Special Types of Property Insurance Coverage Implicated in Catastrophe Claims

Difference in Conditions, Service Interruption, Order of Civil Authority, Ingress/Egress Clauses, Contingent Business Interruption, Earthquake, Federal Flood Insurance, etc.

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by

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A. Difference in Conditions Coverage

1. <u>Traditional Difference In Conditions Coverage:</u> The traditional Difference in Conditions Coverage was sold when generally only two main types of coverage existed: namely, fire and extended perils insurance and boiler and machinery insurance. Since the fire and extended perils policy provided insurance for specific named perils and the boiler and machinery policy provided insurance for specific objects damaged in defined accidents, there remained a gap in coverage for a number of perils and types of property. The traditional Difference in Conditions (DIC) policy filled this gap, sometimes by creating what was then referred to as "wrap-around" insurance and sometimes by creating an early version of "all-risk" insurance. As such, Companies called Difference in Conditions policies "parasol," "balance of perils," "wrap-around," or all risk insurance.

The DIC coverage often provided all-risk coverage and excluded the perils generally insured under named peril contracts as well as mechanical breakdown and other boiler and machinery losses. The DIC policy typically excluded the perils of fire, extended perils coverage, vandalism, malicious mischief and sprinkler leakage, as they would typically be insured under a named perils policy. Thus, the DIC policy often insured the collapse of buildings, collapse or sagging of roofs caused by snow, ice or ponded water, collapse of storage racks, damage by lift trucks, and theft, among other events. Because, at one time, these perils were thought to have the likelihood of causing a larger number of losses but smaller amounts for each loss, DIC coverage could be provided with a low deductible and a low limit tailored to the policyholder's needs.

Historically, the combination of the fire policy, boiler and machinery policy and Difference in Conditions policy was intended to provide an all-risk type package. The DIC policy would often have added coverage for earthquake, flood and other specific items. Special sublimits, deductibles, agreed amount endorsements and other "bells and whistles" then could be added to these coverages.

Now, with the prevalent use of all-risk policies in the marketplace, the traditional Difference in Conditions coverage has become obsolete. For more on DIC, see Couch on Insurance 3d. § 148:50.

2. Current DIC coverages: There are two areas in which a modern form of DIC coverage has arisen. The first may not be considered a true DIC policy but refers to the recent practice of combining a broker's manuscript form combined with a standard form from an insurance company (ISO or other standard company form). In some cases, there is tie-in language which designates one policy as the primary policy with the other policy providing coverage for the "gaps" or differences in the conditions between the broker's manuscript form and the standard form of the insurance company. As one can expect, with the appropriate fact situation, this creates some confusion.

Secondly, and more prevalently, DIC coverages apply in reinsurance situations. Again, there are two areas in which they arise. First, as companies seek specific coverages for worldwide operations, policies are issued for property in foreign countries which may provide more limited coverage than insurance available in the United States. In this situation, the basic purpose of the DIC policy is to protect the insured against variations in the insurance coverage available from different insurers in different countries. U.S. policies provide reinsurance and/or excess DIC type coverage for the types of losses which may not be fully insured under the local country's policy. See, Sherwin -Williams Co. v. Insurance Co. of Pennsylvania, 105 F.3d 258, 261 (6th Cir. 1997) (holding that suit on excess Difference in Conditions policy which provided for worldwide coverage against all risks of loss and physical damage not excluded or covered under primary insurance carriers as premature since primary insurers could cover loss). In this context, the "excess" DIC policies only provide coverage when a peril is not insured under the primary policy. Id. at 259. In order for the insured to recover on the excess DIC policy, it must show that it would be legally or practically unable to recover from the primary carrier despite diligent efforts. Id. The primary insurer's denial of an insurance claim is not enough to make the DIC policy applicable. Id. The court recognized the excess DIC policy as a "gap" or secondary insurance.

Second, excess policies and reinsurance at times are still sold on a named peril basis, which results in specific coverage for boiler and machinery, named perils, and sometimes DIC coverages. For example, in Archer-Daniels-Midland Co. v. Phoenix Assurance Co. of New York et al., 975 F.Supp. 1129 (S.D.Ill. 1997), plaintiff sued for coverage under its excess Difference in Conditions policies with defendants. The court found that the excess policies did not cover losses and expenses following summer flooding of the Mississippi River. ADM claimed under a sue and labor clause for expenses to protect barges which were excluded from DIC coverage. The barges were insured under a separate marine policy. ADM sought to avoid the exclusion with the argument that the expenses actually protected the grain stored on the barges. The court rejected the claim on the basis that the sue and labor coverage only applied to property at "scheduled locations" and the barges were not at scheduled locations.[1]

In each situation, the boundary lines between the various types of coverage can raise questions as to applicable deductibles and limits. Moreover, choice of law issues can be

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[1] The court also recognized that the excess policies at issue did not contain the same terms as the primary policy and only applied to a loss after the primary limits were exhausted to the extent that there was coverage under the DIC policies. Finally the court applied the "inherent vice" exclusion, applied to claims for grain degradation even though the flood was a contributing cause.

difficult. A court will apply the choice of law principles of the state in which the lawsuit is brought. Choice of law principles for insurance can vary from state to state. Some states require application of the lex loci contractus rule. For instance, if the primary policy covers property which was damaged on St. Thomas, U.S. Virgin Islands, but the reinsurance policy was delivered to the primary carrier in Hartford, Connecticut, the reinsurer may argue that Connecticut law applies in the event of a dispute as to reinsurance coverage to the primary policy for a loss in St. Thomas. See, Reichhold Chemicals, Inc. v. Hartford Accident and Indemnity Co., 703 A.2d 1132, 1138 (Conn. 1997) (stating that under Connecticut choice of law rules, "the law of the state in which the bulk of the contracting transactions took place should be applied").

