

WHITE PAPER

Disaster and Business Interruption Coverages

in the Aftermath of Katrina

by

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The human toll from the catastrophes caused by Hurricane Katrina has numbed the country. Obviously, our immediate collective focus must be on aiding the survivors and making the Gulf Coast livable again. Indeed, given the scale of the destruction, attention to matters like insurance coverage for the widespread commercial destruction is largely impossible at present, as affected properties are still inundated.

Nonetheless, as with the attacks of September 11, 2001, Hurricane Katrina will spawn many commercial insurance claims. As with claims stemming from the WTC attacks, many of the claims arising from Katrina will be Business Income claims, seeking loss of business profits arising from property damage or other commercial dislocations. Finally, as with the claims stemming from the terrorist attacks, many of these claims – especially the large ones – will be strenuously resisted by insurance companies.

The following is a short treatment of Business Income insurance and the coverage issues which can arise under various Business Income provisions. The aim of this treatment is to make commercial policyholders aware of the types of coverage that they may have purchased and which may apply to losses stemming from Katrina so that they may give proper notice now and, later, at the appropriate time, pursue the coverage. This coverage will be crucial in ensuring the Gulf Coast makes a full recovery.

A. Business Income (or Business Interruption) Insurance

1. The Coverage

Property insurance policies, or “first party” policies, obligate insurance companies to pay benefits directly to policyholders for losses suffered by policyholders

to their own property or profits. They are, thus, fundamentally different from “third party” or “liability” policies, which cover amounts a policyholder must pay third parties for damage to the third parties’ interests. Property insurance policies cover both tangible property (furniture, equipment, business records, inventory, etc.) and intangible property (anticipated profits, lost income during an interruption, lost income after an interruption, etc.).

With regard to the latter, most property policies promise to pay for losses of Business Income incurred in the wake of damage to covered property. Although many such provisions are in use, a typical one reads as follows:

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. . . . The loss or damage must be caused by or result from a Covered Cause of Loss.

“Business Income” may be defined to include “Net Income (Net Profit or Loss before income taxes) that would have been earned or incurred” and “Continuing normal operating expenses incurred, including payroll.” “Period of Restoration” or “Period of Interruption” is typically defined to begin at the time of “direct physical loss or damage” and to end on the earlier of “the date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality” or “the date when business is resumed at a new permanent location.” In short, Business Income coverage is designed to pay the profits and unavoidable continuing expenses caused by an interruption of the policyholder’s business.

2. The Potential Coverage Issues

There are a number of potential hurdles to recovery for Business Income losses, some of which have been explored by courts considering losses from the attacks of September 11, 2001.

(a) What Is the Rate of Business Income Loss?

The first coverage issue is the most fundamental: figuring the rate at which Business Income is lost during the Period of Restoration. Property policies typically provide little guidance as to how the amount of a Business Income loss is to be calculated: essentially, they state that Business Income is to be calculated from historical figures. This leads to many sources of potential conflict:

- What is looked at, the business as a whole or a small sector of the business? The answer: courts will permit a policyholder to recover all the losses suffered by its operations – even if suffered in locations different from those directly affected by property damage – if the policyholder can demonstrate that its operations are “interdependent.”

- What amount of historical data is looked at? The previous month? The previous year? The answer: This depends upon the type of business; for instance, seasonal businesses can establish loss through reference to previous seasons. In general, experience from the previous few years, along with projections for the Period of Restoration, may be used to establish loss.
- What about new or unprofitable businesses? The answer: both types of businesses are permitted to attempt to establish that they would have enjoyed profits in the Period of Restoration. Further, unprofitable businesses are allowed to recover continuing expenses to the extent that revenues would have been sufficient to cover them.

Essentially, however, the language in most policy forms is so vague that it ensures that, if the claim is large enough, there will be a dispute. Accordingly, for such losses, you should probably hire a Public Loss Adjuster or a forensic accountant, as both professions are well versed in property insurance.

(b) Has There Been an “Interruption”?

A number of insurance companies have denied Business Income coverage for the events of September 11 on the ground that the policyholders have not suffered a total “suspension” of all their operations, and thus that Business Income coverage was not triggered. Simply put, for large businesses – like General Motors, or a hotel chain – this argument is ridiculous: no catastrophe, short of nuclear annihilation, could totally halt every facet of the operations of such a company. Although there is some unfavorable law on this subject, the better-reasoned authority has recognized that an “interruption” does not require a total halt to all operations, but includes adverse effects on performance.

