

# CONTESTING THE COVER

David Goodwin and Natalie MacLean Leino explore some of the key issues which arise in business interruption insurance disputes

Most property insurance coverages involve *tangible losses* – a building burns down; a boiler explodes or a factory is flooded. Business interruption (BI) and other types of ‘time element’ coverages are different. They insure against *intangible economic losses* that a business experiences as a result of a covered peril, and are designed to place the business in the same economic position it would have occupied had the accident not taken place.

The distinction between tangible and intangible losses may make the adjustment of BI claims much more complicated than the adjustment of a property loss. A typical property loss turns on the cost of rebuilding or replacing the damaged property, which usually involves ‘hard’ costs. In contrast, a BI claim necessarily has a ‘guesswork’ component to it, as it requires the insurer and the policyholder to determine what the business would have earned in the hypothetical world in which the accident did not occur.

This article serves to highlight some of the key issues that arise in BI coverage litigation that businesses should keep in mind when purchasing BI coverage.

## **The interruption must be caused by physical loss or damage**

BI coverage is closely intertwined with property damage coverage. As a general rule, the property that the insurance policy covers must suffer physical loss or damage to trigger BI insurance. Thus, if a business loses profits due to an interruption of business but the interruption was not caused by physical loss or damage, a traditional BI policy is unlikely to respond. A classic example of this type of interruption sometimes occurs in the context of rioting or other civil disturbances. In one well-known case, a policyholder sued to recover BI losses resulting from rioting following the assassination of Martin Luther King, Jr. Responding to the rioting, the District of Columbia enacted a curfew and restricted alcohol sales, which caused the policyholder’s business to lose money. The policyholder alleged that its losses directly stemmed from the riots but did not claim physical loss or damage to the property itself. The court found that the losses were not caused by “damage to or destruction of real or personal property”, and held that the policyholder could not recover.

However, BI coverage has been found to exist when a policyholder can prove imminent danger of damage or loss (such as the threat of a pending collapse of a building) despite the lack of actual damage or loss. This is logical – if no coverage existed in this circumstance, the policyholder

might choose to wait for actual damage to occur rather than mitigate its losses. In addition, other types of ‘time element’ coverages extend BI insurance to claims arising when a covered peril or an order from a civil authority prevents access to the policyholder’s property. Prudent policyholders typically will purchase many of these ‘time element’ extensions of coverage. Also, BI policies commonly contain exclusions for damage or loss to electronic property because relatively minor amounts of physical damage can result in disproportionately large BI claims when business data is involved. Again, some insurers are willing to extend ‘time element’ insurance to electronic data losses.

## **The loss or damage generally must be to the policyholder’s property or to adjacent property**

Most BI policy forms protect only against damage or loss to property belonging to the policyholder. Many forms specify that coverage applies to losses ‘at the premises described’; other forms also cover loss or damage to property ‘adjacent’ to these premises. Although this latter coverage may seem straightforward, it can be a hotly contested issue. Does ‘adjacent’ mean the property must be touching the policyholder’s property, or can the property merely be close by if damage to the property has clear effects on the policyholder’s property? To be safe, when purchasing coverage, a business should assume that ‘adjacent’ means immediately next to the property unless otherwise specified in the policy. In one recent case following the September 11 terrorist attacks, a court held it was unambiguous that Washington National Airport was not ‘adjacent’ to the Pentagon, despite evidence that ash from the attacks at the Pentagon landed at one of the insured airline’s gates.

## **Coverage for interruptions caused by loss or damage to property of utilities, suppliers, customers, or nearby flagship companies must be contracted for separately**

Another important limitation of BI insurance is that BI losses suffered by a business because of damage or loss to property owned by the policyholder’s suppliers or customers, by nearby flagship businesses that draw customers to the area, or by public utilities that serve the policyholder’s business, generally are not covered. This is because the physical loss or damage suffered by such entities is not damage to or loss of property owned by the policyholder. For example, if a seafood restaurant is supplied entirely by Gulf of Mexico fisheries, this restaurant may have lost its main sources of fish following the recent oil spill and therefore might lose money. Although the spill



“Under this approach, if a policyholder suffers BI losses for an extended period of time due to construction delays, coverage is available until the restoration is complete”

might be the primary cause of the interruption, if the restaurant owner could not prove physical damage to property owned by the restaurant, these losses would not be covered under a typical BI policy.

If a business relies heavily on certain suppliers or customers or a nearby flagship business, the business should contract specifically for BI coverage based on property damage to these entities. This type of insurance, known as ‘contingent business interruption insurance’, is similar to BI coverage but defines the covered property as the property of these third-party entities. Some contingent BI policies list specific entities or geographic areas covered by the policy; others provide broader coverage based on ‘types’ of entities. The policyholder need not have contractual relationships with the entities listed. For example, in one case, contingent BI coverage was found to exist where the policyholder’s losses were caused by a lack of raw materials and services from ‘Midwest farmers’ and the United States Army Corps of Engineers, neither of which had any contractual relationship with the policyholder.

#### **Not all BI insurance policies will cover an interruption that is less than a total cessation of operations**

The term ‘business interruption insurance’ can be deceiving. Economic losses can occur even though the business continues and operations, thus, have not been completely ‘interrupted’ or ‘suspended’. Courts are divided on how to interpret the terms ‘interruption’ and ‘suspension’, with some holding they are synonymous and refer to a cessation of operations, and others holding that ‘interruption’ includes a slowdown of operations without a stoppage and that ‘suspension’ requires a complete cessation of business activities. It is advisable to secure BI coverage that explicitly states that slowdowns and partial interruptions are covered or that total cessation is not required.

