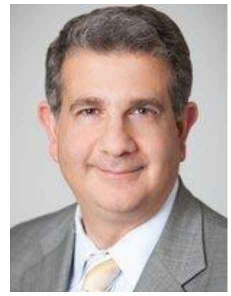
Revisiting Loss Calculations For Business Interruption Claims

By **David Yohai and Heather Weaver** (November 15, 2021)



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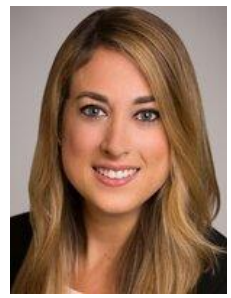

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Courts across the globe are flooded with business interruption insurance claims arising out of the COVID-19 pandemic, extreme weather events, cyberattacks and other catastrophes.

COVID-19 has affected nearly every business, especially wreaking havoc on those in the hospitality, travel and entertainment industries. Natural disasters are also devastating businesses in growing numbers, and are expected to worsen due to climate change. Likewise, cyberattacks are surging, causing businesses to shut down for weeks at a time.

Now, more than ever, business interruption insurance has proven to be a critical component of every business's insurance portfolio, with some businesses relying on the recovery of pending claims to ensure their survival.

This article discusses the challenges that COVID-19 and other recent catastrophes present when calculating business interruption claims. It surveys the two common approaches adopted by courts, examines their outsize effect on an insured's recovery and discusses how the influx of new decisions will change the business interruption landscape.

It also analyzes how the underwriting process is evolving to account for the economic effect of these recent disasters.

Courts Divided on Considerations for Post-Loss Market Conditions

Large-scale catastrophes devastate local and regional economies. Courts are split on whether to consider post-loss market conditions in calculating the insured's business interruption losses.

While a major catastrophe is likely to financially depress affected areas, the effect on businesses is varied. Some businesses, such as hotels and home improvement retailers, may actually prosper in the aftermath of a hurricane given an increase in demand for their goods and services.

This raises the question of whether such businesses should be able to recover for the increased profits they would have earned had they been able to continue operating. Alternatively, questions arise as to whether an insured's losses should be reduced if the insured would have generated minimal revenue or even operated at a loss in the post-catastrophe environment.

Courts generally follow one of two approaches: (1) the "economy ignored" approach, which calculates the loss as if the peril had not occurred; or (2) the "economy considered" approach, which calculates the loss as if the peril occurred, but the insured was not damaged. Neither approach inherently favors the insured or insurer.

Whether a given approach is coverage-maximizing or coverage-minimizing turns, in part, on the type of disaster, nature of the business and policy language at issue. However, the court's approach can drastically affect recovery.

The Economy Ignored Approach

Under the economy ignored approach, courts look to pre-loss income to determine a business's expected profits in a hypothetical post-loss world where the catastrophe never occurred.

Coverage Maximizing

In the U.S. Court of Appeals for the Fifth Circuit's 2005 decision Finger Furniture Co. v. Commonwealth Insurance Co.,[1] the insured furniture retailer was forced to close its stores due to flooding.[2] When Finger Furniture reopened, its sales skyrocketed.[3]

The insurer sought to reduce Finger Furniture's business interruption losses by its post-storm profits.[4] Rejecting this argument, the Fifth Circuit found that the policy did not allow one to "look prospectively to what occurred after the loss," requiring the loss to "be based on historical sales figures."[5]

In 2010, in Consolidated Companies Inc. v. Lexington Insurance Co.,[6] the Fifth Circuit considered whether an insurer could rely on post-catastrophe market conditions to reduce an insured's recovery, since the depressed post-Katrina economy would have reduced their profits even if they had not been damaged.[7]

The court again found that the jury was "not to look at the real-world opportunities for profit post-Katrina, but instead was to decide the amount of money required to place [the insured] in the same positions in which it would have been had Katrina not occurred."[8]

