Horst Krekstein + Runyon

JS|HELD

PERSPECTIVES

The Approaching Storm: Business Income Losses, Catastrophe Claims, and the Post-COVID Economy

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

INTRODUCTION

The National Oceanic and Atmospheric Administration (NOAA) is predicting another active hurricane season.[1] Setting aside the increased likelihood of hurricane-related losses, 2020 has already been a banner year for catastrophic property events, including tropical storms, tornados, and civil unrest.

These claims are only complicated further by the COVID-19 pandemic. COVID-related restrictions are already affecting many businesses, which has resulted in a wave of claims and litigation centering on various business interruption coverages. These restrictions will likely continue during hurricane season, compounding the impact on affected businesses. In this white paper, we address coverage and valuation issues that insurance professionals should consider when handling business income losses related to hurricane and other catastrophe claims in the post-COVID economy.

GENERAL PRINCIPLES OF BUSINESS INTERRUPTION INSURANCE

Business interruption insurance is intended to put a policyholder in same position it would be in if not for the property damage that led to the business interruption.[2] Conversely, it is equally well-recognized that business interruption insurance should not be used to put a policyholder in a better position than it would have occupied if the loss had never occurred.[3]

These general principles are of increased importance in this post-COVID world. In addition to the coverage issues that typically accompany catastrophe claims, challenges can arise when market conditions or generalized economic forces create a different landscape following the loss but those conditions or forces did not result from any covered cause of loss. While the resolution of the issue may turn on the specific policy language at issue, courts are split as to whether such conditions are appropriately considered in the evaluation of a business income claim.[4]

BUSINESS INCOME COVERAGE ISSUES

Business income coverage applies to the actual loss of business income sustained by a policyholder where the policyholder's business operations have been necessarily suspended as a result of direct physical loss or damage to the insured location by a covered peril.

If a policyholder's business is damaged by a hurricane or other catastrophe, the direct physical loss requirement will, of course, be met. However, if the suspension of the policyholder's operations did not result from that damage, but rather from a pre-existing COVID-related restriction, there may be no compensable loss under the policy's business income coverage, or such loss may be reduced.[5] Threshold questions arise as to the proximate cause of the adverse economic impact experienced by the business and the extent to which pre-existing factors, such as limited operations, changes in the nature of the business, and/or the loss or limitation of market demand can be taken into consideration.

CIVIL AUTHORITY COVERAGE ISSUES

Civil Authority Coverage applies to situations where access to a policyholder's property is prevented or prohibited by an action of a civil authority. A policyholder may be entitled to recover a loss of business income

[1] National Oceanic and Atmospheric Administration (2020). Retrieved from https://www.noaa.gov/media-release/busy-atlantic-hurricane-season-predicted-for-2020
[2] See Berkeley Inn, Inc. v. Continental Ins. Co., 422 A.2d 1078, 1080 (Pa.Super. 1980); Pennbarr Corp. Ins. Co. of N. Am., 976 F.2d 145 (3d Cir. 1992); Dictiomatic, Inc. v. United States Fid. & Guar. Co., 958 F.Supp. 594 (S.D.Fla. 1997); Amerigraphics, Inc. v. Mercury Cas. Co., 107 Cal. Rptr. 3d 307 (Cal.App. 2010).
[3] See Eidelman v. State Farm Fire & Cas. Co., 2011 U.S. Dist. LEXIS 5395 (E.D.Pa. Jan. 19, 2011); See also Am. Med. Imaging Corp. v. St. Paul Fire & Marine Ins. Co., 949 F.2d 690 (3d Cir. 1991); Dictiomatic, Inc. v. United States Fid. & Guar. Co., 958 F.Supp. 594 (S.D.Fla. 1997); Legier & Co., APAC v. Travelers Indem. Co., 2010 U.S. Dist. LEXIS 41554 (E.D.La. Apr. 28, 2010).
[4] Compare Catlin Syndicate Ltd. v. Imperial Palace of Miss., Inc., 600 F.3d 511 (5th Cir. 2010), with Stamen v. Cigna Prop. & Cas. Ins. Co., 1994 U.S. Dist. LEXIS 21905 (S.D.Fla. June 13, 1994).
[5] See e.g., Celebrations Caterers, Inc. v. The Netherlands Ins. Co., 2008 U.S. Dist. LEXIS 7477 (E.D.Pa. Jan. 1, 2008)(granting summary judgment to the insurer on the issue of business income coverage because the policyholder could not prove that its lost rental income was related to the fire at its leased premises).