Note that the misinterpretations on this issue by insurance companies prompted the Insurance Services Office – which drafts the language employed in most Business Income forms – to include a definition of “suspension” in its standard-form property insurance policies that expressly makes clear that Business Income coverage includes “slowdowns”:

Like the business interruption coverage forms that preceded it, the business income and extra expense coverage form is designed to provide coverage for income loss that results from direct property damage from a covered cause – regardless of whether the suspension of the insured’s operations is partial or total. In recent years, however, some insurers have interpreted the phrase “necessary suspension of your operations” to mean only a complete cessation of all of the insured’s operations and have refused to pay for otherwise covered business income loss because the insured’s operations did not completely cease during the period of restoration. Unfortunately, some courts have

accepted this argument. To prevent such misinterpretations, a definition of the term “suspension” was added to the definitions section of the 2000 edition of the form. This definition ... clearly establishes that a suspension means either the slowdown or the cessation of the insured’s business activities....

Accordingly, you should forcefully reject any insurance company argument that your business has no coverage because it did not suffer an absolute cessation of operations.

3. What Is the Length of the Period of Restoration?

Issues typically arise regarding the length of the Period of Interruption or Period of Restoration. As typically written, this period, during which the loss of Business Income is covered, is bounded by the shorter of (i) the hypothetical time in which the destroyed property could be repaired, rebuilt or replaced or (ii) the actual time it takes to repair, rebuild or replace the property. A number of issues can arise surrounding the former, “hypothetical” date. For instance, does it start during the period when authorities will not let the policyholder on site due to ongoing investigation, or when access to property is impossible given prevailing flooding? Alternatively, does the Period of Restoration extended to account for the insurance company’s delay in adjusting a claim?

In general, delays occasioned by events out of the policyholder’s control will serve to extend the Period of Restoration. Accordingly, if the insurance company delays in providing the policyholder sufficient money to get back into business, this delay will serve to extend the Period of Restoration; in other words, the insurance company cannot terminate that period on the date that the policyholder hypothetically could have rebuilt had it had sufficient resources.

4. Has There Been a Permanent Replacement?

As noted above, historically, a policyholder was entitled to its loss of Business Income under Business Interruption coverage for the period from the destruction of property at the described premises until the date when the property at the described premises should have been repaired, rebuilt or replaced with reasonable speed and similar quality. This “theoretical” period continued even if the policyholder mounted temporary or interim operations after the loss and damage, thereby recognizing the value of the policyholder’s location. Since 1995, however, the Insurance Services Office standard form has defined the Period of Restoration as the lesser of the time to repair or replace the physical damage or the time at which operations are resumed at a new permanent location.

With regard to losses stemming from the WTC Complex attacks, some insurance companies have argued that policyholders, forced by destruction of their premises to move their operations elsewhere, on a temporary basis, have in fact permanently relocated, thereby terminating the Period of Restoration. Specifically with regard to businesses located in the destroyed WTC Complex, some insurance

companies are arguing that, because of the length of time that will be needed to rebuild that location, any replacement location is a new permanent location terminating the Period of Restoration. This result may not seem that unfair for businesses like Marsh or Aon, which likely can relocate in fungible space, but what about retailers and restaurants? How can Brooks Brothers, or Sbarro, ever replace the value of their locations at the base of towers containing 13 million square feet of office space and a hundred thousand potential customers visiting every day? They cannot. Further, chains like Brooks Brothers and Sbarro are not limited in the numbers of stores they can open; rather, they open stores in any location at which they feel they can make a profit. If Brooks Brothers opens a store in Park Slope, Brooklyn, how can one say that this store is a “replacement” for the one it had in the WTC Complex, rather than a store it would have opened in any event?

