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Technical Advisory

TA 251

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Subject: Business Income & Hurricanes – Q&A

Background: Catastrophic losses such as hurricanes, earthquakes and wildfires bring to the forefront myriad insurance issues, including coverage disputes, valuation problems, and the like.

Business income coverage is in itself one of the most challenging topics in insurance. Given the additional complexities surrounding the recent hurricanes, a number of questions are frequently asked about business income and hurricanes.

Main Points: Below are some of the most common questions that have arisen regarding business income coverage and hurricanes.

Q. What is the latest with the wind vs. flood dispute, and how does this impact business income coverage?

The issue of wind vs. flood damage is shaping up to be the (or one of the) 500-pound gorillas in resolving hurricane coverage claims, both for direct damage as well as indirect losses such as business income. In the ISO business income coverage form (CP 00 30), the coverage trigger relies on a necessary suspension of operations caused by direct physical loss at the described premises, caused by a Covered Cause of Loss. With flood being excluded in standard policies, a potential dispute arises over the cause of the damage which resulted in a loss of business income.

Interestingly, however, the issue of wind vs. flood is not new, nor is the broader problem of multiple causation of loss unique to the current hurricane coverage debate.

In 1949, the Louisiana case of *Ebert v. Pacific National Fire Insurance Company* (40 So.2d 40) raised one of the earliest legal challenges to the wind vs. flood issue. During a hurricane, a small dwelling (being used as a camp) was heavily damaged. The insured contended that it had been blown off its foundation by the force of the wind, and was subsequently further damaged by the rising water. The insurer argued that the dwelling had floated off its foundation due to the rising waters of a nearby lake, which would place the cause of loss within the policy's flood exclusion.

In its ruling for the insured plaintiff, the court held that "*the wind directly damaged the property and was alone the proximate and efficient cause of the camp being deposited in the water.*" [Emphasis added.]

The reference to wind being the “*proximate and efficient cause*” of loss had significant impact on future wind vs. flood litigation in Louisiana and other states. In fact, *proximate cause* itself was described by the Idaho Supreme Court in a 1983 case as “exceedingly complex and difficult.” (668 P.2d 110, 119) The court cited a quotation from *the Handbook of Torts* by Prosser, which opined that in the issue of proximate cause “there is perhaps nothing in the entire field of law which has called forth more disagreement.”

The issue of “*efficient cause*” or “*efficient proximate cause*” has been used by insureds in a number of states over the years to counter exclusions written into insurance policies. Under the concept of *efficient proximate cause*, if a covered peril causes an excluded peril, the entire claim is covered, under the theory that the covered peril set into motion a chain of events which lead to the loss, where the covered peril was the predominant factor in the eventual loss.

This doctrine has been adopted by many states, and has given rise to the counter-argument by insurers, called “*concurrent causation*,” sometimes referred to as “*anti-concurrent causation*.” Here, exclusionary language is crafted with the intent of achieving coverage only for the causes of loss intended by the form, and excluding other intervening causes which are not intended to be covered. The ISO Special Form Causes of Loss (CP 10 30) is typical of *concurrent causation* language found in Commercial Property, BOP, and Homeowners Policies:

B. EXCLUSIONS

1. *We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.*

g. Water

(1) *Flood, surface water, waves, tides, tidal waves, overflow of any body of water, or their spray, all whether driven by wind or not;*

(2) *Mudslide or mudflow;*

(3) *Water that backs up or overflows from a sewer, drain or sump;*

(4) *Water under the ground surface pressing on, or flowing or seeping through:*

(a) *Foundations, walls, floors or paved surfaces;*

(b) *Basements, whether paved or not; or*

(c) *Doors, windows or other openings.*

But if Water, as described in g.(1) through g.(4) above, results in fire, explosion or sprinkler leakage, we will pay for the loss or damage caused by that fire, explosion or sprinkler leakage.

As noted above, several states have adopted the doctrine of *efficient proximate cause*. That does not necessarily negate the acceptance of the doctrine of *concurrent causation*. In some states, the two doctrines co-exist in the jurisprudence, and both are available as viable legal arguments in litigation. At the same time, neither is generally considered against public policy, a condition that would prove legally fatal. Additionally, the majority of cases have consistently placed the burden of proof on the *insured* in establishing that the alleged peril was the proximate and precipitating cause of loss.