A court may apply the law of the state where the risk was located and the loss occurred. See, Sangmo Weston, Inc. v. National Surety Corp., 414 S.E.2d 127, 130 (S.C. 1992)(stating that if the property at issue under an insurance policy is in South Carolina, then by statute South Carolina law must apply). Some states that usually apply the lex loci contractus rule recognize that, when a contract is to have operative effect or is to be performed in a jurisdiction other than where it was entered into, then the place of performance governs validity and construction of the contract. See, Grand Sheet Metal Products Co. v. Aetna Cas. & Sur. Co., 500 F.Supp. 904 (D.Conn. 1980). The Restatement (Second) Conflict of Laws § 193 on choice of law for insurance, agrees with this approach.[2] The Restatement applies the law of the place where the contract is to have its operative effect or in other words, where the loss occurred. Thus, the primary carrier may be in a position of applying the policy to the loss in St. Thomas according to the law in the U.S. Virgin Islands (or other jurisdiction in which the loss takes place), while taking the risk that the application of the reinsurance policy, as part of an arbitration or litigation,

[2] Discussing policies with risks in many states, § 193 of the Restatement (Second) Conflict of Laws refers to the situation where a single policy insures property in states X, Y, and Z and states, "So if the house located in state X were damaged by fire, it is thought that the court would determine the rights and obligations of the parties under the policy, at least with respect to most issues, in accordance with the local law of X." Section 193, Restatement of Laws, pp. 613-614.

may be adjudicated under Connecticut law. Regardless of which state's law ultimately applies, one can expect choice of law issues to arise in the application of a DIC policy when applied in reinsurance situations.

B. <u>Service Interruption</u>

Service Interruption coverages typically are endorsements to an All-Risk policy. Service Interruption coverage, as the name implies, insurers time element loss at the policyholder's location caused by the loss of specified utilities due to an insured event. The scope of the coverage is typically determined by the utilities listed in the Service Interruption coverage (whether by endorsement or as part of the main policy). For instance, loss of incoming electrical power at one time was the typical event insured by a Service Interruption endorsement. Now, policies have been extended to include loss of water, gas, sewage treatment, and even telephone and internet or other networking services. Thus, the policy definitions of Service Interruption are important in determining the application of coverage.

Another issue within Service Interruption coverages concerns the perils to which the coverage applies. Even though the policy may be designated as an all-risk policy, the Service Interruption coverage (as well as coverages in other endorsements) may be limited to specific perils or may exclude certain perils. For instance, Service Interruption Coverage in a flood zone may exclude loss of utilities due to flood. Thus, it is important to obtain and carefully analyze the specific Service Interruption endorsement even where the policy declarations page identifies overall coverage as all-risk.

C. <u>Order of Civil Authority</u>

The Order of Civil Authority Coverage was applied in early cases involving riots where cities issued curfew orders which restricted access to the general area containing the insured business. As a result, some policy holders suffered business interruption losses without sustaining any physical damage to the insured premises. The limited number of cases discussing civil authority provisions involve coverages with significantly different terms from many current forms. Most involve situations where riots caused the city to restrict access to the area containing the insured business and the insured suffered business interruption losses but no physical damage. In many civil authority cases, courts found that there had to be physical damage to the insured or adjacent property. See, Two Caesars Corp. v. Jefferson Ins. Co., 280 A.2d 305 (D.C. App. 1971); Cleland Simpson Co. v. Fireman's Ins. Co. of Newark, N.J., 140 A.2d 41 (Penn. 1958); Adelman Laundry & Cleaners, Inc. v. Factory Ins. Assn., 207 N.W.2d 646 (Wisc. 1973). However, in two cases the courts refused to follow this course, Sloan v. Phoenix of Hartford Ins. Co., 207 N.W.2d 434 (Mich. App. 1973), and Allen Park Theater Co., Inc. v. Michigan Millers Mut. Ins. Co., 210 N.W.2d 402 (Mich. App. 1973). None of the foregoing cases are likely to directly apply to current policies, given the difference in language of the loss of access and civil authority provisions in current policies from the policy language in the earlier cases. The reasons to review these cases is to recognize how the current coverages differ from earlier forms and to recognize courts which focused on the policy wording.