Coverage Minimizing

The Fifth Circuit maintained its economy ignored approach in 2010 with a pro-insurer holding in Catlin Syndicate Ltd. v. Imperial Palace of Mississippi Inc.[9]

An insured casino whose revenue spiked when it reopened before its competitors after Hurricane Katrina argued that its claim should be calculated using its higher post-hurricane sales, increasing its claim by $70 million dollars.[10] Unpersuaded, the court held that "sales figures after reopening should not be taken into account" and directed the parties to use historical sales figures to determine the loss.[11]

The Economy Considered Approach

Under the economy considered approach, business interruption losses are calculated based on a hypothetical situation where the peril occurred, but the insured was able to continue operating.

Coverage Maximizing

In the U.S. District Court for the Eastern District of Louisiana's 1997 decision, Levitz Furniture Corp. v. Houston Casualty Co.,[12] a furniture retailer that suffered flood damage sought to recover for its "lost opportunity" to benefit from increased, post-disaster consumer demand.[13]

The insurer argued that business interruption coverage was designed to place the insured "in the position it would have been had no loss occurred," and, absent the flood, there would have been no increased demand for Levitz's products.[14]

Favoring the insured, the court found that the policy allowed for recovery of earnings Levitz would have made "had no business interruption occurred, i.e., had Levitz not been forced to shut down after the flood."[15]

Coverage Minimizing

In the U.S. District Court for the North District of Iowa's 2010 decision, Penford Corp. v. National Union Fire Insurance Co.,[16] flooding damaged the insured's manufacturing facility.[17]

Penford sought to bar the opinion of the insurer's expert that Penford's losses should be adjusted downward to account for the effect of the 2008 recession.[18] Finding in favor of the insurer, the court held that "unfavorable market conditions" were "relevant to the question of what Penford's likely revenues would have been in the absence of the flood" as the recession would have affected Penford's earnings even if the flood did not occur.[19]

Influx of Cases Will Reshape Landscape for Post-Catastrophe Damages Calculations

Recent precedent analyzing the proper method for calculating business interruption claims is limited.[20] That will soon change as courts begin to resolve the thousands of pending COVID-19 and other business interruption claims.

To date, the analysis of COVID-19 claims has focused on whether insurers have an obligation to pay, e.g., whether the presence of a virus constitutes a "physical loss" under the policies, not how much they should pay. Before long, in those cases that survive, courts will shift gears to focus on the value of those claims, a complex but critical process for both insurers and insureds.

The method adopted by courts in COVID-19 cases in particular, where businesses experienced extended closures and restrictions, could affect the value of a claim by tens or even hundreds of millions of dollars. This is especially true given COVID-19's major economic impact.

For many businesses, the economy considered approach could potentially be harmful as courts could find that those businesses would have taken a financial hit even if they had continued operating given reduced consumer demand. Alternatively, a court could find that if a business had been able to continue operating without its competitors, demand would have increased due to the limited supply or access to other similar businesses.

The calculation of COVID-19 business interruption claims is further complicated by the fact that restrictions and regulations were constantly changing. As a result, the income of certain businesses fluctuated considerably based on various factors such as the season and state of the pandemic.

For example, when a national emergency was declared in March 2020, most restaurants were forced to shut down completely. Many restaurants then reopened for takeout and delivery. Eventually, restaurants were permitted to reopen for indoor dining but with varying capacity restrictions.

During the warmer months, many restaurants converted their outdoor spaces to maximize business.

All of these factors, which remained in flux over an extended timeframe, complicate the calculations of COVID-19 business interruption losses.

The resolution of COVID-19 claims will also affect the calculation of other types of business interruption claims. For example, courts in many jurisdictions, including those that have not yet addressed the issue, will be forced to set precedent regarding which approach to take when calculating business interruption losses.

