreme rain and snowfall in the western United States over the past several months, as of the end of February, more than 41% of the lower 48 states is currently in drought.¹ And forecasts predict ongoing drought conditions for much of the continental U.S., particularly in the southwest, through the remainder of 2023.² Many reservoirs and other water resources remain at record lows,³ and some regions are already operating under severe water restrictions.⁴ Other communities are actually going without water because of extreme drought conditions. In January, water shortages left one Arizona suburb cut off due to competing demands from a neighboring community.⁵ As the water crisis deepens, public authorities have explored measures that prioritize agricultural use above water demand from major metropolitan areas.⁶ Entire cities may lose access to water service in the coming year.⁷

Businesses within these communities cannot operate without water, and in some cases, a prolonged loss of water service may cause damage to other property, including supplies, inventory and machinery. If water shortages lead to interruptions in water service, the potential exists for businesses to sustain substantial financial losses, whether in the form of direct property damage or business interruption loss. Many companies vulnerable to drought and water shortages maintain commercial property insurance coverage, including some form of time element/business interruption coverage. However, the coverage available for utility service interruption varies widely from one policy to another. In many policies, service interruption property damage and time element coverage is subject to sublimits that may be a fraction of the coverage available for other insured perils.

Beyond policy limits, there may be significant differences in policy terms for service interruption property damage and time element coverage, which may or may not afford coverage in the context of drought-driven water shortages. For example, some policies condition coverage for the insured's service interruption time element loss on covered physical loss or damage to the supplier's property, which results in the insured's lack of service:

The Company will pay for direct physical loss of or damage to Covered Property and for the actual Time Element loss sustained as provided by the Policy during the Period of Service Interruption at Insured Locations caused by the interruption of an incoming service consisting of electricity, gas, fuel, steam, water, refrigeration, voice, data or video or from the lack of outgoing voice, data, video or sewage service.

The lack of service must result from direct physical loss of or damage caused by a Covered Cause of Loss to property (other than satellites but including transmission and distribution lines) of the supplier of such service located within this Policy's Territory, that immediately prevents in whole or in part the delivery of such usable services.

Other policies require that the loss of incoming water service be the result of an “event” or “occurrence” at the service provider’s facilities, as exemplified below:

This Policy covers Business Interruption Coverage loss incurred by the Insured during the Period of Liability caused by the interruption, in whole or part, of incoming electric, gas, fuel, steam, water, refrigeration, and outgoing sewerage services at a location. The interruption of such services must be by reason of any accidental event, not otherwise excluded by this Policy, at the facilities of the service provider(s) while anywhere within this Policy’s Territory.

Some policies’ service interruption time element coverage provisions expressly require “complete suspension” of operations, while other policies may contemplate a partial cessation of business operations. Service interruption time element coverage may also be subject to deductibles or “qualifying periods,” as well as any number of specific exclusions, including those avoiding coverage for interruptions caused by the insured’s failure to comply with the terms of any contracts between the insured and the service provider.

Given the variation in policy terms and the emerging risk of water shortages across the United States, corporate policyholders should be familiar with the particular terms governing service interruption property damage and time element coverage in their own policies. Depending on individual facts and circumstances, corporate insureds may want to ensure at the next renewal that the broadest coverage available, with appropriate limits, is included in their individual policies.

For those electing to obtain service interruption coverage that is contingent on an “event,” “accident” or “occurrence,” such terms are typically either undefined or, in the case of “occurrence” are defined in terms of an undefined “accident” or “event.” Here, there can be little doubt that the extreme drought conditions, which have resulted in utilities’ inability to maintain water service, qualify as an “event” and/or an “accident.” See, e.g., BLACK’S LAW DICTIONARY (11th ed. 2019) (defining “accident” as “[a]n unintended and unforeseen injurious occurrence; something that does not occur in the usual course of events or that could not be reasonably anticipated; any unwanted or harmful event occurring suddenly, as a collision, spill, fall or the like, irrespective of cause of blame.”). After all, the depletion of freshwater reservoirs and other resources is without precedent.⁸

For those with policies that require physical loss or damage to the service provider’s facilities, the loss of available water stocks is unquestionably a “physical loss” to the service provider. Although published opinions do not appear to have addressed the issue on all fours. After all, “inventory loss” has historically been an exception in some policies to a grant of coverage for all other risks of physical loss or damage to insured property. That exception, as well as the very insuring clauses for service interruption property damage coverage, implicitly acknowledge that the lack of incoming water service qualifies as a physical loss for purposes of commercial property coverage.

The ongoing water crisis will require governments, utilities and entire communities to reevaluate water use, enact appropriate conservation measures and plan for the future. This crisis will also require corporate insureds to examine and prepare for the emerging risk of service interruption property damage and time element loss. If you have any questions about service interruption coverage or about insurance recovery in general, please contact one of Haynes Boone’s [Insurance Recovery Practice Group](#) partners listed below.

¹ U.S. Drought Monitor, [National Drought Status, February 15, 2023 - February 21, 2023](#).

² National Weather Service, Climate Prediction Center, [U.S. Seasonal Drought Outlook \(Feb. 16, 2023\)](#).

³ Haley Smith, [*With all this rain and snow, can California really still be in a drought? Look deeper.*](#) LA TIMES (Feb. 22, 2023).

⁴ See, e.g., [*Stage 3 water restrictions loom with Lake Waco more than 11 feet down.*](#) WACO HERALD TRIBUNE (Feb. 21, 2023).

⁵ Jack Healy, [*Skipped Showers, Paper Plates: An Arizona Suburb's Water Is Cut Off.*](#) NEW YORK TIMES (Jan. 16, 2023).

⁶ Ella Nilsen, [*California floated cutting major Southwest cities off Colorado River water before touching its agricultural supply, sources say.*](#) CNN (Feb. 1, 2023).

⁷ Hunter Bassler, [*These 3 Arizona cities will see the biggest water reductions in the coming years. Here's why.*](#) 12NEWS (Feb. 24, 2023).

⁸ Elizabeth Weise, [*Water crisis in West: Massive reservoir Lake Powell hits historic low water level.*](#) USA TODAY (Feb. 20, 2023).