#### **BI coverage applies only to losses incurred during the period of restoration**

BI insurance generally covers losses that occur while the damaged property is being repaired or replaced. The appropriate length of time, often called the ‘period of restoration’ (or ‘loss period’ or ‘period of indemnity’) is a frequent subject of litigation. For instance, if a repair is estimated to take three months but actually takes six months, will BI coverage apply during the entire six months (until the damage is actually repaired) or only during the three months that were anticipated?

Courts are divided on whether to apply an objective standard (i.e., the time it would take a reasonable person in the policyholder’s position to repair the damage and reenter business) or a subjective standard (i.e., the time it actually takes the policyholder to do so). The law appears to be headed towards the application of an objective standard to determine the loss period when the policyholder chooses *not* to repair the damage and a subjective standard when the policyholder chooses to repair the damage. Under this approach, if a policyholder suffers BI losses for an extended period of time due to construction delays, coverage is available until the restoration is complete. It is important to note, however, that delays due to upgrades or to comply with changes in building codes generally must be borne by the policyholder (although coverage for upgrades may be endorsed onto BI policies); similarly, purposeful delays by the policyholder (such as a decision to expand a damaged



facility as long as repairs are occurring anyway) would not be included in the loss period. In contrast, if a loss period is extended because the insurer has been slow to adjust the loss, courts generally include that extension.

#### **What constitutes restoration is often debated**

Another hotly contested issue that arises with regard to the calculation of the period of indemnity is whether the period should last until the property can be restored exactly to the condition it was in before the accident, or only until a reasonable substitute can be completed.

An interesting dispute in this area occurred in the aftermath of the September 11 attacks. A policyholder owned hundreds of pharmacy branches, but the World Trade Center branch, because of high foot traffic, was the policyholder’s single most profitable location. When the branch was destroyed, the policyholder argued that its BI policy, which covered all of the branches, should provide coverage until the World Trade Center was rebuilt and the branch could be reopened in its previous location. The insurer argued, however, that the loss period should span only during the time it would take the company to open a comparable branch nearby. The court sided with the insurer. The court noted that neither the branch nor its address was singled out in the policy, so the parties did not specifically intend the loss period to last until the branch could be restored at its exact location. A lesson to be gleaned from this case is that if BI coverage is desired until a particular location can be restored exactly to its pre-loss condition, the policy should include specific details regarding the property and make clear that this coverage is being contracted for in the policy.

#### **Generally only lost profits and fixed expenses during the loss period can be recovered**

Under many standard BI policies, only lost profits and fixed expenses that occur during the loss period can be recovered. A common misunderstanding centres around



“Does ‘adjacent’ mean the property must be touching the policyholder’s property, or can the property merely be close by if damage to the property has clear effects on the policyholder’s property?”

what constitutes a loss that occurs *within* the policy period. BI policies typically exclude coverage for loss of contracts or markets. However, that exclusion does not bar coverage for profits lost during the ‘period of restoration’, even if caused by a lost contract or market. Instead, the exclusion applies to losses involving lost contracts or customers after the loss period.

In a commonly cited example, an insured bowling alley lost a number of commitments from bowling leagues during the league season due to a fire that destroyed the bowling alley. The policyholder and insurer stipulated to a theoretical period of restoration, and it was not disputed that the policyholder lost these pre-arranged commitments for the entirety of the bowling season. Despite acknowledging that the policyholder suffered losses that would last for months after the theoretical loss period ended, the court held that the policyholder was entitled to recover only the profits it would have earned from these commitments during the loss period. One way a business can protect against this type of situation is by purchasing ‘extended period of indemnity’ coverage, which extends the loss period until the policyholder’s operations are restored to their pre-loss levels.

#### **The policyholder has the burden of proving lost profits**

Finally, in order to recover under a BI policy, the policyholder must demonstrate what its profits would have been had the loss or damage never occurred. Thus, adequate business records that demonstrate past performance and likely future performance are essential. Also, if a business was losing money prior to the loss or damage, the business likely would not be able to show lost profits and thus would not be able to recover for BI losses (although other types of ‘time element’ coverages, such as extra expense or expense to reduce loss insurance might apply). Likewise, if a firm were about to go out of business when the loss or damage occurred, it would be difficult to show that the business lost future

earnings. On the flip side, if a business can show that a recent improvement meant that the lost earnings would have been greater than those before the loss period, the policyholder may be able to recover more than past experience would suggest.

One interesting issue that has arisen in this area is whether the standard for lost profits is the amount of profits the business would have made had a catastrophic event (such as a hurricane) never occurred or whether the loss consists of the profits that the business would have earned had the catastrophic event taken place but the insured business alone had been spared. In a recent case, a court applied the former test and held that a casino’s lost profits are those that the casino would have earned had the hurricane not occurred.

#### **Art and science**

Because BI claims thus often can involve as much ‘art’ as ‘science’, and because large economic losses may be involved, some BI insurers have become increasingly reluctant to pay BI claims, especially those arising out of catastrophes such as Hurricane Katrina. As a result, litigation over BI insurance coverage disputes, which was almost unheard of twenty years ago, has become commonplace today.

*The views and opinions expressed in this piece are those of the authors and do not necessarily reflect the views of Covington & Burling LLP or any of its clients.*

#### **DAVID GOODWIN AND NATALIE MACLEAN LEINO**

David Goodwin is a partner in the San Francisco office of Covington & Burling LLP. Natalie MacLean Leino is an associate in the New York office of Covington & Burling LLP. They represent insurance policyholders in business interruption and other types of insurance coverage disputes.

[dgoodwin@cov.com](mailto:dgoodwin@cov.com) and [nleino@cov.com](mailto:nleino@cov.com)