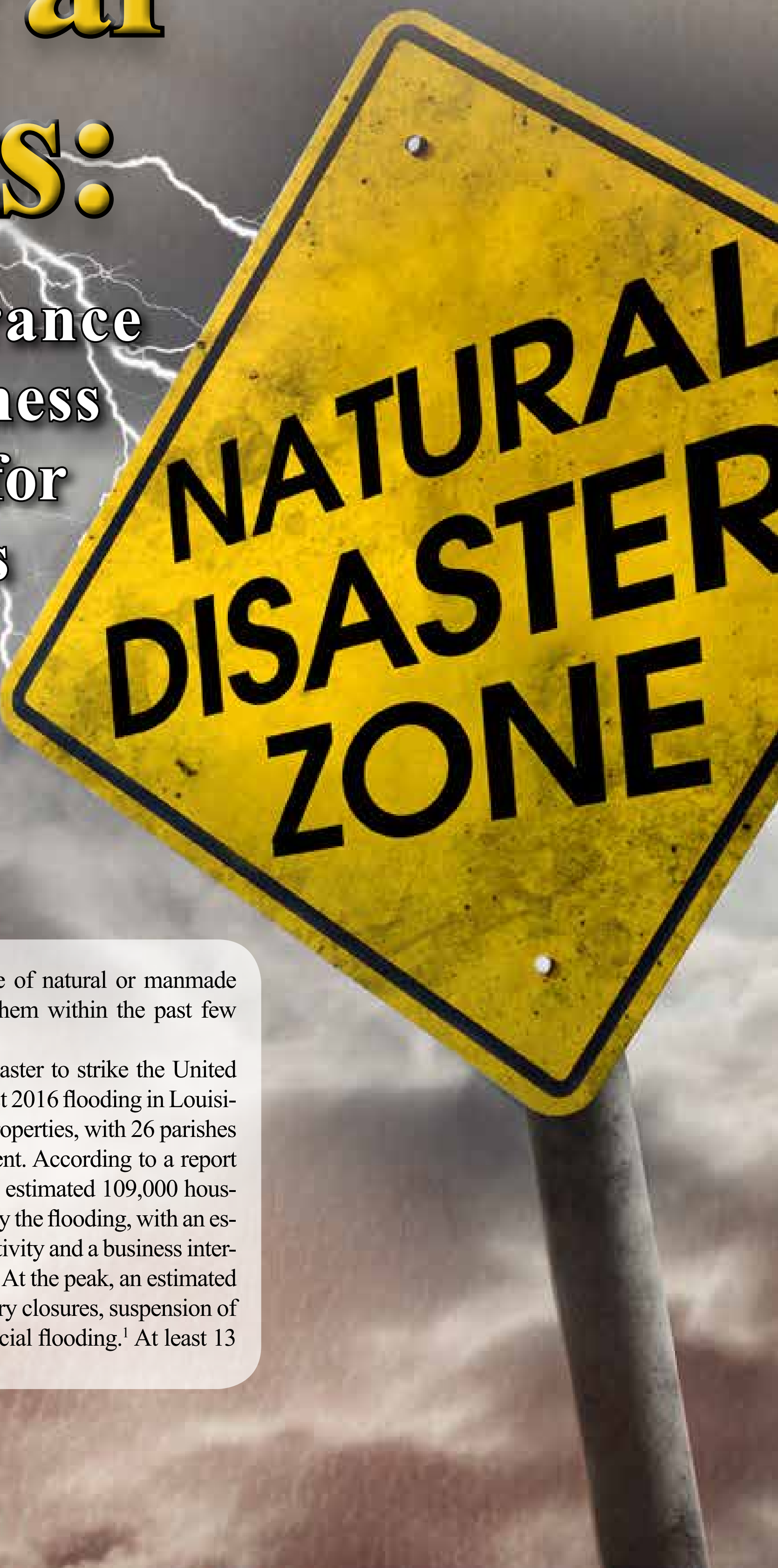
In the Aftermath of Natural Disasters:

An Update on Insurance Coverage for Business Interruption Claims for You and Your Clients



By José R. Cot

Unfortunately, Louisiana has had more than its share of natural or manmade disasters in the past few years — and several of them within the past few months.