1. Cases implying requirement of physical damage

The seminal case on this issue is Bros. Inc. v. Liberty Mut. Fire Ins. Co., 268 A.2d 611 (D.C. Ct. App. 1970). There, a restaurant owner was insured under a policy that included a business interruption endorsement which extended coverage to Actual Loss Sustained resulting from business interruption when "as a direct result of damage to or destruction of property adjacent to the premises . . . by the peril(s) insured against, access to such described premises is specifically prohibited by order of civil authority."

During the civil disorder following the assassination of Martin Luther King in 1968, the D.C. government imposed a curfew and other restrictive regulations. The insured restaurant experienced a business "fall off" as a result. The insured did not allege that it experienced any physical damage to its own or to adjacent property. The court held there was no coverage under the civil authority provision because the curfew and regulations "did not prohibit access to the premises because of damage to or destruction of adjacent property." Id. at 614. Thus, because the order was not due to physical damage to any property, there was no coverage.

In the District of Columbia, Bros. was followed by Two Caesars, in which the insured was also a restaurant owner forced to curtail its operations because of the curfew following Martin Luther King's death. As in Bros., the insured could not demonstrate any property damage. The fire policy contained a business interruption endorsement which stated that "This policy insures against loss resulting directly from necessary interruption of business *caused by damage to or destruction of real or personal property by the peril insured against*. . . ." Two Caesars, 280 A.2d at 306 n.2 (*italics* in decision). The business interruption endorsement contained the following civil authority provision:

> 7. Interruption by Civil Authority: This policy is extended to include the actual loss as covered hereunder during the period of time not exceeding the 2 consecutive weeks, when as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority.

Id. at 306-07 n.2.

The insured attempted to distinguish Bros. on the basis that the policy in Bros. required that access to the premises be prohibited by civil authority as a direct result of damage to property adjacent to the insured property. By contrast, the policy in Two Caesars covered business interruption resulting "when, as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority."

The court rejected the attempted distinction, stating:

> The inescapable fact is, however, that, by the clear provisions of the policy, the loss is compensable only when the Order of Civil Authority, which prohibits access, is predicated upon damage to or destruction of the business property.

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Two Caesars, 280 A.2d at 308. Thus, the basis for the order of the civil authority was the key factor in this court's analysis. On this issue, the court said:

> The plain fact is that access to appellant's restaurant during the hours of the curfew was not prohibited because of damage to or destruction of its property by riot or civil commotion, but rather to achieve a compelling and legitimate governmental objective – that of facilitating the movement of police and fire fighting equipment during an actual or anticipated emergency.

Two Caesars, 280 A.2d at 307. Thus, because the civil authority was not motivated by any condition at the insured's premises, but rather by other governmental objectives, there was no coverage.

The court in Two Caesars construed the civil authority provisions to require physical damage to the insured property. The court apparently applied the introductory language to the business interruption endorsement which required physical damage to property of the type insured to the civil authority provision in paragraph 7 of the same endorsement.

In Cleland the insured sought to recover under its fire policy for losses incurred when the insured's store was closed by order of the mayor during a state of emergency caused by a flood which cut off the city's water supply. The mayor ordered all stores to close due to the risk of fire. The policy contained a business interruption endorsement with introductory language stating that the policy covered loss directly resulting from necessary interruption of business caused by destruction or damage by the perils insured against. The business interruption endorsement contained a civil authority provision in paragraph 11 that read as follows:

> Interruption by civil authority: Liability under this policy is extended to include *actual loss as covered hereunder sustained during the period of time, not exceeding two weeks,* when as a direct result of a peril insured against access to the premises described is prohibited by order of civil authority.

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Cleland, 140 A.2d at 43 (*italics* in decision). The court concluded that "the risk insured against is loss of profit through business interruption caused directly by fire and extended for a period of time to continued interruption caused by the action of civil authority in preventing access to the business premises as a direct result of fire." Cleland, 140 A.2d at 44. Since there was no damage by fire to the insured premises, there was no coverage under the civil authority provision.

The court in Adelman also followed the decision in Two Caesars. In Adelman the plaintiff sought to recover under its fire policy for business interruption losses sustained as a result of a curfew imposed after rioting in Milwaukee in 1967. As in Cleland and Two Caesars, there was no damage to the insured's property in Adelman. The court in Adelman construed the civil authority provision to cover losses only when the order of civil authority which prohibits access to the premises is predicated upon damage to or destruction of the insured's property.

The decisions in Adelman, Cleland and Two Caesars concluded that the order of civil authority must directly prohibit access to the insured property and must be given as a direct result of physical damage of the type insured against at the insured's location. Significantly, these courts required physical damage at the insured premises despite differences in the policy language among them.

2. Cases refusing to imply physical damage requirement

In two cases, Sloan and Allen Park, the Michigan Court of Appeals rejected these judicial applications of the civil authority provision and found coverage. In Sloan the insured theater owner sought to recover its business interruption losses from the curfews ordered because of rioting. The insurance company argued that there was no coverage without actual physical damage to the insured property. The insured argued that the policy insured against prohibition of access to the premises by order of the civil authority stemming from rioting without any requirement of physical damage to the insured property.