COVID-19, in general, will also affect the value of pending and future claims given its substantial economic effect regardless of which approach a court adopts. Under the economy considered approach, some businesses will struggle to show that their income would not have plummeted regardless due to COVID-19, while others might be able to establish a pandemic-related increase in demand for their goods or services.

Under the economy ignored approach, COVID-19 may still affect claim calculations because recent sales data preceding the loss event could reflect atypical numbers due to COVID-19.

For example, a question arises as to how the historical profits of a business affected by Hurricane Ida should be calculated if the business experienced pandemic-related supply chain disruptions and labor shortages. This raises other questions regarding whether a longer lookback period would more accurately reflect the revenue of a particular business over time, and therefore be a more appropriate business loss calculation.

Avoiding the Unknown With Clear Policy Language

The COVID-19 pandemic has underscored the importance of a meaningful underwriting process and more meticulous policy drafting so that the coverage being afforded is clear and predictable.

Many business interruption policies include standard language measuring the insured's recovery in terms of the insured's net income "had no loss occurred." While some courts interpret "loss" to mean the peril, consistent with the economy ignored approach,[21] others interpret "loss" to mean damage to the insured, consistent with the economy considered approach.[22]

Given these conflicting interpretations, some insurers have sought to add clarifying policy language expressly denying an insured's recovery of advantageous post-catastrophe market earnings. Such provisions, typically referred to as "favorable conditions" clauses, exclude the consideration of "any Net Income that would likely have been earned as a result of an increase in the volume of the business due to favorable business conditions caused by the impact of the Covered Cause of Loss on customers or on other businesses."[23]

These provisions, which first became popular following Hurricane Katrina,[24] exist in many of the policies at issue in COVID-19 and other business interruption claims working their way through the courts.[25]

Few cases have addressed the effect of "favorable conditions" clauses on post-loss recovery and, thus, the pending cases will play a significant role in clarifying the law in this area. The limited cases dealing with this issue, however, have not all favored insurers.[26]

Because the policy language typically requires that the favorable business conditions be "caused by" the insured peril, some courts are disinclined to apply them where the changed economic conditions are tied to other external events.

For example, in Hampden Auto Body Co. v. Owners Insurance Co., the U.S. District Court for the District of Colorado in its November 2020 decision permitted expert testimony considering advantageous post-catastrophe profits despite a "favorable conditions" provision because the increased business demand stemmed from a series of subsequent storms and not only the storm that caused the interruption to the insured's business.[27]

This raises interesting questions regarding the effectiveness of these provisions in today's environment where natural disasters are more frequent and often overlap.

In light of COVID-19 and the uptick of other disasters, insureds and insurers will be incentivized to include policy language clarifying how post-catastrophe economic conditions will affect the calculation of business interruption losses.

For example, insureds may seek to exclude "favorable conditions" clauses, and instead include language that would allow recovery of any increased profits that would likely have been earned due to beneficial business conditions after the catastrophe.

Insurers will likely continue to push for "favorable conditions" clauses to exclude recovery of any increased profits due to the post-catastrophe economy. Both sides may wish to ensure that their respective language applies regardless of whether the favorable post-loss business conditions were caused by the peril that initially interrupted the insured's business.

For example, if an insured hotel is forced to shut down after sustaining fire damage, and then a subsequent hurricane increases demand for that hotel, the insured will want to make sure that it can recover those increased profits even though the fire is what caused the hotel to close. To the contrary, an insurer will want to ensure that the "favorable conditions" clause excludes recovery of increased profits regardless of whether the fire or a subsequent hurricane triggered the increased demand.

It is also possible that insurers and insureds will increasingly wish to avoid the uncertainties of post-loss economic conditions altogether, and agree to include policy language that would allow an insured to recover based on its historical sales data and financial performance before the loss occurred.

To ensure further predictability, the parties may seek to define the lookback period in the policy so that there is no debate as to the timeframe that should be considered in calculating losses.

