

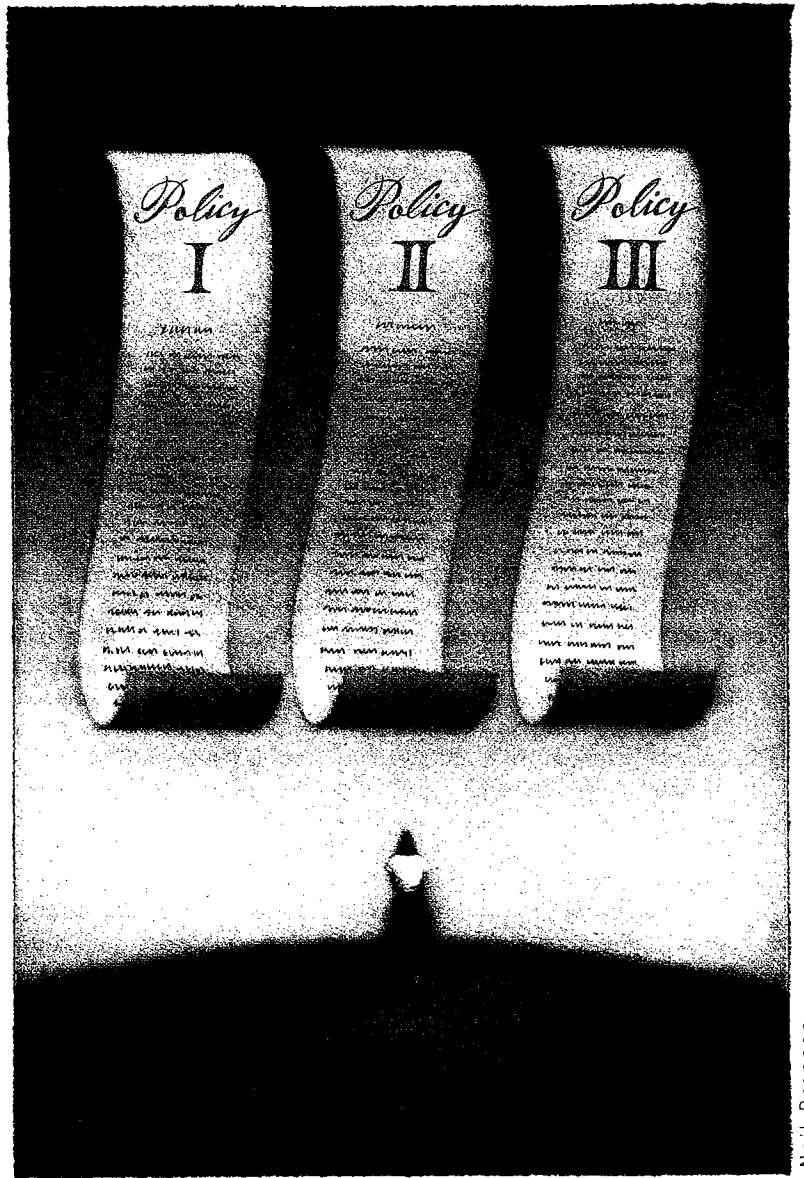
# Re-Examining Business Interruption Insurance

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**B**usiness interruption (BI) insurance has been available for over a century. The earliest policies covered rental value, a notion tied to the physical destruction of real property. Use and occupancy insurance policies were introduced later to protect the manufacturing earnings stream. Under early use and occupancy policies, the amount of loss correlated directly with the extent of direct damage to property. From there, a transition was made to calculate BI loss on the basis of a fixed daily value.

The 1920s saw the last great revision of the BI policy form. With the manufacturing economy in full swing, an effort was undertaken to create a form that would indemnify the insured for its actual loss of earnings. The term selected to embody this concept was “actual loss sustained,” meaning, in the view of the late Clyde Kahler, the highly regarded professor of insurance at The Wharton School of the University of Pennsylvania in Philadelphia, “the loss of earnings consequent to the peril insured against.” In this simple concept, however, great complexity was embedded. Without the safety net of the valued form in place, just how would actual loss sustained be determined?

