SIMPSON THACHER MEMORANDUM

# Business Interruption Insurance in the Wake of the Gulf Oil Spill – What Insurers Can Do to Keep Slippery Claims at Bay

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As the environmental and economic consequences of the Gulf Oil Spill continue to expand, it is hardly surprising that law firms specializing in insurance recovery have commenced aggressive efforts to recruit policyholders to make claims for business interruption losses. Of course, Gulf State businesses and their insurers are not newcomers to this issue. Hurricanes Katrina, Hugo and others have yielded their fair share of business interruption insurance disputes, and these disputes are still wending their way through the courts. The resulting opinions are sometimes difficult to reconcile, particularly where the insured sustains a business interruption loss as a result of damage from a catastrophe and then later experiences a gain as a result of the same catastrophe. Two basic questions frequently arise. First, was the claimed business interruption loss, in fact, caused by physical damage to the insured property (rather than by the broader impact of the catastrophe at large)? Second, if it was, how do Gulf State courts measure that business interruption loss?

It is axiomatic in first-party property insurance that a business interruption loss must be directly tied to physical damage to the insured's property that was caused by a covered peril. Under standard business interruption coverage, without physical damage and a nexus between that physical damage and the business interruption loss, there is no business interruption coverage.[1] Thus, under typical business interruption coverages, a beachfront hotel's loss in revenue would not be covered if it resulted from decreased tourism stemming from the Gulf Oil Spill, rather than from physical damage to the hotel.[2]

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[1] *See, e.g., United Airlines, Inc. v. Ins. Co. of the State of PA*, 439 F.3d 128, 129 (2d Cir. 2006) (denying business interruption coverage for loss of revenue flowing from national aviation shutdown following September 11 "because United cannot show that such lost earnings resulted from physical damage to its property"); *accord E.Eric Guirard & Associates v. America First Ins. Co.*, Case No. 07-9334, 2010 WL 989174, at *3 (E.D. La., Mar. 15, 2010), order amended on other grounds, 2010 WL 1743193 (E.D.La. Apr 29, 2010) (acknowledging that only business interruption losses attributable to destruction of property in question are covered); *South Texas Medical Clinics, P.A. v. CNA Financial Corp.*, Case No. H-06-4041, 2008 WL 450012, at *10 (S.D. Tex., Feb. 15, 2008) (requiring causal link between physical damage and business interruption losses).

[2] *See, e.g., Milliken & Co. v. City of New York*, 619 N.Y.S.2d 714, 716 (App. Div. 1993) (for business interruption claimants "must establish more than a mere interruption of the business cycle"; they must "pro[ve] that the damages suffered were peculiar to these particular plaintiffs, as opposed to injury affecting the community at large.") (citation omitted).

If the insured has suffered a business interruption loss as a result of physical damage, the next step for any court (or appraisal panel) is measuring the covered loss. Under standard business interruption coverage, an insured can recover its lost earnings during a "period of indemnity," which is generally defined as the amount of time necessary to repair the physical damage. *SR Int'l Bus. Ins. Co. Ltd. v. World Trade Ctr. Props. LLC,* No. 01-cv-9291, 2005 WL 827074, at *9 (S.D.N.Y. Feb. 15, 2005) (holding that the period of restoration is "the theoretical, not the actual, time needed to repair, rebuild, or replace" the damaged premises). This determination can, of course, become highly fact specific, particularly when the time it takes the insured to complete actual repairs falls behind the time it should have taken a reasonable insured.

Once the period of indemnity is fixed, courts (or appraisal panels) must then measure lost earnings during the period of indemnity. A Fifth Circuit Court of Appeals decision, applying Mississippi law, shed some light on this issue only days before the Deepwater Horizon explosion. In *Catlin Syndicate Ltd. v. Imperial Palace of Mississippi, Inc.*, 600 F.3d 511 (5th Cir. 2010), the Court upheld an insurer's calculation of business interruption loss based ***only*** on the policyholder's pre-catastrophe sales figures, without taking into account the policyholder's significantly higher, post-interruption sales figures. 600 F.3d 511 (5th Cir. 2010). The facts in the *Catlin* case were straightforward. Imperial Palace, the insured, was damaged by Hurricane Katrina and, as a result, was forced to suspend its casino business. Upon re-opening, its revenues were substantially greater than before the hurricane, due in large part to the closing of several competitor casinos that were also damaged in Katrina. Imperial Palace submitted a business interruption claim to Catlin Syndicate Ltd. ("Catlin"), calculating loss at $80 million based on post-Katrina, post-period of indemnity, sales figures. By contrast, Catlin calculated the loss at $6.5 million based on the casino's pre-Katrina sales.[3]

In the ensuing coverage litigation, Imperial Palace argued that its loss of earnings should be measured by assuming a hypothetical scenario in which Hurricane Katrina struck, caused damage to other casinos, but caused no loss to Imperial Palace. Thus, the insured sought to calculate its business interruption loss during the period of indemnity based on projected revenue and expenses in a post-interruption, post-Katrina world. Consistent with the principle of indemnity, i.e., returning the insured to the position it would have been in had the loss never occurred, Catlin contended that the appropriate hypothetical was one in which Hurricane Katrina never struck in the first place. The Court agreed with Catlin, finding that "in the business-interruption provision at hand, only historical sales figures should be considered when determining loss, and sales figures after reopening should not be taken into account." *Id.* at 516.

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[3] The business interruption provision in Catlin's policy provided:

> In determining the amount of Time Element loss as insured against by this policy, due consideration shall be given to experience of the business before the loss and the probable experience thereafter had no loss occurred.

*Id*. at 513.