The policy language in Sloan was essentially the same as the policy language in Two Caesars. The court in Sloan reasoned that the civil authority provision did not expressly require physical damages to the insured premises as a condition for coverage. In addition, the court in Sloan noted that it would have been simple for the insurer to condition the civil authority on physical damage to the insured property. The court held that:

> a plain reading of the policy would lead the ordinary person of common understanding to believe that, irrespective of any physical damage to the insured property, coverage was provided and benefits were payable when, as a result of one of the perils insured against, access to the insured premises was prohibited by order of civil authority.

Sloan, 207 N.W.2d at 436-37.

Allen Park also involved a theater owner who suffered business interruption losses due to the curfew imposed because of rioting but suffered no physical damage. The majority opinion in Allen Park was only one paragraph long and simply followed Sloan.

3. Current Civil Authority Provisions

Many current Civil Authority forms eliminate some of the trigger requirements and function as limited lack of access coverage. However, some Civil Authority provisions expressly require physical damage at the described location or within a certain distance from it.

> F. If an order of civil authority prohibits access to the described location and provided such order is the direct result of physical damage of the type insured against under this policy at the described location or within 1,000 feet of it, the period of time:
> 1. starting at the time of physical damage; but
> 2. not to exceed twelve weeks.

Thus, under this type of civil authority provision, coverage exists when:

[1] an order of civil authority
[2] prohibits access to the described location
[3] where the order is a direct result of physical damage
[4] of the type insured against under the policy
[5] at the described location or within 1000 feet of it.

A broader Civil Authority clause can be found as follows:

J. CIVIL OR MILITARY AUTHORITY:
This policy insures against the actual loss sustained, subject to a limit of 12 weeks, caused by acts of destruction by order of civil or military authority at the time of and for the purpose of preventing a loss or of preventing the continuation of or increase in severity in any way of any losses covered hereunder. This policy also insures against loss caused by acts and/or orders of civil or military authority declaring or rendering the premises untenable for occupancy as a result of an occurrence occasioned by a peril Insured against.

As you can easily see, both terms provide a good deal of room for interpretation.

The essential issues under most Civil Authority forms include the following:

(1) What is the triggering event (e.g., how is the insured peril referenced)?
(2) Is physical damage to any property required and is physical damage to the insured property (or close by) required?
(3) What type of order triggers the policy? Hurricane warning; curfew; road closures; other?
(4) Are there limits, deductibles, time restrictions, or other restrictions on coverage once coverage is triggered?

D. Ingress/Egress Provisions

Ingress/Egress provisions are relatively new and apparently derive from the Order of Civil Authority coverages and case law reviewed above. Ingress/Egress provisions provide coverage when a defined event causes the loss of ingress to or egress from an insured location. The coverage is often referred to as “loss of access” coverage.

As with early Order of Civil Authority provisions, the language of Ingress/Egress provisions varies significantly from policy to policy. Some Ingress/Egress provisions provide coverage only when production is interrupted or business operations or services are suspended as a result of an Order of Civil Authority prohibiting access to or egress from the described location and only when the order is given as a direct result of physical damage or destruction of the type insured against. Other Ingress/Egress provisions specifically state that the property of the insured does not need to be physically damaged. Finally, other provisions, typically found in a broker's form, provide coverage when ingress to or egress from the insured premises is prevented "from any cause whatsoever irrespective of whether the premises or property of the insured shall have been damaged."

Under these varying definitions, some common issues arise. First, is there a requirement of physical damage to insured property? Second, is there a requirement of physical damage to any property which causes ingress or egress to be barred or simply that ingress to or egress from the insured's property be prevented? (Under the second definition, a bad traffic jam arguably may suffice). Third, are there any overlaps or ties to Order of Civil Authority or other special coverages? As always, the policy must be carefully reviewed to see whether definitions in other parts of the policy apply.

Fountain Powerboat Industries, Inc. v. Reliance Insurance Co., 119 F.Supp.2d 552 (E.D.N.C. 2000)[3] is significant because it is the first reported decision which applies an ingress/egress provision of a property insurance policy. In Fountain, Hurricane Floyd and related flooding barred access to the insured's manufacturing facility resulting in business interruption loss. Because the insured property sustained no damage, the insurer, Reliance, denied the claims for business interruption loss. The insured brought an action against Reliance for business interruption losses caused by the lack of to the manufacturing facility due to flooding of major roads and bridges. The court rejected Reliance's argument that the ingress/egress provision required physical loss or damage to the insured property in order to

[3] The citations to the Federal Supplement pages are not yet available.

trigger the business interruption coverage. The ingress/egress clause in the Fountain case provided as follows:

> 6. 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 or egress from, real and personal property not excluded hereunder is thereby prevented.

Id. at *2.

The court found this provision to be "exceedingly clear." Id. at *4. The court found that the "Perils Excluded" section of the policy did not exclude hurricanes or other natural disasters. The Fountain facility was not excluded property. The court concluded:

> Therefore, substituting 'hurricane' and the 'Fountain facility' into the ingress/egress provision yields, 'This policy covers loss sustained during the period of time when, as a direct result of a hurricane, ingress to or egress from the Fountain facility is thereby prevented'.

