

Advanced BI Subjects

“But for the Damage” in Business Interruption Claims following Natural Disasters

**(Based on part of an address to the Insurance Law Association’s
Annual Conference in October 2004)**

In recent years natural disasters have raised again, the huge gap between insureds’ expectations of Business Interruption (“BI”) claims and the reality of what the policies really cover. The issue, simply referred to as “de-population” or “loss of attraction”, has been around at least since Cyclone Tracey in Darwin in 1974. It was a source of contention after the Tsunami in South Asia in December 2004 and I have more recently been asked to give an opinion on the effect of depopulation in the 2008 earthquake in Central China.

The simplest understanding of BI claims is that they reimburse the financial loss that results from a drop in sales or an increase in costs. How these two are measured is set out in the “Specification” of the policy and the fundamental item of cover is the Gross Profit item. Depopulation is a complication that is primarily related to the measure of the reduction in turnover (loss of sales).

In respect of “acts of God”, the ancient legal principle applies to BI insurance, namely that “things are rarely what you think they should be”.

I only use the term “acts of God” as a convenient expression for earthquakes, floods, cyclones and volcanic explosions. I have never seen it in a BI insurance policy and it contradicts my theology to think that God sits up there somewhere deciding on whom to visit such calamities. The essential characteristic of them is that they damage a wide area; not just the property of a single insured, but also its customers, suppliers, public utilities and access routes.

A simple example will illustrate this not-so-simple issue. Assume that you are a broker or insurer who has sold a BI policy to a client after which it suffers a major interruption to its business following a storm. In this context my experience is mostly related to cyclones in resort areas of Fiji.

Case Study: Cyclone Damage at a Fiji Resort

A cyclone in Fiji caused substantial damage to your client’s island resort. The roof was blown off the central core facility, which contained the reception, office, dining room and bar, and sea surge carried water and sand into all the ground floor rooms along the beachfront. This damage was insured and underwriters accepted liability for the claim.

In contrast, its neighbour was virtually undamaged because it was protected from the prevailing winds by a convenient hill. Its gardens were shredded and the pool was filled

with debris but there was negligible damage to its buildings. For our illustration we will say that it was undamaged.

Both resorts would have expected occupancy rates of about 65% at that time of the year.

Your client’s damaged resort was totally closed for 2 months, and only some of its rooms were available over the 3rd and 4th months. Average occupancy over the 6 months after the cyclone was only 25%. Does its BI policy indemnify it for the loss consequent upon the drop in turnover that resulted from the fall in occupancy from an expected 65% to the actual 25%?

Before answering, let us consider the undamaged neighbour.

It also did not achieve the expected 65% occupancy. Its occupancy averaged only 45% because the news of devastation was well reported in Australia and New Zealand resulting in a major decline in visitor arrivals to Fiji generally. Does its BI policy indemnify it for the loss consequent upon the drop in turnover that resulted from the fall in occupancy from an expected 65% to the actual 45%?

The simple answer is that the damaged resort has a valid claim but the undamaged resort does not. As you might guess, the owners of the undamaged resort would suggest that the loss adjuster was, on behalf of the insurers, using the fine print of the policy to defeat its basic intention to insure the loss of profit consequent upon the cyclone.

We shall look at the notorious fine print, using a cross section of BI policies. I will skip the introduction, agreement to insure and the other formalities that are not unique to BI.

The Indemnity – from a reasonably typical or conventional BI policy:

“We will indemnify you for the resultant amount of loss if your business is interrupted or interfered with in consequence of damage at the premises during the period of insurance.”

That is clear. The resort that’s property was damaged has a claim. The undamaged resort does not.

There is another pertinent clause called the Material Damage Proviso.

“Provided that:

.... (the insurer) will not be liable under Part 2 (i.e. the business interruption section of the combined property and BI policy) unless the insured’s property destroyed or damaged is insured against such insured Damage under Part 1 Material Damage

..... and (the insurer) shall have (or would have, but for the application of an excess or deductible) paid for or admitted liability in respect of the Insured Damage.”

The owner of the undamaged resort thought that the adjuster was using this clause to deny liability for its business interruption loss and argued that it had, in fact, suffered damage. But does this clause mean that, provided there is some damage that is insured, the policy will respond to the entire BI loss? Would a couple of blown out windows or a pool filled with debris satisfy this proviso and cause the policy to respond to the interruption loss?

I refer you back to the contract:

“We will indemnify you for the resultant amount of loss if your business is interrupted or interfered with in consequence of damage at the premises during the period of insurance.”

Minor damage that did not cause any interruption to the business does not validate a BI claim that arises from other factors. The claim can only be for the loss resulting from the damage. The damage must be the effective cause of the interruption, not just coincidental to it.

I suppose that the undamaged insured could claim the loss that resulted from the debris in its pool and several broken windows but this damage probably did not cause any of the reduction in occupancy over the next 6 months.