The recent law on this issue is rather mixed. Many courts have taken a very narrow view of the “property” or the “premises” to which the policyholder is entitled to replacement, and have given short shrift to policyholder arguments that they were entitled to the value of their location. Note, however, that one tenant of the WTC Complex – Lumbermen’s Mutual Casualty Company – filed a complaint against its property insurance company arguing that the Period of Restoration for its loss was the period needed to rebuild the WTC Complex. Like most tenants of the WTC Complex, Lumbermens had to relocate after September 11, 2001 during a chaotic real estate market, and ended up paying considerably higher rents than it had previously paid. Lumbermens sought its increased lease payments as Extra Expense – similar to Business Income and covering costs incurred during the Period of Restoration due to the catastrophe – and sought coverage for these Extra Expenses for the entire period needed to reconstruct the WTC Complex. Specifically, Lumbermens requested the court to declare “that the applicable Period of Liability for the Extra Expense coverage provided under the Policy for Lumbermens’ loss started on September 11, 2001 and will end when with due diligence and dispatch the destroyed building could be replaced and made ready for Lumbermens’ operations under the same or equivalent physical operating conditions as existed prior to the damage caused on September 11, 2001.” This case has been settled, but should indicate that it is reasonable for policyholders to conclude that the Period of Restoration for businesses for which a particular location is important is the time needed to rebuild at that location.

5. Can the Business Income Loss Be Reduced by the Wider Effects of the Catastrophe?

Some property insurance companies have argued that Business Interruption recovery is diminished by the wider economic effects of the September 11 attacks. Typically, “Business Income” for a Business Interruption provision is defined to include “Net Income (net profit or loss before income taxes) that would have been earned or incurred.” Further, the profit component of lost Business Income is figured by computing the net income the policyholder was earning prior to the “physical loss or damage” and the net income that the policyholder would have earned “if no direct physical loss or damage occurred.” There is typically no provision permitting insurance companies to reduce estimates of their policyholder’s lost Business Income on account

of generalized lack of consumer demand throughout the affected area because the “direct physical loss or damage occurred.” Nonetheless, this is what insurance companies have attempted to do. Courts have, however, consistently found that Business Income losses must be computed based on net profit expectancies as they existed prior to the loss. More specifically, the insurance industry has been very successful in making the exact opposite of the argument insurance companies have made in the wake of the September 11, 2001 attacks: insurance companies have successfully contested Business Income claims where the policyholder seeks to increase the amount of lost income by including consideration of the widespread effect of the physical loss or damage.

For instance, in Prudential LMI Commercial Insurance Co. v. Colleton Enterprises, Inc., the policyholder owned a hotel which, along with a great deal of surrounding housing, was destroyed by Hurricane Hugo. The policy provided that Business Income was to be figured by considering “the earnings of the business before the date of damage or destruction and to the probable earnings thereafter, had no loss occurred.” Although the policyholder was operating at a net loss prior to the hurricane, it made a claim for “probable earnings resulting from accommodating the burgeoning demand due to the hurricane,” which the insurance company contested. The court considered the issue to be as follows: “did the lost opportunity to house the influx of temporary residents after the hurricane constitute a loss of earnings cognizable under a policy that is designed to return [the policyholder] to the position it would have occupied had the hurricane not occurred.” The court rejected the policyholder’s argument, finding that Business Income losses, both in general and under the terms of the policy at issue, were to be figured based upon the performance of the business prior to the loss. Further, the court found that the policyholder was not entitled to a windfall based on the happening of the insured peril:

[H]ad the hurricane not occurred (the policy’s built-in premise for assessing profit expectancies during a business interruption), neither would the specifically claimed earnings source have come into being. To allow the claim therefore would be to confer a windfall upon the insured rather than merely to put it in the earnings position it would have been in had the insured peril not occurred.

The reverse should also be true: insurance companies should not be permitted to decrease the amount of money paid for Business Interruption on account of generalized lack of demand in the Gulf Coast.

On the other hand, cases do exist which reach opposite conclusions, and permit policyholders to base their Business Income claims on the higher profits they would have enjoyed had the catastrophe occurred but their business survived. Often, the differences in these cases stem from the language of the Business Income provision; again, you may need to consult with a Public Loss Adjuster or forensic accountant to determine how your claim should be framed.