Notably, the Court's conclusion – favorable to the insurer in *Catlin* – relied on a prior decision that favored the ***insured***. *See Finger Furniture Co. v. Commonwealth Ins. Co.*, 404 F.3d 312 (5th Cir. 2005). In *Finger Furniture*, the insured, a furniture store, suffered damage in a tropical storm and was forced to close its business for two days as a result. The insured incurred business interruption loss during the two days immediately after the storm. A week later, however, Finger Furniture slashed prices and realized a significant gain.[4] Finger Furniture filed a claim for $325,000 for losses incurred on the first two days after the storm. The insurer denied the claim, contending that the gains realized after the period of indemnity (when the insured slashed prices) offset the losses during the period of indemnity. The Court rejected the insurer's contention that post-interruption experience could be taken into account in determining what the insured would have earned had the storm not occurred. As echoed in *Catlin*, the Court held that "[h]istorical sales figures reflect a business's experience before the date of the damage or destruction and predict a company's probable experience had the loss not occurred. The strongest and most reliable evidence of what a business would have done had the catastrophe not occurred is what it had been doing in the period just before the interruption." *Id.*

Both *Catlin* and *Finger Furniture* stand for the premise that, in measuring business interruption loss, courts look to pre-loss earnings data to discern what the insured's earnings would have been during the period of indemnity as though the loss never occurred, without regard to post-interruption commercial developments, positive or negative, arguably related to the catastrophe at large.

A related question arises when an insurer denies business interruption coverage based on a determination that the insured, as an overall business, exceeded pre-loss earnings projections during the period of indemnity. Two business interruption cases decided by the Eastern District of Louisiana in the wake of Hurricane Katrina take divergent approaches. In *B.F. Carvin Construction Co. v. CNA Ins. Co.*, the insured, Peabody, contended that it incurred a total business interruption loss of over $200,000 due to its inability to operate because of physical damage to its warehouse. Case No. 06-7155, 2008 WL 5784516 (E.D. La. July 14, 2008). The insurer denied the claim, arguing that in the eight months prior to Hurricane Katrina, the insured lost over $80,000, while in the six months following the storm, it earned over $300,000. Thus, the insurer contended that the insured suffered no actual business interruption loss. The Court agreed with the insurer, finding that "this type of policy is designed to 'prevent the

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[4] The business interruption provisions in Furniture Finger's insurance policy provided:

> [The Insurer] shall be liable for the ACTUAL LOSS SUSTAINED by insured resulting directly from such interruption of business, but not exceeding the reduction in gross earnings less charges and expenses which do not necessarily continue during the interruption of business.
>
> In determining the amount of gross earnings covered hereunder for the purposes of ascertaining the amount of loss sustained, due consideration shall be given to the experience of the business before the date of damage or destruction and to the probable experience thereafter had no loss occurred.

*Id*. at 314.

insured from being placed in a *better* position than if no loss or interruption of business had occurred.'" *Id*. at 3 (quoting *United Land Investors, Inc. v. Northern Ins. Co. of America*, 476 So.2d 432, 436 (La.App.2d Cir. 1985) (emphasis in original).[5]

By contrast, in *Orrill, Cordell, & Beary, L.L.C. v. CNA Ins. Co.*, Case No. 07-8234, 2009 WL 701714 (E.D. La. March 16, 2009), the Court ruled against the insurer on similar facts. In *Orill*, the insured conceded that it had realized an increase in overall income after Hurricane Katrina due to an increase in hourly fees, but the insured contended that it lost contingency fee income and, thus, "was not placed in a better position" than if the storm had not occurred. *Id*. at 2. The insurer denied the claim, arguing that there was no actual loss of business income because the insured's overall income had increased. Distinguishing *B.F. Carvin*, the Court found that lost contingency fee income was covered as business interruption loss, holding that "public policy and the overall purpose of insuring for business income losses are best served in providing coverage here," where the policy language was "ambiguous" and the intent of the parties did not "expressly foreclose coverage." *Id*. at 3.

What can be gleaned from these cases? Clearly, disputes over the calculation of business interruption losses are highly fact-specific both in terms of the policy language at issue and the nature of the claimed loss. As a result, outcomes are often difficult to predict. Insurers should emphasize the basic underpinnings of business interruption insurance: coverage is confined to indemnification for monies the insured would have made had the loss not occurred – no more.[6]

For insurers confronted with disputes over the calculation of business interruption losses, keeping the foregoing principle in mind and articulating it clearly will likely improve the chances of prevailing in a coverage dispute. *Catlin* suggests that if an insured has sustained a business interruption as a result of the Gulf Oil Spill, for example, but profited from the circumstances that arose in the wake of the disaster, the insurer should scrutinize the business interruption claim carefully. Will payment of the claim put the insured back where it was if the

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[5] The relevant policy language provided:

> We will pay 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, including personal property in the open (or in a vehicle) within 1000 feet, at premises that are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations. The loss or damage must be caused by or result from a Covered Cause of Loss.

*Id*. at 1.

[6] *See Prudential LMI v. Colleton Enterprises, Inc.*, 976 F.2d 727, at *4 (4th Cir. 1992) (unpublished opinion). In the aftermath of Hurricane Hugo, the Fourth Circuit rejected a hotel owner's calculation of loss based on the earnings it would have made accommodating workers and others after the hurricane. The Court held an insured under a business interruption provision "may not claim as a probable source of expected earnings . . . a source that would not itself have come into being but for the interrupting peril's occurrence." *Id*.

Gulf Oil Spill had never happened? Or will payment be a windfall that permits the insured to recover insurance in addition to the gains it has realized on account of the Oil Spill? As with any insurance dispute, the terms of the policy and the specific facts at issue will control the business interruption coverage analysis. But insurers should be prepared to examine such claims closely in light of the complex legal and economic issues that arise in calculating the true value of a business interruption claim.

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