under these provisions if the business income loss is caused by:

1. An action of civil authority;
2. Prohibiting access to the policyholder's property;
3. Due to direct physical loss of or damage to the insured premises, or property other than the policyholder's property; and
4. Resulting from a covered cause under the policy.

Disputes frequently arise regarding whether an action of civil authority is the result of direct physical loss or damage to property. In the context of an evacuation order based on a hurricane striking the loss location, courts will generally find that the property damage requirement is satisfied. However, questions exist where orders are made in anticipation of a storm and/or to prevent potential injury/damage, with many courts ruling that no coverage exists where a civil authority order is anticipatory or preventative.[6]

This hurricane season, catastrophe-related evacuation orders may be issued on top of existing COVID-related orders (as was the case in response to recent civil unrest and rioting). In this regard, we expect that evacuation orders may be more readily issued in areas where emergency response systems and hospitals are already stressed and, therefore, do not have the capacity to handle the increased strain associated with a significant hurricane or flood event.

Although the issue is presently being litigated, Civil Authority Coverage should not exist for business interruptions caused by COVID-related shutdown orders because such orders were not issued in response to property damage, but rather were issued to slow the spread of the COVID-19 virus outbreak. Where businesses are already closed or operations are limited due to COVID-related order, a subsequent hurricane evacuation order should not create coverage, as doing so would put policyholders in a better position than they would have occupied had no loss occurred.[7]

INGRESS/EGRESS COVERAGE ISSUES

In addition to Civil Authority Coverage, which applies where an order of civil authority prohibits or prevents access to an insured property, some commercial insurance policies also include an additional coverage for impairment or prohibition of ingress to or egress from an insured location. The key distinction between these two coverages is that Ingress/Egress Coverage is triggered without need for an order of civil authority.

One example where Ingress/Egress Coverage may be implicated today is Seattle's Capitol Hill Autonomous Zone (CHAZ), where a group of peaceful protesters have cordoned off several city blocks, potentially limiting access to business owners in the area.

A common issue in Ingress/Egress claims is whether physical damage to property is a necessary prerequisite to coverage. The United States District Court for the Eastern District of North Carolina interpreted an Ingress/Egress Coverage provision in Fountain Powerboat Indus. v. Reliance Ins. Co., which contained the following language:[8]

> *"Loss of Ingress or Egress: This policy covers loss sustained during the period of time when, as a direct result of a peril not excluded, ingress to or egress from real and personal property not excluded hereunder, is thereby prevented."*

[6] See United Air Lines, Inc. v. Ins. Co. of the State of PA, 439 F.3d 128 (2d Cir. 2006)(no coverage where civil authority order stopped flights due to 9/11 terrorist attacks, as order based on fear of future attacks); S. Tex. Med. Clinics, P.A. v. CNA Fin. Corp., 2008 U.S. Dist. LEXIS 11460 (S.D.Tex. Feb. 15, 2008)(finding appropriate denial of coverage where evacuation order was due to anticipated threat of damage); Two Caesars Corp. v. Jefferson Ins. Co., 280 A.2d 305 (D.C. App. 1971)(imposition of a curfew to facilitate movement of police and fire equipment was not due to property damage); Syufy Enters. v. Home Ins. Co., 1995 U.S. Dist. LEXIS 3771 (N.D.Cal. March 21, 1995)(denying coverage because no property adjacent to the policyholder's premises sustained physical damage); Dickie Brennan & Co. v. Lexington Ins. Co., 636 F.3d 683 (5th Cir. 2011)(mandatory evacuation order issued due to fear of future hurricane damage was not issued due to property damage in other locations).
[7] Insurers should be aware of any regulatory mandates or bulletins from state departments of insurance or other regulatory bodies, which purport to limit the effect of COVID-related business losses. See e.g. IL DOI Bulletin, 2020-15 (June 8, 2020); MN Admin. Bulletin, 2020-3 (June 22, 2020).
[8] 119 F.Supp.2d 552, 556 (E.D.N.C. 2000).