Id. The Fountain trial court opinion establishes that physical damage to the insured property is not necessary to trigger an ingress/egress provision which does not contain that requirement. The Fountain opinion did not address what would be considered an insured event to trigger the coverage since Hurricane Floyd clearly caused insured physical damage in eastern North Carolina which prevented access to the insured's plant. While we have found no reported cases on this provision, the phrase, "all risk of physical loss or damage" generally has been applied to require actual physical damage to some property. Thus, ingress/egress provisions which require an insured event at the least will require actual physical loss or damage to property which causes the lack of access.

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E. Contingent Business Interruption[4]

Business Interruption Insurance is intended to indemnify against income or profit losses that result directly from physical damage to the insured's property. The physical damage must be caused by risks insured under the Business Interruption policy. Contingent Business Interruption differs from Business Interruption coverage in that it insures against income or profit losses caused by physical damage to a third party's property. Under Business Interruption coverage, the insured owns the damaged property that causes an interruption to the business of the insured. Under Contingent Business Interruption coverage, the insured is protected against specified losses caused by physical damage to a supplier's or customer's operations. The same issues that arise with Business Interruption coverage arise with Contingent Business Interruption coverage. Thus, the period of indemnity, the concept of idle periods, and the concept of actual loss sustained all apply to Contingent Business Interruption coverage.

The key area of focus on Contingent Business Interruption coverage is, again, definitional. Some policies require the policyholder to specify the locations to which the insured's Contingent Business Interruption coverage applies. Air Liquide America Corp. v. Protection Mutual Ins. Co., 132 F.3d 38 (9th Cir. 1997)[5] concerns a fertilizer distributor which was located immediately adjacent to a plant that manufactured fertilizer products. The plant and the distribution company were separately owned. An explosion at the plant physically damaged both properties. The business of the distribution company would have been interrupted the by physical damage to the distributor's premises; but, in any event, it would have had no fertilizer to

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[4] This discussion of contingent business interruption issues and the discussion of idle periods at H (1) and actual loss sustained at H (2) rely substantially on my partner Alan Miller's analysis. See, e.g., *Business Interruption Losses in the Context of a Catastrophe: Calculation of the Period of Restoration and Projected Business Income*, Property Insurance Issues and Catastrophe Losses, ABA Tort and Insurance Practice Section monograph, 1996; *Business Interruption -- Contingent and Recipient Beneficiaries*, Defense Research Institute, 1998.

[5] Air Liquide is an "unpublished opinion" referenced in the Table of Decisions Without Reported Opinions.

supply its customers because of the destruction of the adjacent plant. The distributor had business interruption insurance, but the policy contained an <u>idle periods</u> provision which provided that there would be no loss payable for any period of time during which the business would not have been in operation in the absence of a loss, that is, insured physical damage to its property. The distributor's recovery was precluded by the idle periods clause–regardless of its own damage, it could not have continued operations due to the loss of its principal supplier. The insured fertilizer distributor depended upon the adjacent fertilizer manufacturer on adjoining premises. Since both were damaged by the explosion, the distributor could not recover because it would not have had any products for its customers, since its primary supplier was out of operation. The court recognized that had Air Liquide purchased Contingent Business Interruption ("CBI") coverage, the loss likely would have been covered. The CBI coverage would have insured Air Liquide for the sales loss when the supply of fertilizer from the manufacturer was interrupted by the explosion.

F. <u>Earthquake</u>

Earthquake coverage typically is available by endorsement to a property insurance policy and excluded in the main form. A typical earthquake endorsement that insures against physical loss or damage caused by an earthquake contains a very specific definition of the occurrence:

> Earthquake defined and limited. Each loss by earthquake shall constitute a single occurrence hereunder; provided, if more than one earthquake shock shall occur within any period of seventy-two hours during the term of this endorsement, such earthquake shocks shall be deemed to be a single earthquake within the meaning hereof. This Company shall not be liable for any loss caused by any earthquake shock occurring before the effective date and time of this endorsement, nor for any loss occurring after the expiration date and time of this policy.

The extent of Coverage under an earthquake endorsement often hinges on whether there were single or multiple occurrences. The issue of single vs. multiple occurrences is important in determining the applicability of the various deductibles and limits provided by the policy and in applying possible exclusions pursuant to an earthquake endorsement. For example, suppose an earthquake causes a fire to the property and both the earthquake and fire caused multiple separate losses; the foregoing may be classified as multiple occurrences or as a single occurrence since the earthquake was the original causative factor. If the losses are classified as a result of multiple occurrences, more deductibles will apply, and reduce the ultimate insured loss. For more on deductibles and limits, <u>see</u> H.3. below.

Even without a specific earthquake endorsement to a policy, insureds may recover for losses incurred by an earthquake. Courts have circumvented policy language that excludes loss by earthquakes by finding coverage under other policy provisions. In reviewing a homeowner's policy covering collapse of a building, a court held that the earthquake exclusion applies only when it can be shown that earth movement was the sole cause of damage. <u>Vormelker v. Oleksinski</u>, 199 N.W.2d 287 (Mich. App. 1972). The court found that if it could be proved that the building was improperly constructed and "but for" the inadequate construction, the building would not have collapsed even with the earth movement. Accordingly, the court refused to apply the exclusion for earthquake so as to preclude coverage.