One interesting case illustrates the legal hurdle an insured must overcome to establish this argument. With a Hurricane Betsy brewing in September 1965, the owner of a horse moved the horse from the barn to a more secure location. When the hurricane passed, the horse was moved back to the barn, but put in a different stall, due to some damage in the barn. The horse later kicked in a portion of a wall in his stall, and gained access to an adjoining room in which a large bag of wheat was stored. After overeating, the horse later died of laminitis (founder).

The owner of the horse claimed for the loss under a policy providing windstorm coverage, asserting that the hurricane was the proximate cause of the horse's death. The Louisiana Supreme Court rejected this claim, holding that while the hurricane played an indirect role in the events, windstorm was not the proximate or immediate cause of the horse's death. (*Lorio v. Aetna Insurance Company*, 232 So.2d 490.)

In cases where there is unrefuted evidence that both wind and flood caused a loss, courts often attempt to determine the relevant pro rata amount of damage done by each peril. A typical case is *Urrate v. Argonaut Great Central Insurance Co.*, 881 So.2d 787. A waterfront restaurant was damaged by Hurricane Georges in 1998. The insured and insurer disputed the amount of damage done by the wind. (The flood insurer paid \$524,055 for building and contents loss.)

The appellate court awarded the insured 25% of his 1998 business income loss, and 15% of the 1999 business income loss, which the court determined was the pro rata amount of the loss attributable to wind. In addition, he was awarded \$35,000 for broken glass in the restaurant.

However, this came after over six years of litigation, which included appeals to the state supreme court by both the insured and insurer. Both writs were denied by the Louisiana Supreme Court in January 2005 – (see 891 So.2d 686 & 690).

As one prominent insurance attorney later commented about wind vs. flood litigation, “the decisions are highly fact-intensive, are admittedly non-scientific, and sometimes take several years from the time that it stopped raining.”

There is little doubt that with the pending (and growing) litigation arising out of the recent hurricanes, it will likely take years to resolve the cases. For example, in the dead horse case above, the hurricane occurred in 1965, and the case wasn't finalized by the courts until 1970. Many of the cases involving *efficient proximate cause* vs. *concurrent causation* normally involved two causes of loss, such as wind vs. flood. The current litigation now present and on the horizon will often involve multiple *defendants*, such as oil companies, government officials, and insurers, as well as multiple *issues*, such as the design, construction and maintenance of levees, pollution, faulty decisions, insureds' expectations, matters of public policy, and, of course, wind vs. flood.

Thus, for insureds with direct property damage as well as business income losses, resolution could be a long time coming.

Q. For insureds with flood coverage, is there any business income coverage?

In the standard NFIP flood policy, there is no business income coverage. For insureds who have a DIC (Difference in Conditions) policy – which generally includes flood – some include business income from flood and some don't.

Q. What about the Civil Authority coverage as it relates to business income? Would coverage apply to most business income claims that resulted from the evacuation orders, and has there been any progress in resolving some of the issues that surfaced about this?

The civil authority provision of the business income form is one of the Additional Coverages, and reads as follows:

Civil Authority. We will pay for the actual loss of Business Income you sustain and necessary Extra Expense caused by action of civil authority that prohibits access to the described premises due to direct physical loss of or damage to property, other than at the described premises, caused by or resulting from any Covered Cause of Loss.

The coverage for Business Income will begin 72 hours after the time of that action and will apply for a period of up to three consecutive weeks after coverage begins.

The coverage for Extra Expense will begin immediately after the time of that action and will end:

- (1) 3 consecutive weeks after the time of that action; or*
- (2) When your Business Income coverage ends;*

whichever is later.

Note several key points about the civil authority coverage: (1) a civil authority must prohibit access to the described premises; (2) the reason for restricting access must be because of damage to some other premises; (3) the damage to some other premises must be due to a covered cause of loss in the insured's policy; (4) coverage lasts for up to 3 consecutive weeks; (5) there is a 72-hour wait (i.e., deductible) for Business Income coverage (but not Extra Expense coverage).

