Insurance Coverage for Business Interruption Claims in the Aftermath of Hurricanes Katrina and Rita

By José R. Cot

In the aftermath of Hurricanes Katrina and Rita, many business owners in southeast Louisiana have filed insurance claims in connection with damage to their buildings, equipment and other assets. Coverage with respect to these claims is generally provided under comprehensive first-party property policies. These policies are typically written on an "all-risk" or "multi-peril" basis, meaning that they are designed to indemnify the policyholder 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 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 — centers on the proverbial "wind v. flood" controversy, *i.e.*, whether the ensuing losses were caused by the hurricane's 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.

Scope of Business Interruption Coverage

A significant component of commercial first-party property insurance policies is the so-called "business interruption" insurance.[1] This type of coverage is designed to protect the insured for the risks associated with an interruption of the insured's business as a result 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.[2]

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 few 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.[3] 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.[4] 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.[5] 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.

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. 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.[6]

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Standard Exclusions

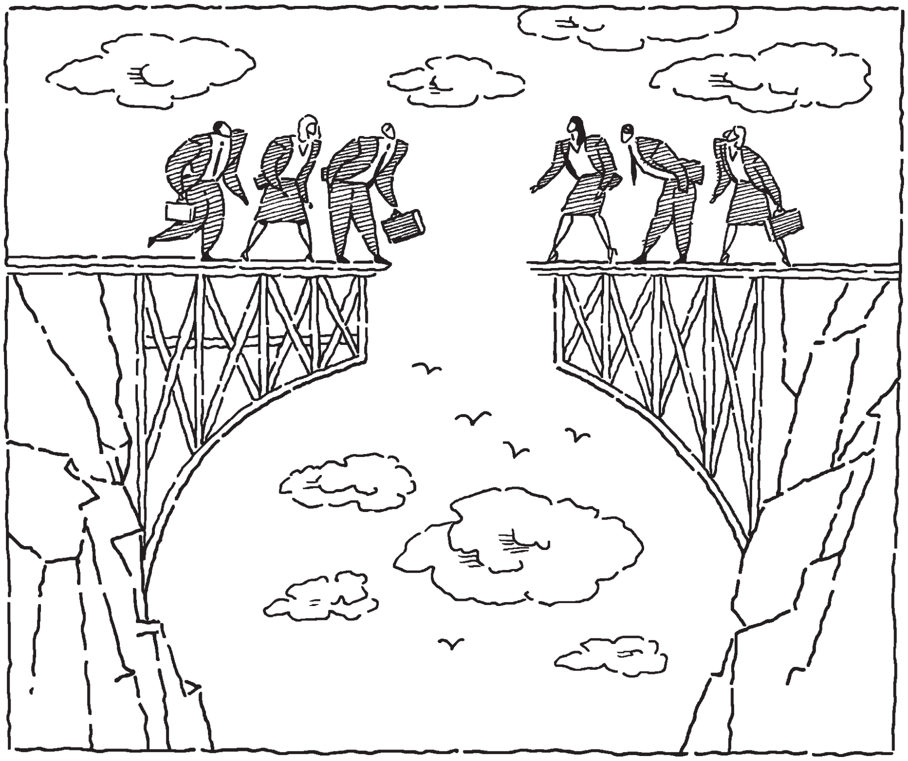
As with most types of insurance coverage, standard business interruption policies also contain certain policy exclusions. For example, there is no coverage for any extra expense or increase of business income loss caused by enforcement of any ordinance or law regulating the use, construction, repair 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.[7] 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.

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.



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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.[8] 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.[9] 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, raise applicable policy defenses and, if 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. For a comprehensive discussion of business interruption insurance, see generally B. Ostrager and T. Newman, *Handbook on Insurance Coverage Disputes*, §16.01 (12th Ed. 2004), and "Business Interruption Insurance," 37 A.L.R. 5th 41 (1996-2005).

2. *See* United Land Investors, Inc. v. Northern Ins. Co. of America, 476 So.2d 432 (La. App. 2 Cir. 1985).

3. *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., ____ So.2d ____, 2005 WL 3528761 (La. App. 4 Cir. 2005).

4. *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).

5. *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).

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

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

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

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

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