B. Other Business Income Coverages

In addition to coverage for losses of Business Income stemming from the destruction of the policyholder's own property, there are a number of other coverages available for losses of Business Income stemming from other events, including the following:

- **Contingent Business Income** coverage is designed to cover a policyholder for loss of income caused by damage to or destruction of property owned by others, usually identified as “contributing” or “recipient” locations (i.e., suppliers and customers). The property damage to the third-party property typically must be of a type that would be covered had it happened to the policyholder's own property. An example would be coverage purchased by a car maker to protect it if its sole supplier of a key component suffers destruction of its factory, and the car maker suffers a Business Income loss from its inability to complete manufacture of cars.
- **Contingent Extra Expense** coverage is designed to pay for increased costs incurred after the disaster to minimize or avoid a Contingent Business Income loss. Accordingly, if a business incurred additional expenses in order to avoid or minimize a Contingent Business Income loss – for instance, a domestic ethanol maker's purchase of more expensive Canadian corn after flood destroys the corn crops of domestic producers – it may have coverage for those costs under Contingent Extra Expense coverage.
- **Leader Property** coverage is designed to cover a policyholder for losses of Business Income stemming from damage or destruction to a third-party property that attracts customers or business to the policyholder. For instance, smaller stores at a mall may have Leader Property coverage to cover them for the drop off in customer traffic and business that might befall them if the flagship store at the mall – e.g., a Wal-Mart or Nordstrom's – is damaged or destroyed.
- **Service Interruption** coverage is designed to provide coverage for Business Income losses attributable to dislocation of utility or telecommunications service. Income losses from such dislocations should be covered under most property insurance policies. A business's costs in avoiding or minimizing service interruption losses – again, for instance, by purchasing cell phones for its employees – should also be covered, under Contingent Extra Expense coverage, or under provisions in the policy promising to pay for a policyholder's efforts to avoid or minimize loss. Such clauses – which come in many varieties, including “sue and labor” and “expense to reduce loss” provisions – simply reinforce the established “loss mitigation” rule of insurance law, which holds that a policyholder's costs in avoiding or mitigating covered losses are themselves covered.

- **Ingress/Egress** coverage is designed to pay for the loss of Business Income caused by physical loss or damage to third-party property that prevents or hinders ingress to or egress from the policyholder's business. Again, typically, the property damage to the third-party property must be of a type that would be covered if it had happened to the policyholder's own property.

By far, however, the coverage which has received the most recent attention is the Civil Authority clause, often listed as an "additional coverage" in property insurance policies. This clause is designed to provide coverage for Business Income losses incurred as a result of an order by a civil or military authority, made as a result of property damage, preventing access to the policyholder's place of business. Unfortunately, most of the cases stemming from the WTC attacks have construed Civil Authority provisions in a very narrow manner.

On the other hand, case law construing Ingress/Egress coverage has given it an expansive view. For instance, in Fountain Powerboat Industrial, Inc. v. Reliance Insurance Co., the policyholder was a manufacturer of boating equipment, whose facility was on a barrier island and served by one road, Whichard's Beach Road, which in turn was served by one highway, US 17. After Hurricane Floyd, both Whichard's Beach Road and US 17 were flooded for days. During this period, the policyholder used large trucks to collect its workers from various pick-up points and transport them to the manufacturing facility; accordingly, the flooding did not absolutely prevent ingress to or egress from the policyholder's property. Nonetheless, production fell to thirty-three percent of capacity, and did not match pre-flood levels for nearly a month. The policyholder sought coverage for its losses of income under an Ingress/Egress provision. The insurance company conceded "that the terms ingress and egress are unambiguous and generally mean 'access' to" the policyholder's facility, but argued that the policyholder could not recover under the Ingress/Egress provision unless it suffered property damage. The court rejected this argument, finding the clause to cover the policyholder when road routes of access to the policyholder's property were impaired:

This court cannot find, and neither party has provided, any case in any jurisdiction that interprets an ingress/egress clause contained in the business interruption loss section of an insurance policy. **The court believes that this is due to the fact the meaning of the clause is exceedingly clear. Loss sustained due to the inability to access the [policyholder's] facility and resulting from a hurricane is a covered event with no physical damage to the property required....**

C. Conclusion

It is still simply too early to shift focus from recovery efforts to mundane concerns like insurance coverage. Nonetheless, insurance coverage will be crucial to recovery. Further, insurance coverage can be voided if a policyholder does not give

timely notice of its losses. Prudence should compel a policyholder to give a brief review of its first-party coverages and give appropriate notice of potentially-covered losses, so that, at the appropriate time, it can pursue the coverage to which it is entitled.