G. <u>Federal Flood Insurance</u>

Government-sponsored flood insurance policies are issued pursuant to the National Flood Insurance Act of 1968 ("NFIA"). 42 U.S.C. § 4001 (1994). The NFIA was created to provide federally subsidized insurance to floodplain residents.[6] Congress found that numerous factors make it "uneconomic for the private insurance industry alone to make flood insurance available . . . on reasonable terms and conditions." 42 U.S.C. § 4001(b). The NFIA was passed to replace the burden on the Nation's resources in providing disaster relief with federally subsidized

[6] For an in-depth analysis of the purpose of the NFIA and the National Flood Insurance Program <u>see</u>, <u>The National Flood Insurance Program: Unattained Purposes, Liability in Contract, and Takings</u>, 35 W & M L. Rev. 727 (1994).

insurance. The NFIA has made flood insurance available and affordable to individuals and businesses in the flood plains.

Flood coverage policies issued pursuant to the NFIA are subject to specialized rules of construction. As such, proof of loss requirements and suit limitation provisions in federal flood insurance policies are given strict construction because the insurer is in effect, an agency of the United States. Several cases have specifically addressed the construction of the proof of loss requirements and suit limitation provisions in flood insurance policies.[7]

Courts have held that in the Federal Flood Insurance context, an insured cannot avail itself of the doctrines of waiver and estoppel to escape failure to file a timely proof of loss or suit. See e.g., Gagliardi v. Omaha Property and Insur. Co., 952 F.Supp. 212 (D.N.J. 1997). Pursuant to the NFIA, the insured has sixty days to file its proof of loss. 42 U.S.C. §4001. The insured did not file its proof of loss within the time required under the policy. In rejecting the insured's substantial compliance argument, the district court ruled that doctrines of waiver and estoppel do not apply when the insurer is an agency of the United States. Id. at 217. Although the flood insurer is not itself an agency of the United States, it is afforded government agency status because it issued a policy with federally sponsored coverage. The court recognized that courts generally do not permit claims of estoppel to be raised against the government absent a showing of "affirmative serious misconduct by a government agent that was reasonably relied upon to a party's detriment." Id. at 217. Courts strictly enforce the proof of loss and suit limitation requirements pursuant to Federal Flood Insurance policies. See, id.; See also,

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[7]These flood cases were reported in earlier TIPs publications and this discussion relies substantially on those more detailed analyses. Special thanks to Robert E. Chudakoff, Andrew B. Downs, Susan B. Harwood, William W. Speed, Daniel F. Sullivan and Wesley Ward for the information provided by their article Recent Developments in Property Insurance Law, 35 Tort & Ins. L. Journal No. 2 Winter 2000, pg. 601-602. Also thanks to Andrew B. Downs, Susan B. Harwood, David R. Lane, Stephen P. Pate and Christopher L. Troy for the information provided by their article Recent Developments in Property Insurance Law, 34 Tort & Ins. L. Journal No. 2 Winter 1999, pg. 637-638.

Kennedy v. Aetna Ins. Co., 969 F.Supp. 931 (D.N.J. 1997); Steelcraft, Inc. v. Bankers & Shippers Ins. Co., 979 F.Supp. 60 (D. Mass. 1997).

As with proof of loss requirements, suit limitation clauses are strictly enforced. Pursuant to the NFIA the insured must bring suit in federal court within one year. The filing of a state court action under the NFIA fails to toll the one year statute of limitations. See, James v. Auto Owners Ins. Co., 1998 U.S. Dist. LEXIS 20394 (S.D.Ga. 1998); Parsons Footwear, Inc. v. Omaha Prop. & Cas. Co., 19 F.Supp.2d 588 (N.D.W.Va. 1998). Actions based on state law tort causes of action alleging the impropriety in the investigation and adjustment of a flood insurance claim also can be brought in federal court predicated on the NFIA. See, Van Holt v. Liberty Mutual Fire Ins. Co., 163 F.3d 161 (3d Cir. 1998). In summation, if an insured fails to file suit or proof of loss timely under the policy, typically it will be unable to recover under Federal Flood Insurance.

H. Common issues

1. Idle periods. Idle periods arise in the context of a catastrophe because even though there may be an insured event triggering time element coverage at a specific policyholder's location, that policyholder would have had business interrupted because of the catastrophic loss to the entire region. The idle period provision or concept applies where the interruption of business can be traced to two causes, only one of which is insured. In determining the period of insured interruption of business, the concept of "idle periods" requires exclusion of the time the business would not have functioned even if it had not suffered insured damage. The calculation of the "idle period" may, unlike the calculation of a projected loss, consider at least some of the effect of the damage to uninsured property or damage to insured property by uninsured risks.

The idle periods concept is simple. A traditional application of idle periods is to a manufacturing plant which had scheduled a shutdown (for maintenance, vacation, or any other purpose) within the period of interruption. Because the plant would have produced no product during the scheduled shutdown, it should not recover for loss of earnings or continuing expenses during the planned shut-down period.