The framers devised an elegant solution still used as standard language in manuscript policies today: By giving “due



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*This is the first of three articles that will address business interruption (BI) insurance as part of the Crisis Management Series. In this installment, the authors examine the evolution of today's BI insurance terms and conditions; the three classes of policies generally available before September 11, 2001; the potential exposures; and the legal precedents that may hold a clue to coverage determination. Coming in March and April: "Risk Management Best Practices for Preparing BI Claims" and "Resolving BI Claims Fairly while Preserving Market Relationships."*

consideration to the experience of the business before the date of damage and the probable experience thereafter had no loss occurred," the insured and insurer could reach reasonable accommodation regarding the actual loss sustained. Based on past experience and the future probable experience, the insured loss could be determined in a commercially reasonable manner. From this principle, courts articulated the widely accepted purpose of BI insurance: to do for the insured what it would have done for itself had no loss occurred.

### Three Classes of Policies

Unlike standard form commercial liability insurance policies, first party property and BI insurance policies lack the uniformity businesses would expect from a worldwide system of risk management. Thus, the precise language of a given insurance policy must be examined before any coverage conclusions can be drawn.

The vast majority of small and midsized businesses in the United States are insured under BI forms developed by the Insurance Services Office (ISO). These standard forms embody what is perhaps the most carefully crafted (and in many respects, the most restrictive) language of any BI policy.

Insurers that specialize in covering highly protected risk (HPR) issue their own policy forms containing language unique to their underwriting requirements. These policies generally expand the coverage provided under the ISO forms to meet the needs of more sophisticated and complex risks. The HPR forms may also contain language covering novel loss situations, such as earnings lost while access to insured property is pre-

vented by physical damage to adjacent property.

A third category of policy forms—manuscript policies—provides the broadest coverage available. These have been developed and marketed for many years by the major international insurance brokers and contain unique terms and conditions. The recent competitive marketplace aided greatly in their proliferation.

### The September 11 Attacks and Resulting Business Interruptions

Before September 11, the largest insurance event on record was Hurricane Andrew, which caused insurable losses of approximately \$22 billion, taking into account inflation. Although a number of large commercial claims were among those paid, Andrew largely affected homeowners and featured many small claims with minimal BI impact. By way of contrast, the events of September 11 will result in billions of dollars of insured physical damage losses and billions more in associated BI losses. A number of individual losses are expected to exceed \$1 billion.

Also unique are the extraordinary loss situations that have arisen: hotel chains are measuring losses at resort hotels due to the Federal Aviation Administration ban on air travel; manufacturers are assessing financial damages incurred when just-in-time inventory systems were disrupted by border closures; and retailers are analyzing losses attributable to changes in buying patterns precipitated by the attacks.

These circumstances have triggered potential coverage under previously underutilized provisions—service interruption, contingent BI, interruption by civil or military authority and ingress/egress—and also raise the question of whether losses are recoverable if the business sustained no physical damage to either its insured or described property.

### The Necessity for Direct Physical Loss or Damage to Insured or Described Property

A relatively small number of businesses sustained direct physical loss as a result of the events of September 11. Will business interruption recovery be possible for loss incurred by a business that did not sustain direct physical loss or damage to property either insured or described in its BI policy? The answer is found in the specific language of the insurance policy at issue.

For example, the standard ISO business income coverage form reads:

"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 at the premises described in the Declarations . . .* caused by or resulting from any Covered Cause of Loss." (Emphasis added.)

Under this form, insurance companies contend that the suspension of operations and corresponding loss of business income must be caused by direct physical loss or damage to property described in the declarations.