Given the complexities of events surrounding the recent hurricanes, even this seemingly simple coverage provision has gotten fairly complicated and confusing. For starters, there has been some debate about the exact content of the "evacuation orders." It appears that in some areas, the evacuation was mandatory, while it was voluntary in others. In either case, these steps were taken in advance of the hurricane, as a precaution.

In addition, there was involvement by federal, state and local officials in issuing various warnings, declarations, and evacuation orders.

Following the hurricane, however, especially where levee-related flooding occurred afterwards, return access was prohibited in the days immediately afterward. Certainly, there was also damage in the area due to windstorm from the hurricane.

Secondly, the requirement that the prohibited access be the result of damage to a premises “*other than the described location*” is considered by some authorities to be so vague, and thus so potentially broad, that one could argue the damage in one state would logically lead authorities in a neighboring state to evacuate and prohibit access to areas threatened by the oncoming hurricane.

Lastly, the issue of covered cause of loss is present again, as discussed in the first question above. Where there is damage in an area from both covered and non-covered events, some insurers have been reluctant to provide coverage.

In Louisiana, the issue was raised with the Department of Insurance. Subsequently, the Independent Insurance Agents & Brokers of Louisiana (IIABL), issued the following information bulletin to its members:

LDI will not issue a blanket statement that all policyholders are automatically covered under Civil Authority for these hurricanes, because there may be some situations where the facts may exclude coverage. However, LDI has determined that in most areas (including Orleans & Jefferson) where the civil authority prohibited people from returning, the orders were primarily a result of dangers created by wind damage (power lines & trees down, looting, etc.), and that Civil Authority claims as a general rule should be covered. Insurance companies should only deny Civil Authority claims if they have specific evidence that the reason for the Civil Authority order was specifically a result of flood, or for other reasons that are clearly excluded under the terms of the policy. Insurers should make an individual determination on each claim and should not deny Civil Authority coverage simply because there was flooding in the area of the insured property.

Policyholders and insurance agents, who believe that their Civil Authority claim was improperly denied, should file a complaint with the Louisiana Department of insurance.

Q. As businesses slowly start to reopen, many will not see an immediate return to pre-storm levels. How does the business income coverage respond to this?

Business income coverage typically ends once operations are resumed, which terminates the defined “period of restoration.” The coverage form states that the “period of restoration” ends as follows:

*“Period of Restoration”...
Ends on the earlier of:*

- (1) The date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality; or*
- (2) The date when business is resumed at a new permanent location.*

However, there is a recognition in the business income form that often, insureds experience what is sometimes referred to as a “lag loss” – that is, the insured’s business location is repaired and operating, but the level of sales or income have not fully resumed to pre-loss levels yet. Therefore, the Additional Coverage called “Extended Business Income” is provided in the business income form. It grants a 30-day extension to the end of the “period of restoration,” as follows:

*Extended Business Income.
Ends on the earlier of:*

- (i) The date you could restore your "operations" with reasonable speed, to the level which would generate the business income amount that would have existed if no direct physical loss or damage occurred; or*
- (ii) 30 consecutive days after the date determined in (1)(a) above.*

In addition, this 30-day provision can be increased in increments up to 730 days (2 years) with the Extended Period of Indemnity option.

It is important to note, however, that both the Extended Business Income provision and the Extended Period of Indemnity option have a restrictive condition that will have a negative impact on some businesses in the affected areas. It deals with the diminished business climate and depressed business conditions that often linger in the area long after the hurricane has passed.

Here is the restrictive condition:

However, Extended Business Income does not apply to loss of Business Income incurred as a result of unfavorable business conditions caused by the impact of the Covered Cause of Loss in the area where the described premises are located.

This condition was added after Hurricane Andrew, and is intended to provide coverage for the amount of time the insured's operations could be restored, and does not allow coverage for a reduced business climate in the general area, even if caused by the same covered peril that damaged the insured's location.

Q. As is always the case, some businesses fare better after a catastrophe than others. For a business that could be doing a bang-up business in the recovery and reconstruction period but can't take advantage of the opportunity due to damage at their facility, does their business income coverage take into account this larger potential lost income?

No. The business income coverage is designed to measure only the amount of lost income that is based on the "likely" business income had no damage occurred, but without consideration for what the business could have earned given the "favorable" business climate that prevails after the actual loss.