There are two published cases which have applied this concept. The first is Manufacturers Mutual Fire Insurance Company v. Royal Indemnity Company, 1501 F.2d 299 (CA 9 1974), which involved a dispute between two insurers on a claim by Kaiser Aluminum arising out of Hurricane Betsy in 1965. Both the Manufacturers Mutual and the Royal policies contained "idle periods" clauses.

As a result of the hurricane, Kaiser sustained damage to its plant; however, it would have been unable to operate the plant because of a reduction in gas from an off-premises supplier. The court stated that the idle periods clause required an analysis of what would have happened if the covered loss had not occurred. The court determined that because of the off-premises damages to the supplier, no goods would have been produced. Therefore, there was no business income coverage under the Manufacturers Mutual policy for the period of time during which the supply of gas was curtailed.

The second case is Simkins Industries, Inc. v. Lexington Insurance Company, 401 A.2d 181 (Court of Appeal MD 1979) which involved tropical storm Agnes which led to a rise in the Patapsco River. A tree carried by the river struck a steampipe on a bridge between buildings. The damage to the steampipe was not covered under that policy. There was, however, other damage which was within the policy coverage. The court applied the idle periods clause and held that the business interruption period did not include any part of the shut down that was attributable to the time necessary to replace steampipes across the river. This eliminated the first six months of the period of interruption.

Both of those cases involve policies which expressly contained an idle periods clause. That clause typically reads as follows:

> This policy does not insure against time element loss for any period during which business would not or could not have been conducted for any reason other than physical damage of the type insured against.

It has been asserted that an idle periods clause is not necessary to accomplish the same result. It has been argued that the "actual loss sustained" language of the policy accomplishes the same purpose as an idle periods clause. In Volume 2 Commercial Property Insurance issued by the International Risk Management Institute, the authors state:

> But the exclusion (idle periods) is probably unnecessary . . . coverage is provided only for the actual loss sustained during the indemnity period, giving 'due consideration' to the probable experience of the business . . . had no loss occurred. With or without an idle periods exclusion, there would be no coverage for any period of time during which the insured's operations would have been suspended even had no loss occurred.

However, there is no case which has applied the actual loss sustained language as a substitute

for an idle periods clause.

2. **Actual Loss Sustained.** A twist in the actual loss sustained argument was presented in a case arising out of Hurricane Hugo, Prudential-LMI Commercial Ins. Co. v. Colleton Enterprises, Inc., Table 976 F.2d 727 (4th Cir. 1992) (unpublished). The insured motel (Econolodge) argued that its hurricane business interruption loss should be based on additional business it would have received because of the hurricane damage in the area. The motel claimed that it would have attained a much higher occupancy rate because many people were displaced from their destroyed homes and many additional people had moved into the area for construction jobs, etc. The court rejected this argument and stated that it would not condone the recovery of a "windfall" resulting from the very insured event.

The decision makes sense. If all insureds could project their losses to include additional income resulting from the catastrophe, the sum of losses would be larger than the amount the insureds would have earned if the catastrophe had not occurred. For example, without a hurricane each motel might project 50% occupancy. After a hurricane each would claim (as Econolodge did) that it would have attained 100% occupancy because of the storm. This would cause the anomalous and unacceptable result that each motel would recover for loss based on projection of 100% recovery. The victims of the hurricane would in effect profit from it.

Another variation on the issue was addressed in Gregory v. Continental Ins. Co., 575 So. 2d 534 (Miss. 1990). The insured sustained damage to its golf course and related buildings during hurricane Elena. The insured claimed it should recover for its losses resulting from the damage to the golf course (which was closed for two weeks to clean up debris). But only the pro shop and restaurant were insured -- the golf course was not. The court restricted recovery to that resulting directly from the physical damage to the buildings, and rejected any claim for that part of the loss due to the inability to use the golf course.[8]

3. Deductibles and Limits. The application of special deductibles and limits are often complex in a catastrophe claim. Service Interruption, earthquakes, and flood endorsements (among others) may have more restrictive limits and larger deductibles than found in the main policy form. The varying deductibles and limits for specialty coverages may influence the

[8]See also Ramada Inn Ramogreen, Inc. v. Travelers Indemnity Co., 835 F.2d 812 (11th Cir. 1988). The hotel sought coverage for a decline in business that resulted from a fire to the adjoining restaurant. Both the restaurant and the hotel were insured under the policy, although as separate locations. The insured claimed that the decline in hotel business was insured because of the “mutual dependency” between the hotel and the restaurant. The court rejected this argument and limited the loss to the restaurant because only it sustained insured physical damage. See also Keetch v. Mutual of Enumclaw Ins. Co., 831 P.2d 784 (Wash. Ct. App. 1992). The insureds owned and operated a motel that was buried in 6 inches of ash as a result of the volcanic eruption. The motel remained open but sustained an understandable decrease in business. The court noted that the physical attractiveness of the motel was damaged, but rejected the insured’s business interruption claim, and stated that business interruption coverage is intended “to indemnify for loss due to inability to continue to use specified premises . . .”

strategies insureds and insurers employ in defining whether the claim is comprised of single or multiple occurrences. Many policies contain per occurrence limits that provide a ceiling to the insurer's liability for an occurrence at a specified amount. An occurrence may be specially defined for hurricanes, earthquakes and flood events. Many property policies also contain self-insurance features such as deductibles which provide that for each occurrence covered under the policy, the insured will pay the first portion of the loss up to a specific amount, designated by a dollar amount or sometimes stated as a percentage of overall liability.