Other BI policy forms, however, are not so restrictive. For example, in *Archers-Daniels-Midland Co. v. Phoenix Assurance Co. of New York* (1996), ADM sought coverage for extra expenses when flooding of the Mississippi River and resulting crop damage caused ADM to incur increased transportation and raw materials costs. The insurance policy at issue read:

"Extra Expense sustained by the insured as a result of direct physical damage caused by the perils insured against under this policy and not excluded elsewhere in this form . . ."

ADM argued that there were only two preconditions to coverage: (1) the extra expense was incurred as "a result of direct physical damage" that was (2) "caused by the perils

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insured under this policy." The insurance company countered by arguing that the extra expense provision was limited to situations in which the insured's described property was damaged.

In holding in favor of ADM, the federal court reasoned that when the insurance company wanted to limit coverage to either insured or described property it did so expressly, as was done explicitly for other provisions of the policy.

"In the case at hand, the [insurance company] could have insisted that coverage under the [extra expense] provision be limited to extra expense incurred as a result of damage to property at scheduled locations, but they did not," the court stated. "Such a requirement was stated in at least nine other places in the policy. After the insured has sustained a loss is too late to add such a restriction."

### **Contingent Business Interruption**

Contingent business interruption and contingent extra expense coverage reimburses lost profits and extra expenses resulting from an interruption of business at customers' or suppliers' locations. Coverage is generally triggered by physical damage to the property of the dependent customer or supplier, or to property upon which the insured depends to attract customers. The extent of loss is based on the time required to repair or replace the dependent property.

In one of the few, if not only, cases decided under a contingent BI clause, the court in the ADM case concluded that Midwest farmers and the United States government were suppliers of goods and services to ADM and that ADM was entitled to coverage when flooding prevented those suppliers from supplying it with necessary raw materials and transportation services.

### **Interruption by Civil or Military Authority**

Interruption by civil or military authority coverage reimburses policy-

holders for BI losses incurred when access to property, usually the insured premises, is affected by an order of a civil or military authority following a specified event. Potentially, no coverage extension has broader implications for September 11 claims.

Under ISO language, coverage is limited to losses incurred, after a seventy-two-hour waiting period and limited to three consecutive weeks, when action of an authority "prohibits access to the described premises due to direct physical loss or damage to property caused by a covered cause of loss." HPR policies are similarly worded, with some containing additional restrictions on the location of the property damage that triggers coverage, such as within one thousand feet of the insured premises.

The broker manuscript forms broaden coverage in many respects. First, many policies contain no time period limitations. Those manuscript policies that do contain time period limitations may provide for up to sixty days of coverage. Second, the word "prohibit" ("to forbid by authority") has in many cases been replaced by the word "impair" ("to make worse by diminishing in some material respect"). Third, while ISO and HPR forms state physical damage must give rise to the action by an authority, broker manuscripts are not as restrictive and often refer to governmental orders made "following or in connection with a peril." Also, some policies replace the phrase "access to the described premises" with "access to real or personal property," without specifying the location or ownership of the property to which access is prohibited.

Courts around the country are split on the issue of whether coverage for interruptions caused by orders of civil and military authorities requires physical damage. Compare *Bros., Inc. v. Liberty Mut. Ins. Co.* (1970) (no coverage absent physical damage to property) with *Kilroy Indus. v. United*

*Pacific Ins. Co.* (1985) (coverage found notwithstanding absence of physical damage to property).

### **Ingress/Egress**

Ingress/egress coverage is similar to the coverage provided for interruptions caused by civil or military authorities, absent the requirement of governmental action. It is not available under ISO forms, is in some HPR policies and is most prevalent in broker manuscript policies.

There is one reported interpretation of ingress/egress in the context of BI insurance. In *Fountain Powerboat Industries, Inc. v. Reliance Ins. Co.* (2000), the court noted the paucity of case authority on this issue, stating that "this is due to the fact that the meaning of the clause is exceedingly clear."