Here is the provision for loss determination:

D. LOSS CONDITIONS

4. Loss Determination

a. The amount of Business Income loss will be determined based on:

(1) *The Net Income of the business before the direct physical loss or damage occurred;*

(2) *The likely Net Income of the business if no loss or damage had occurred, but not including any Net 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 Loss on customers or on other businesses.*

This condition to ignore the possible increased loss of income due to a “favorable business condition caused by a covered cause of loss” was added after Hurricane Andrew. It is often described in insurance literature as intending to bar “windfall profits” an insured might have enjoyed following an upturn in the local business climate resulting from a covered cause of loss.

Q. Based on past hurricanes, especially the ones last year, what are some of the lesser-known issues that come to the forefront in business income situations?

Here are some of the most common issues.

1. Off-premises utility services. Once known as “off-premises power failure,” the exclusion now more broadly refers to the failure of “*power or other utility.*”

The Cause of Loss Form, which is used in conjunction with the Business Income Form, contains an exclusion for off-premises utility services, as follows:

4. Special Exclusions

The following provisions apply only to the specified Coverage Forms.

a. Business Income (And Extra Expense) Coverage Form, Business Income (Without Extra Expense) Coverage Form, or Extra Expense Coverage Form

We will not pay for:

(1) Any loss caused directly or indirectly by the failure of power or other utility service supplied to the described premises, however caused, if the failure occurs outside of a covered building.

But if the failure of power or other utility service results in a Covered Cause of Loss, we will pay for the loss resulting from that Covered Cause of Loss.

It is important to note that the exclusion applies no matter the cause of the utility failure, even if by a covered cause of loss such as windstorm. Coverage can be obtained with endorsement CP 15 45 – Utility Services – Time Element. The endorsement includes options for “*water, communications and power*” utility services.

Incidentally, there is a similar exclusion which applies to the direct damage forms, such as the Building and Personal Property Coverage Form, and a buy-back endorsement is CP 04 17 – Utility Services – Direct Damage.

However, these two endorsements only provide coverage for an interruption in utility services that is caused by a Covered Cause of Loss in the policy, so disputes about wind vs. flood will likely arise here, too.

By comparison, the August 2003 power blackout that affected 9 states and approximately 50 million people in the U.S. and Canada was estimated by the Electric Consumer Research Council to have cost between \$4 billion and \$10 billion in losses in the U.S., both from direct damage and indirect or consequential loss. But, according to ISO's Property Claims Service, only about \$180 million in claims were paid, with just one-third going to commercial insureds.

According to ISO and other industry sources, there were several reasons for the relatively small amount of insured losses. First, it is estimated that only 10%-15% of commercial insurance customers purchase the coverage buy-back for power or utility failure. Second, standard business income coverage includes a 72-hour waiting period, which is essentially a 3-day deductible. Third, a significant cause of the outage was not due to a Covered Cause of Loss in the policy, but rather was due to various problems with the electric grid itself.

2. Ordinance or Law. The O&L exclusion bears on the "period of restoration" condition in the business income form, as follows:

G. DEFINITIONS

3. *"Period of Restoration"*

"Period of restoration" does not include any increased period required due to the enforcement of any ordinance or law that:

- (1) Regulates the construction, use or repair, or requires the tearing down of any property;*

If there is a delay in repairing or restoring the described location due to an ordinance or law, the "period of restoration" does not extend to cover the additional time to resume operations. A buy-back is available with endorsement CP 15 31 – Ordinance or Law – Increased Period of Restoration.

As with off-premises utility failure, there is a direct damage buy-back endorsement, the CP 04 05 – Ordinance or Law Coverage.

3. Pollution. Similar to the O&L exclusion above, the "period of restoration" has a limitation relating to pollution, as follows:

G. DEFINITIONS

3. *"Period of Restoration"*

"Period of restoration" does not include any increased period required due to the enforcement of any ordinance or law that:

(2) Requires any insured or others to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize, or in any way respond to, or assess the effects of "pollutants."

Note that in the case of pollutants and contaminants left over from flood waters, a delay in repairing or rebuilding the insured's location due to testing, cleaning up, etc., does not extend the "period of restoration" for business income coverage. In addition, ISO does not offer a buy-back endorsement.