Kuhn's of Brownsville v. Bituminous Cas. Co., 270 S.W.2d 358 (Tenn. 1954), is cited by other jurisdictions to support the proposition that when the cause of multiple accidents is interrupted, the courts will generally find more than one occurrence or accident under insurance policies. See, e.g., Slater v. United States Fidelity and Guaranty Co., 400 N.E.2d 1256, 1260-61 (Mass. 1980). In Kuhn's, the plaintiff had limited coverage on two retail buildings. Kuhn's, 270 S.W.2d at 358. For purposes of remodeling and combining the two buildings into one, the plaintiff excavated under the buildings. Id. After the excavation and the removal of the wall between the buildings, the two buildings and one adjoining them to the east collapsed. Id. at 359. Two days later, the adjoining building on the west collapsed. Id. There was no excavating on the days between the two occurrences. Id. The policy provided coverage for $10,000 per accident and $25,000 aggregate. Id. The court determined that there has been "two separate unforeseen events." Id. at 360. The court explained its decision as follows:

> If the excavation was a single act, and constitutes a single accident, then the question comes as to when the accident occurred. The owners on the west suffered no loss and experienced no unforeseen event until (two days after the excavation).

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Id. In sum, the court found that the plaintiffs were entitled to recover for "the two separate accidents resulting from the excavation." Id. Essentially, the court found two occurrences resulted from one cause.[9]

The insured and insurer need to understand how the court in a particular jurisdiction would define an "occurrence" and whether there is a factual relationship leading to a conclusion that there is one event or multiple events. In Lexington Ins. Co. v. Commonwealth Ins. Co., 2000 WL 74117, *5 (U.S.D.C. N.D. Cal., January 24, 2000) the federal court relied, in part, on the policy 72 hour definition of occurrence for earthquakes in concluding that four separate fires caused by one arsonist to county buildings constituted four separate occurrences. The court reviewed case law in which a series of thefts pursuant to a common scheme has been held to be a single occurrence. The court recognized that the 72 hour provision for earthquake damages constituting a single occurrence would be unnecessary unless losses to separate locations caused by an earthquake would generally be considered separate losses. Thus, the policy definitions as well as local case law on occurrences must be checked carefully for catastrophe claims.

[9]In Newmont Mines, Ltd. v. Hanover Ins. Co., 784 F.2d 127 (2d Cir. 1986), the insured brought an action to recover property damages arising out of the collapse on two different days of two separate sections of a roof on one of its buildings. The insured argued that the various insurers providing layers of coverage were obligated to pay their respective policy limits for each of the two collapses of different parts of the building's roof which occurred between 3 and 17 days apart. In response, the insurers argued that the loss resulted from a single occurrence because it was caused by or was the result of the same accumulation of snow and ice on the roof. A jury found that the collapse of the insured's roof constituted two separate occurrences. The trial court denied the insurer's motion of JNOV and the Second Circuit affirmed. Perhaps the most important part of this opinion is the court's express rejection of the insurer's argument that the term "occurrence" takes on a special and more narrow meaning within the context of insurance policies. The Second Circuit noted that within the context of determining limits of coverage afforded by *liability* policies, the majority of courts determine the same by reference to the cause or causes of the damage rather than the number of injuries, claims or events giving rise to damage. The court specifically held that those authorities within the third-party context had no application or impact upon the same analysis within a first-party insurance context.

In Altru Health System v. American Protection Insurance, 238 F.3d 961 (8th Cir. 2001), United States Court of Appeals for the Eighth Circuit, Submitted October 19, 2000; Filed February 6, 2001, the United States Court of Appeals for the Eighth Circuit held that a flood sublimit provided the cap for time element coverage under the Civil Authority provision of a property insurance policy. The hospital sustained no physical damage from the flood but was shut down by the State Department of Health because of the flood waters and lack of potable city water. The Civil Authority provision contained a two-week limit on time element coverage which the trial court found as the applicable limit. The appellate court reversed the judgment and found that the flood sublimit applied. The appellate court relied on the policy preamble which indicated that the smallest applicable sublimit would control. The court also referenced the statement in the Flood Coverage that "all claims". . . "arising out of any one Flood occurrence shall be adjusted as one claim." Finally, the court relied on statements in a letter from the underwriter to the broker which stated that reducing the flood sublimit would impact the time element coverage available arising out of a flood.

CONCLUSION

This hodgepodge of specialty coverages and issues illustrates how a general catastrophe can create complex adjustment and coverage issues. The most important rule for the consulting attorney is to thoroughly review the policy language. Policy terms have changed significantly over the years and existing case law does not address many of the current provisions. Moreover, catastrophes raise difficult issues for application of idle periods, actual loss sustained, and loss of access concepts when a general area is severely damaged.