As an example, considered the worst natural disaster to strike the United States since Superstorm Sandy in 2012, the unprecedented August 2016 flooding in Louisiana caused catastrophic damage to residential and commercial properties, with 26 parishes receiving a Major Disaster Declaration by the federal government. According to a report commissioned by Louisiana Economic Development (LED), an estimated 109,000 housing units flooded and nearly 20,000 businesses were interrupted by the flooding, with an estimated economic loss of more than $300 million in labor productivity and a business interruption loss (in terms of value added) of more than $800 million. At the peak, an estimated 278,500 Louisiana residents were unable to work due to temporary closures, suspension of operations, transportation impasses, and residential and commercial flooding.[1] At least 13 deaths were reported across the state, with tens of thousands of residents rescued or evacuated from their homes or forced to seek refuge in shelters. Because the impacted areas were in elevated zones not included in the FEMA flood plains, the vast majority of those impacted by the flooding did not have flood insurance. Nevertheless, it was estimated that industry ground-up insurable losses were between $8.5 billion and $11 billion.[2] As of December 2016, FEMA had issued more than $588 million in Federal Assistance Disaster grants to those affected, including more than $2 billion to National Flood Insurance Program (NFIP) policyholders to repair or rebuild damaged properties, and more than 63,000 families had sought FEMA assistance for housing.[3]

Add in the March 2016 flooding in the northern part of Louisiana and powerful tornadoes in many parts of the state and it becomes very obvious that disaster preparedness should be on the "to-do" list of all legal practitioners.

As in the aftermath of Hurricanes Katrina and Rita in 2005, many business owners across Louisiana filed insurance claims in connection with damage to their buildings, equipment and other assets as a result of the 2016 floods. Coverage with respect to these claims is generally provided under comprehensive first-party property policies. These policies are typically written on an "all-risk," "multi-peril" or "named peril" basis, meaning that they are designed to indemnify the policy holder for all direct physical loss or damage to his/her premises caused by a covered peril, as well as business personal property (the so-called "contents loss" coverage), unless coverage for the loss is otherwise excluded under the policy. Generally speaking, these policies contain water or flood exclusions, and resolution of the scope of coverage afforded under the policy — particularly after a hurricane or similar natural disaster — centers on the proverbial "wind v. flood" controversy, *i.e.*, whether the ensuing losses were caused by high winds (which is a covered peril under the policy) as opposed to wind-driven water or tidal surge flooding (which are excluded perils). The risk of damage as a result of water or flooding, however, is typically covered through a separate policy (such as a flood policy), designed to complement the coverage afforded under the property policy.[4]

Because of the potential application of policy exclusions, particularly regarding losses caused by rain, flood, surface water, overflow of bodies of water, rainfall runoff, etc., counsel must consider whether a particular loss is attributable to "rain" or "flood" as opposed to other causes. Accordingly, issues regarding apportionment of the loss, or concurrent causation, and interpretation of the corresponding policy wording are central to the successful presentation, or defense, of a claim. This analysis is fact-intensive and, in many cases, requires the testimony of expert witnesses, such as engineers, meteorologists and other technical experts.

For example, in the absence of a definition in the policy, most courts define "surface water" as water on the surface of the ground, generally derived from falling rain, that does not have a permanent existence, has no banks, and follows no defined course or channel. However, some courts have made distinctions among claims for property damage caused by "surface water" depending upon differences in the way in which the water accumulated and caused the property damage. The distinctions generally fall into three categories — rainwater runoff, rainwater collected on a rooftop, and rainwater after it has reached the ground and been channeled or contained. There are also reported cases discussing whether "surface water" that becomes collected or contained (or diverted) loses its character as "surface water."[5]

Because the wording of water damage exclusions may differ depending on specific policy provisions, counsel should conduct a thorough analysis of the policy wording and the applicable jurisprudence and work closely with the appropriate experts to effectively frame the issue of coverage.

Scope of Business Interruption Coverage

A significant component of commercial first-party property insurance policies is the so-called "business interruption" insurance.[6] This type of coverage is designed to protect the insured for the risks associated with an interruption of the insured's business because of damage to the insured's property that results in a total or partial suspension of the insured's business operations. Although business interruption insurance is designed to protect the insured, it is also designed to prevent the insured from being placed in a better position if no loss or interruption of business had occurred.[7]

Although the phrase "business interruption" is widely used in the insurance industry, many commercial policies incorporate other terms such as "delay," "loss of market" and/or "consequential" loss or damages. Practitioners should be mindful of the fact that differences in the phraseology used in many of the policies providing such coverage have resulted in a significant amount of litigation regarding the interpretation and application of policy terms and conditions to specific factual scenarios. A comprehensive analysis of the terms and conditions of a particular policy is essential to determine the insurer's obligations with respect to covered perils and any applicable policy exclusions or limitations, as well as the proper methodology to compute the insured's business interruption losses. While there is not a plethora of reported cases interpreting business interruption insurance policies under Louisiana law, the reported cases provide some guiding principles in evaluating coverage under these types of policies.