In *Fountain Powerboat*, access to the policyholder's facility was impaired after Hurricane Floyd caused flooding of the only road leading to the location. As in the ADM case, the insurance company argued that coverage was available under an ingress/egress clause only if there was physical damage to the policyholder's facility. The court rejected the insurance company's contention: "the court finds no requirement for physical loss to the [insured] property is required under the contract of insurance in order to trigger BI coverage under the ingress/egress clause."

### **Service Interruption**

Service interruption coverage pays for losses due to the interruption of incoming utilities caused by physical damage to property that supplies utility services, such as communication transmission lines, microwave relays, transformers and substations.

This coverage is available under the ISO form by endorsement. Some company policies require that the off-premises utility equipment be within one thousand feet of the insured property. The broker

manuscripts generally contain no such limitation, and service interruption coverage is written with specific sublimits of liability.

In *Thornton-White, Inc. v. Industrial Risk Insurers* (1981), the policyholder's business was interrupted when Hurricane Hugo knocked out the transmission lines within five hundred feet of the policyholder's business. The insurance company denied coverage by arguing that even if the transmission lines were not knocked out, the policyholder's business would nevertheless have been idle because the local utility was unable to provide service to the community generally.

In rejecting the insurance company's contention, the court held: "The [insurance company] cannot deny coverage by postulating that the hurricane would have interrupted electrical power generally even if it had not damaged Plaintiff's transmission lines. [The insurance company] does not know this and, by the very nature of the circumstances, such a proposition is necessarily speculative and cannot be proved."

### Extended Period of Indemnity

The purpose of extended period of indemnity (EPI) coverage is to restore the business to the condition that would have existed had no loss occurred. This coverage begins when the underlying BI coverage ends, and is typically purchased in thirty-day increments. It is not uncommon for policies to provide up to two years of additional coverage.

### **Other BI Coverage Features**

- Rental Value
- Leasehold Interest
- Extra Expense
- Extra Expense Incurred to Reduce Loss
- Expediting Expense Provisions

In a landmark decision, the court in *Fountain Powerboat* ruled that EPI coverage was also available in the case of ingress/egress loss. In holding for the insured, the court stated:

"[T]he length of time for which loss of ingress/egress may be claimed is the length of time to restore Fountain's business to the condition that would have existed had no loss of ingress/egress occurred."

### Future Implications

Twenty-four thousand businesses operated in lower Manhattan before September 11. Many thousands more depended on those businesses as buyers and sellers. Disruptions in utility services affected financial institutions worldwide. The FAA ban on air travel brought whole industries to the brink of bankruptcy.

Initial estimates of insurable losses were \$25 billion to \$30 billion. Revised estimates are now as high as \$70 billion and even \$100 billion. The full extent of business interruption losses remains uncertain.

Notwithstanding these projected losses, the insurance industry is ex-

pected to have a banner year. David Hale, chief economist at Zurich, Switzerland-based Zurich Financial, predicts commercial property/casualty premiums will double in the coming year to \$300 billion. Add another \$20 billion or so in fresh capital, governmental guarantees (or bailouts) and improved combined ratios, and the insurance industry is likely to be awash in cash—vastly more than enough to cover even the most inflated forecast of September 11 claims. It is clear where the money to pay for the losses will come from.

In the short term, risk managers will be asked to absorb higher premiums, higher deductibles, terrorist exclusions, loss of blanket limits, more restrictive terms and conditions, sublimits and perhaps even the elimination of indirect coverage such as ingress/egress. With reinsurance capacity at issue, and the ultimate liability for claims unknown, the markets are simply not willing to engage in business as usual.

Due to their size and complexity, September 11 BI claims will not likely be resolved any time soon, which may not be a bad thing. Risk managers should be patient until the markets settle, when they may end up using their exotic BI claims to leverage lower premiums when renewing policies. Risk managers holding broad coverage wording and unresolved BI claims might cause the market pendulum to swing back, and if the economy recovers in 2002, could well create the shortest hard market in history. 