Notably, the Court found the meaning of this ingress/egress wording to be "exceedingly clear" and held that the ingress/egress provision did not require physical damage to trigger coverage.

A small change in the language of ingress/egress provisions can lead to significantly different results. In County of Clark v. Factory Mut. Ins. Co, the policy language at issue included a requirement that prevention of ingress/egress be the direct result of physical damage.[9] Based on the use of the term "direct," the court held that no coverage was provided for losses of business income sustained as a result of the mandatory ground stop order issued by the FAA following the September 11th attacks because prevention of ingress was, at best, an indirect result of the damage to the World Trade Center.

Insurance professionals should analyze whether the impairment or prohibition of ingress/egress is a result of direct physical loss or something else. In this regard, it will be important to holistically understand any and all existing COVID-related restrictions and their impact on the policyholder's business.

MARKET CONSIDERATIONS IN VALUING LOSS OF INCOME

Valuation of covered business income losses has become increasingly complicated in the post-COVID world. Businesses across the country are still being affected by COVID-related shutdown orders. What happens when a covered loss occurs during a period when the policyholder would not have been permitted to operate? Should the policyholder be put in a better position than it would have occupied had no loss occurred?

Courts have reached different results when considering whether post-hurricane market conditions are appropriately considered in the evaluation of a business income claim. Some courts that have held that the proper method for valuing a business income loss is to look at sales before, rather than after, the interruption have reasoned that "[t]he strongest and most reliable evidence of what a business would have done had no catastrophe occurred is what it had been doing in the period just before the interruption."[10] Other courts that have taken the contrary position have based their decisions on the policy's requirement for consideration of the probable future experience of the business.[11]

Determining whether market conditions, including COVID-related restrictions, are appropriately part of the calculus of a hurricane-related business income claim will depend on relevant policy language, as well as the applicable case law and regulatory bulletins directives. Where the relevant policy language requires consideration of the expected performance the business would have had if no loss had occurred, a strong argument can be made that it is reasonable for an insurer to consider COVID-related restrictions.[12]

VALUING BUSINESS INCOME LOSSES

Calculating the business interruption loss requires understanding the business and how its operations were impacted, i.e. it is necessary to know "who, what, when, where, why, and how." A well-organized and focused initial discussion with the insured is critical, as it is where the facts are first gathered. After establishing a general understanding of the operations and how they were impacted from the event, a more focused request for information can be developed. These requests vary depending on the industry, the period of restoration, and other facts surrounding the loss. In general, requested documentation is meant to assist in quantifying the damages (tax returns, profit and loss statements, sales records, production records, inventory reports, payroll, etc.).

Once the necessary records are obtained, the next step is to project sales and expenses during the period of