For example, some policies provide that the insurer will pay for the actual loss of business income that the insured sustains due to the suspension of his/her business "operations" during the "period of restoration." "Operations" generally means business activities occurring at the insured's premises.[8] Moreover, the "period of restoration" generally means the period of time that begins with the date of direct physical loss or damage caused by, or resulting from, a covered peril and ends on the date when the property should be repaired, rebuilt or replaced, or the date when business is resumed at a permanent or new location.[9] Some policies actually provide a specific time frame (for example, 12 or 18 months) to delineate the "period of restoration."

In addition to any loss of net income, most business interruption policies also cover normal operating expenses incurred by the insured, including payroll, employee benefits, FICA payments, union dues and insurance premiums. However, officers, executives, department managers and contract employees are typically excluded from the standard payroll expense coverage.

Computation of the Loss

Business interruption insurance is either "valued," meaning that the parties have agreed upon the value of the insured's loss in advance, or "open," which requires proof of the actual loss of business sustained by the insured.

Under most business interruption policies, the loss is calculated by reference to the insured business' net income, *i.e.*, the net profit or loss (before income taxes) that would have been earned or incurred if no physical loss or damage had occurred.

In other words, the loss is based on the difference between the net profit the insured business would have received without the interruption and the net profit that it actually received. Some policies define net income so as to *exclude* any income that would likely have been earned as a result of an increase in the volume of business due to favorable business conditions caused by the impact of the covered cause of the loss on customers or other businesses.

Other types of business interruption policies provide that the formula for calculating the insured's loss is in terms of reduction of gross earnings. Under these policies, a "projection" of earnings is an accepted method of calculating the business interruption loss.

Therefore, in determining gross earnings, due consideration is given to the experience of the business *before* the date of damage or destruction and the *probable* experience thereafter had no loss occurred.[10] Some policies include specific appraisal provisions for valuing the loss of income and extra expense. Appraisal clauses may provide for the selection of independent appraisers and an impartial umpire to adjudicate disputes under the policy.

An important issue concerning the valuation of business interruption claims is whether the claim calculation should take into account the effects that the catastrophic event had on the surrounding region, positive or negative, including its impact on the insured's competitors and the local economy. Louisiana jurisprudence allows consideration of post-catastrophe economic conditions in valuing the loss, although depending on the policy wording.[11]

Extra Expenses

The typical business interruption policy also indemnifies the insured for any necessary "extra expense," which refers to expenses incurred to avoid or minimize the suspension of business and to continue business operations either at the insured premises or at a temporary location. An "extra expense" is by nature a temporary expense — one that makes it possible for the insured to maintain business operations that otherwise would have been interrupted pending permanent repair or restoration of the insured's property.[12] Extra expense usually includes any moving or relocation expenses, the cost to equip and operate temporary locations, and the cost to research, replace or restore lost information on damaged valuable papers and records, provided that it reduces the amount of the loss that otherwise would be paid under the business interruption coverage.[13]

Standard Exclusions

Damage resulting from a covered cause of loss is a prerequisite for business income coverage, which means that business income claims caused by flood are usually not covered unless the policy provides flood coverage. As with most types of insurance coverage, standard business interruption policies also contain certain policy exclusions. For example, there is no coverage for any extra expense or increase of business income loss caused by enforcement of any ordinance or law regulating the use, construction, repair or demolition of property. Delays in rebuilding, repairing or replacing the property, or in resuming business operations, which are attributable to interference by strikers or other persons, is also excluded. Similarly, business interruption policies typically exclude extra expense or increase of business income loss due to suspension, lapse or cancellation of any license, lease or contract. Some policies also provide that delay in adjustment of the claim (if there is a dispute between the insurer and the insured) will not extend the period of time for which coverage applies.