4. The 72-hour waiting period. The definition of the "period of restoration" was changed in 1995 to add a 72-hour waiting period, which is essentially a 3-day deductible. This provision was also added to the Civil Authority coverage, but does not apply to Extra Expense coverage. There are two endorsements available to amend this waiting period. The endorsement CP 15 55 – Business Income Changes – Time Period reduces the waiting period to 24 hours, while the endorsement CP 15 56 – Business Income Changes – Beginning of The Period of Restoration provides a no waiting period option.

Q. Given the devastation and dislocation in some areas hardest hit by the hurricane, some businesses are going to permanently relocate to nearby locations. How will their business income coverage work in these cases?

Another significant change made in 1995 was to amend the "period of restoration" to take into account the possibility that the insured might choose to relocate, rather than rebuild at his/her present location. Here is the current language from the business income form:

G. DEFINITIONS

3. "Period of Restoration"

b. Ends on the earlier of:

(1) The date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality; or

(2) The date when business is resumed at a new permanent location.

Note that if the insured chooses to relocate, he/she is not given any *additional* time to do so. The "period of restoration" lasts only as long as the amount of time it would have taken to repair, rebuild or replace the original location.

Q. What if my insured never reopens? I know some are seriously considering that option. Would they get any recovery from their business income coverage?

Actually, that is not unusual. Industry studies show that approximately 43% of businesses that suffer a major loss never reopen. The business income coverage recognizes that potential, and includes a provision for it as follows:

4. Loss Determination

d. If you do not resume "operations," or do not resume "operations" as quickly as possible, we will pay based on the length of time it would have taken to resume "operations" as quickly as possible.

As with the previous question about an insured who chooses to relocate, an insured who elects not to reopen at all is still provided business income coverage for the amount of time it would have taken to repair, replace or rebuild.

Q. One of the reasons some of my insureds might be unable to reopen is that either their suppliers or customers have suffered major losses, and will remain closed for who knows how long. Does my insured's business income policy provide any coverage for this?

There is an optional coverage for what is generally known as "contingent business income," although today it is provided by an endorsement called Business Income From Dependent Properties – Broad Form (CP 15 08). (A second endorsement is the CP 15 09 – the Limited Form.)

Essentially, the coverage is designed for just the situation in the question – that is, the insured suffers a loss of income because of damage to some other business on whom he depends for materials, products, or customers.

The endorsement includes four optional categories of "dependent properties" the insured might elect coverage on: *a. contributing locations; b. recipient locations; c. manufacturing locations; and d. leader locations.* They are defined as follows:

1. *"Dependent Property" means property operated by others whom you depend on to:*
 - a. *Deliver materials or services to you, or to others for your account (Contributing Locations). With respect to Contributing Locations, services does not mean water, communication or power supply services;*
 - b. *Accept your products or services (Recipient Locations);*
 - c. *Manufacture products for delivery to your customers under contract of sale (Manufacturing Locations); or*
 - d. *Attract customers to your business (Leader Locations).*

Additionally, the "period of restoration" in the insured's policy is amended for these dependent properties in the following manner:

"Period of Restoration", with respect to "dependent property", means the period of time that:

- a. *Begins 72 hours after the time of direct physical loss or damage caused by or resulting from any Covered Cause of Loss at the premises of the "dependent property"; and*
- b. *Ends on the date when the property at the premises of the "dependent property" should be repaired, rebuilt or replaced with reasonable speed and similar quality.*

"Period of restoration" does not include any increased period required due to the enforcement of any ordinance or law that:

- a. *Regulates the construction, use or repair, or requires the tearing down of any property; or*
- b. *Requires any insured or others to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize, or in any way respond to, or assess the effects of "pollutants".*

The expiration date of this policy will not cut short the "period of restoration".

Note, however, that a Covered Cause of Loss (in the insured's policy) is still required for a loss to be insured arising out of damage to any of the dependent properties.

For an excellent resource on a wide variety of issues relating to hurricanes and insurance, see the IIABA's Virtual University at www.independentagent.com/vu.

Special thanks to John Eubank, CPCU, ARM, for his valuable assistance with this article.

Necessary Action: Circulate this Technical Advisory to all appropriate agency staff.