These are just a few ways that insurers and insureds can manage expectations and clarify coverage on the front-end to avoid unforeseen circumstances arising out of major crises such as COVID-19 and other recent disasters.

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[1] Finger Furniture Co. v. Commonwealth Insurance Co. , 404 F.3d 312 (5th Cir. 2005).

[2] Id. at 313.

[3] Id.

[4] Id.

[5] Id. at 314.

[6] Consolidated Companies, Inc. v. Lexington Insurance Co. , 616 F.3d 422 (5th Cir. 2010).

[7] Id. at 430-32.

[8] Id. at 432 (cleaned up).

[9] Catlin Syndicate Ltd. v. Imperial Palace of Mississippi, Inc. , 600 F.3d 511 (5th Cir. 2010).

[10] Id. at 512.

[11] Id. at 516.

[12] Levitz Furniture Corp. v. Houston Casualty Co. , No. 96-1790, 1997 U.S. Dist. LEXIS 5883 (E.D. La. Apr. 28, 1997).

[13] Id. at *6.

[14] Id.

[15] Id. at *8.

[16] Penford Corp. v. National Union Fire Insurance Co. , No. 09-CV-13-LRR, 2010 U.S. Dist. LEXIS 60083 (N.D. Iowa June 17, 2010).

[17] Penford Corp. v. Nat'l Union Fire Ins. Co., No. 09-CV-13-LRR, 2010 U.S. Dist. LEXIS 3737, at *13 (N.D. Iowa Jan. 19, 2010).

[18] Penford Corp., 2010 U.S. Dist. LEXIS 60083, at *28.

[19] Id. at *31-32.

[20] See Hampden Auto Body Co. v. Owners Ins. Co. , No. 17-cv-1894-WJM-SKC, 2020 U.S. Dist. LEXIS 206926 (D. Colo. Nov. 5, 2020); Alley Theatre v. Hanover Ins. Co. , No. H-19-1987, 2020 WL 1650659 (S.D. Tex. Mar. 26, 2020).

[21] See, e.g., Imperial Palace, 600 F.3d at 515; Finger Furniture, 404 F.3d at 314.

[22] Stamen v. Cigna Prop. & Cas. Ins. Co. , No. 93-1005-CIV-DAVIS, 1994 U.S. Dist LEXIS 21905, at *7-8 (S.D. Fla. June 10, 1994).

[23] ISO Commercial Property Form, CP 00-30-04-02, ¶ C(3)(a)(1)-(2) (emphasis added).

[24] See, e.g., Rimkus Consulting Group, Inc. v. Hartford Cas. Ins. Co. , 552 F. Supp. 2d 637, 639 (S.D. Tex. 2011); Berk-Cohen Assocs., LLC v. Landmark Am. Ins. Co. , Nos. 07-9205, 07-9207, 2009 U.S. Dist. LEXIS 77300, at *10 (E.D. La. Aug. 27, 2009).

[25] See, e.g., Ramaco Res., LLC v. Fed. Ins. Co. , No. 2:19-cv-00703, 2021 U.S. Dist. LEXIS 117249, at *56 (S.D.W. Va. June 23, 2021); Dotexamdr, PLLC v. Hartford Underwriters Ins. Co ., No. 3:20cv698(MPS), 2021 U.S. Dist. LEXIS 145713, at *5 (D. Conn. Aug. 4, 2021).

[26] See Imperial Palace, 600 F.3d at 515 (noting presence or absence of a "favorable conditions" clause "did not impact" analysis); Berk-Cohen Assocs., LLC v. Landmark Am. Ins. Co., 433 Fed. App. 268, 270 (5th Cir. 2011); Hampden Auto Body Co., 2020 U.S. Dist. LEXIS 206926, at *8.

[27] Hampden Auto Body Co. v. Owners Insurance Co., 2020 U.S. Dist. LEXIS 206926, at *8; see also Berk-Cohen Assocs., 433 Fed. App. at 270.