Additionally, some business interruption policies contain "idle period" clauses designed to exclude coverage for a period during which the insured's business operations would not have been maintained even if no peril insured against had occurred. Generally, there is no coverage for additional business income loss due to the enforcement of any ordinance or law requiring the insured to test for, clean up or remove any pollutants. Finally, business interruption policies typically exclude "consequential or remote" loss and/or delay, loss of use or loss of market.

Civil Authority Coverage

A standard coverage extension contained in most business interruption policies provides that the insurer will indemnify the insured for the actual loss of business income and any necessary extra expense caused by action of civil authority that prohibits access to the insured's premises as a result of off-premises damage caused by, or resulting from, a covered peril under the policy.[14] This coverage is commonly referred to as the Civil Authority Coverage and is often available for a period of up to 30 consecutive days from the date of the action of civil authority. This type of coverage is significant in the context of mandatory evacuation orders imposed before a hurricane and curfews or road closures that may impact operation of the insured's business after the storm. The typical Civil Authority Clause is triggered only if the following elements are met: (1) there is a loss of earnings by the insured and (2) access to the business is prohibited (3) by an order or action of civil authority (4) as a result of direct physical loss to property other than a covered location, and (5) the loss or damage to the property other than a covered location was caused by, or resulted from, a covered cause of loss.

Some business interruption policies also contain coverage for prevention of ingress/

egress as a result of physical damage and do not require an order of civil authority. However, generally speaking, ingress/egress coverage is inapplicable when it is possible to gain access to the insured's premises, even if access is limited.

Duty to Mitigate and Adjustment of the Claim

As with most first-party policies, the insured has an affirmative obligation to mitigate or reduce the loss by taking reasonable steps to shorten the indemnity period. For example, if possible, the insured must reduce the business interruption loss by complete or partial resumption of the business at a temporary location or by making use of the merchandise or other property at the insured premises.

As with other forms of property insurance, adjustment of a business interruption claim usually requires assistance from expert witnesses, such as a forensic accountant. This is particularly important in calculating and documenting the amount of lost earnings that the insured has suffered as a result of the business interruption caused by damage to covered property. Courts have generally recognized that lost earnings need only be proved to a reasonable certainty. Where it is not possible to state or prove a precise measure of lost earnings, the trier of fact has reasonable discretion to assess damages based on all the facts and circumstances of the case.[15] From an evidentiary standpoint, the insured's books and other financial records are admissible to establish the extent of the loss. Additionally, the insured's accounting practices are also considered, although they are not necessarily controlling in terms of the ultimate adjustment of the loss. Practitioners should consult applicable state statutes and jurisprudence with respect to the admissibility of business records, claim support documentation and related evidentiary issues.

Insurance coverage disputes involving business interruption insurance are not significantly different from most other insurance coverage litigation.[16] From the insured's standpoint, it is important to note that business interruption insurance claims are, as are most first-party insurance claims, subject to established claims handling and settlement requirements under Louisiana law, including the bad faith statutes. From a defense perspective, the insurer's counsel should be proactive in the investigation of the claim, affirmatively raise applicable policy defenses and, where appropriate, issue reservation of rights under the policy. Of course, all of this is particularly important if it appears that a coverage dispute is likely to result in litigation.

On the other hand, because adjustment of business interruption claims requires interpretation of technical policy provisions and is generally based on evaluation of objective financial data, consideration should be given to the resolution of these claims by means of ADR mechanisms, particularly mediation. In most cases, an effective mediator should be able to assist the parties in identifying the key issues and in reaching a prompt and cost-effective, out-of-court settlement.

FOOTNOTES

1. *See*, "The Economic Impact of the August 2016 Floods on the State of Louisiana," a report commissioned by LED and prepared by Dek Terrell, Ph.D. (Lewis Terrell and Associates, L.L.C.).

2. Press release issued by catastrophe modeling firm AIR Worldwide, Sept. 19, 2016, *www.air-worldwide.com*.

3. *See*, "2016 Roundup: Louisiana August Flood Recovery" (FEMA, Release No. NR-118, Dec. 28, 2016).