[9] 2005 U.S. Dist. LEXIS 47574 (D.Nev. March 28, 2005).
[10] See Finger Furniture Co. v. Commonwealth Ins. Co., 404 F.3d 312, 314 (5th Cir. 2005); Catlin Syndicate Ltd. v. Imperial Palace of Miss., Inc., 600 F.3d 511 (5th Cir. 2010).
[11] See Consol. Cos. v. Lexington Ins. Co., 2009 U.S. Dist. LEXIS 8542 (E.D. La. Jan. 23, 2009); Stamen v. Cigna Prop. & Cas. Ins. Co., 1994 U.S.Dist. LEXIS 21905 (S.D.Fla. June 13, 1994); Berkeley Inn, Inc. v. Continental Ins. Co., 422 A.2d 1078, 1080 (Pa. Super. 1980)(recognizing that an assessment of liability for a business interruption loss requires consideration of the probable future experience of the business after the loss).
[12] See e.g., Consol. Cos. v. Lexington Ins. Co., 2009 U.S. Dist. LEXIS 8542 (E.D. La. Jan. 23, 2009).

restoration. These projections can be based on a variety of methodologies— averages, trends, budgets, benchmarks from other locations, and even post loss sales data. The methodology used depends on the specific business. The goal is to use the methodology that would best represent what the sales and expenses would have been had no loss occurred and compare them to what actually occurred.

In determining the best methodology, a variety of conditions that may impact what the insured would have achieved during the period of restoration are considered. These can include competition, the ability to make up the sales, holidays, normal shutdowns, introductions of new business lines or products, abnormal weather, new technology, elections, etc. The conditions surrounding the specific insured during the specific period of restoration must be considered. Therefore, changes in market conditions are factored into these considerations.

In relation to COVID-19, what the insured would achieve throughout the COVID-19 related shutdowns should be taken into account. Again, this varies by each insured, including where they are located, their local restrictions, and their reaction to COVID-19.

The below are three different scenarios where COVID-19 would impact the analysis:

1. *An insured sustains a loss prior to COVID-19, but the period of restoration continues throughout COVID-19.* In this situation, the methodology that is used leading up to March 2020 may need to be adjusted to account for what the insured would have achieved had no loss occurred.

2. *An insured sustains a loss, such as physical damage from a fire from rioting, during the COVID-19 period.* In this situation, what the insured would have done within the current restrictions must be determined. For example, if historically the insured's busiest month was June, and in June 2020 they sustained a loss, would they have still had their busiest month? What if they had been shut down since March and no sales were planned in June?

3. *An insured sustains a loss, such as due to a hurricane, in August 2020.* In this case, current restrictions should be considered. Further, if operations are back to pre-COVID-19 conditions, the COVID period cannot be used as a basis in projections.

In each of these scenarios, forensic accountants will consider all of the factors to properly quantify the loss(es) during the period of restoration under the conditions of the policy.

CONCLUSION

As discussed above, there are many coverage and valuation issues that must be accounted for when handling business income losses in the COVID-affected economy. At Horst Krekstein & Runyon, we are staying closely engaged with the COVID-related developments and attendant coverage issues discussed above. At J.S. Held, we are at the forefront of all accounting and valuation issues that may arise in this post-COVID environment. If you would like additional information concerning this or any other issue, please do not hesitate to contact us.

ACKNOWLEDGMENTS

We would like to thank Robert Runyon III, Esq., Matthew Malamud, Esq., Daniel Grossman, Esq. (Horst Krekstein & Runyon, LLC) & Aubrey Shea (J.S. Held) for providing insight and expertise that greatly assisted in this research.

MORE ABOUT J.S. HELD'S CONTRIBUTOR

Aubrey Shea is a Senior Vice President and the Forensic Accounting – Insurance Services Practice Leader for J.S. Held. Based out of Philadelphia, PA, Aubrey utilizes her expertise to address complex financial matters spanning a variety of industries including healthcare, education, construction, manufacturing, gaming, hospitality, retail, marine, and energy. She brings more than a decade of forensic accounting experience in quantifying claims related to cyber, builder's risk and soft costs, construction defects, physical damage, stock and contents, business interruption, extra expenses, theft, and personal injury. Aubrey has worked extensively on projects related to floods, hurricanes, and wildfires. She has also provided litigation support on numerous occasions and delivered expert assistance for depositions and mediations.

Contact Aubrey Shea at ashea@jsheld.com or
+1 215 620 6542