4. Years after Hurricanes Katrina and Rita, most of the unanswered questions that triggered the hurricane-related litigation now have been addressed by state and federal courts throughout Louisiana. For a discussion of the post-Katrina hurricane litigation, *see generally*, James M. Garner, Darnell Bludworth and Martha Y. Curtis, "The Status and Evolution of First-Party Property Insurance Bad Faith Claims after Hurricane Katrina," 62 Loy. L. Rev. 25 (Spring 2016); and Judy Y. Barrasso and Kristin L. Beckman, "Katrina's Impact on Litigation of Insurance Claims under Louisiana Law," 62 Loy. L. Rev. 47 (Spring 2016).

5. *Compare* Cali v. Republic Fire & Cas. Ins. Co., 2009 U.S. Lexis 117299 (E.D. La. 2009) (rain water that accumulated on ground and seeped into house through weep holes in brick façade was "surface water" within policy exclusion), with Cochran v. Travelers Ins. Co., 606 So.2d 22 (La. App. 5 Cir. 1992) (rainwater that collected on roof, overflowed, and seeped into building was not included in policy's surface water exclusion).

6. For a comprehensive discussion of business interruption insurance, *see generally* "Business Interruption Insurance," 37 A.L.R. 5th 41 (1996-2016).

7. *See*, United Land Investors, Inc. v. Northern Ins. Co. of America, 476 So.2d 432 (La. App. 2 Cir. 1985). The general purpose of business interruption coverage is to protect the earnings which the insured would have enjoyed had no interruption or suspension of business had occurred. Generally, a business interruption is a temporary cessation or impairment of the operations of an established business. Young v. Lafayette Ins. Co., 4 So.3d 162 (La. App. 4 Cir. 2009).

8. *See*, Copes v. American Central Ins. Co., 85 Fed. Appx. 391 (5 Cir. 2004). However, some business interruption policies extend coverage where damage occurs to the property of the insured's suppliers and/or customers, as opposed to the insured's own property. This is referred to as "contingent" business interruption coverage. See, C II Carbon, L.L.C. v. National Union Fire Ins. Co. of La., Inc., 918 So.2d 1060, 2005 WL 3528761 (La. App. 4 Cir. 2005). Another form of "off premises" coverage is the "Service Interruption Coverage." This covers business interruption losses resulting from damage to personal property of a utility necessary for supplying the insured premises with things such as power, water, natural gas, communication, Internet access, etc. Typically, the property damage of the utility must be caused by a covered cause of loss under the policy.

9. *But see*, United Land Investors, *supra* at 437-438 (providing coverage for the "actual length of the business interruption" where the insured could not begin rebuilding until it received payment from the insurer).

10. *See*, Cotton Bros. Banking Co. v. Industrial Risk Insurers, 774 F.Supp. 1009 (W.D. La. 1989), *aff'd*, 951 F.2d 54 (5 Cir. 1992). For a discussion of the standard form business interruption loss valuations provisions, see Christopher C. French, "The Aftermath of Catastrophes: Valuing Business Interruption Insurance Losses," 30 Ga. St. U. L. Rev. 461 (Winter 2014).

11. *See e.g.*, Finger Furniture Co. v. Commonwealth Insurance Co., 404 F.3d 312 (5 Cir. 2005); Orrill, Cordell & Beary, L.L.C. v. CNA Ins. Co., 2009 WL 701714 (E.D. La. 2009); Sher v. Lafayette Ins. Co., 973 So.2d 39 (La. App. 2007), *aff'd in part and rev'd in part on other grounds*, 988 So.2d 186 (La. 2008); Berk-Cohen Associates, L.L.C. v. Landmark Insurance Co., 433 F. App'x 268 (5 Cir. 2011).

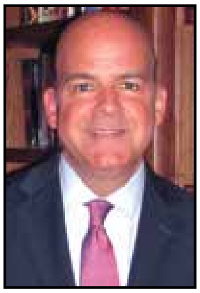
12. *See*, Chalmette Retail Ctr., L.L.C. v. Lafayette Ins. Co., 21 So.3d 485 (La. App. 4 Cir. 2009).

13. *See generally*, M. Quinn and P. Hopper, "Extra Expense and Business Interruption Coverage," 26 No. 3 Ins. Litig. Rep. 97 (2004).

14. *See*, 730 Bienville Partners, Ltd. v. Assurance Company of America, 2002 WL 31996014 (E.D. La. 2002) (Feldman, J.).

15. Cotton Bros. Banking Co., 774 F.Supp. at 1028.

16. *See generally*, D. Polin, "Recovery Under Business Interruption Insurance," 41 Am. Jur. Proof of Facts 3d 319 (2005).



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