Therefore my opinion is not based on an adversarial interpretation of the fine print. It is based on the fundamental undertaking of the insurers as expressed in the contractual clauses.

And the opinion is also supported by the detail of the specification.

“Item 1: Gross Profit

The insurance under this Item is limited to the loss of Gross Profit due to (a) reduction in turnover and (b) increase in cost of working and the amount payable as indemnity under this Item shall be:”

The more important and unfortunately, the more complex element of a claim is usually the loss due to a reduction in turnover. A typical policy specifies it in the following manner:

“(a) in respect of reduction in Turnover, the sum produced by applying the Rate of Gross Profit to the amount by which the Turnover during the Indemnity Period, in consequence of the Damage, falls short of the Standard Turnover.”

We will look first at the calculation of lost sales, which is “the amount by which the Turnover during the Indemnity Period, in consequence of the Damage, falls short of the Standard Turnover”.

“ ‘Standard Turnover’ means the Turnover during the period in the twelve months immediately before the date of damage which corresponds with the Indemnity Period”

But BI policies do not insure history. They insure future profit and the definitions cater for this by requiring that the historical Standard Turnover is merely a starting point:

“to which such adjustments shall be made as may be necessary to provide for the trend of the Business and for variations in or other circumstances affecting the Business either before or after the Damage or which would have affected the Business had the Damage not occurred, so that the figures thus adjusted shall represent as nearly as may be reasonably practicable the results which but for the Damage would have been obtained during the relative period after the Damage.”

For the damaged resort, the historical Standard Turnover is based on 65% occupancy because that is what was achieved during the corresponding period 12 months ago. But this has to be adjusted for trends, variations and special circumstances to get the best possible estimate of what would have been obtained but for the Damage.

And this is the critical point!

Both resorts achieved 65% occupancy during the equivalent period of the previous year. Following the cyclone the undamaged resort achieved only 45% occupancy because of a countrywide downturn in visitor arrivals. From that evidence of the undamaged neighbour the reasonable conclusion is that the damaged resort could only have achieved a 45% occupancy if it had not been damaged.

This produces the standard against which its claim is measured.

Quite simply, the damaged resort is not insured for the consequences of the peril, the cyclone. It is insured for the results of the Damage. Any impact that would have been felt by the business even if it had not been damaged must be allowed for first, namely the reduction to 45% occupancy. Only the additional loss (to an actual 25% occupancy for the damaged resort) is attributed to the damage and claimed.

Fair? I suppose it depends on your point of view. But whether it is fair or not, it is what the policy provides when it states that Standard Turnover must be adjusted to achieve the best possible estimate of the turnover that would have been achieved “but for the Damage”. In these circumstances, irrespective of the damage to your client’s property, there would have been a reduction in demand for its resort experience.

On the other hand there is another side to these adjustments.

Reduction in Supply – Damage to Competitors

In a previous life I acted for a transit hotel in Nadi, which suffered serious damage in a cyclone in 1984. In the previous year its occupancy had been 70% and its historical Standard Turnover as defined in the policy, was based on this 1983 data. However, there was a cyclone also in 1982 and the transit hotel achieved a windfall 98% occupancy because the area was crowded by loss adjusters, engineers, quantity surveyors and insurers, many of who stayed at this hotel because most of its neighbouring transit hotels had been damaged.

What is the adjusted standard against which its 1984 claim should be measured?

Well, because most of the neighbours were again seriously damaged in 1984, I argued successfully for the insured that, on the evidence of 1982 (cyclone, no damage, 98% occupancy), but for the damage, it would again have enjoyed an occupancy rate of 98% in 1984.

This policy-based logic can theoretically be extended further.

Every transit hotel in the area could also claim that, because its neighbouring competitors were severely damaged, then but for the damage to the buildings and other property it used at its premises, it would have been the only available accommodation in town. Surely in those circumstances it would have enjoyed a similar 98% occupancy.

So every hotel in the town would either achieve this windfall by being one of the very few undamaged hotels or it would achieve the same windfall by claiming from its BI insurers that but for its damage it would have been one of the very few undamaged hotels in town and that it would have achieved 98% occupancy. Therefore this is the adjusted standard against which its claim should be assessed.

To summarise the Fiji cyclone scenario, the historical Standard Turnover as defined in the policy must be adjusted to remove any circumstances that are not insured by the policy. First there is an overall reduction in tourists. Then there is the influx of people connected with cyclone relief, rebuilding and insurance. These two probably produce a net reduction in demand for rooms.

Thirdly there is a reduction in the supply of rooms because of the damage to most of the hotels in the area.

As ridiculous as this situation might appear, it is a factor to be addressed in many of the BI claims that arise from natural disasters, which cause widespread damage and disruption to a local economy.

I was told that an expert insurance lawyer has commented that no sensible judge would allow a claim to succeed that sought to benefit from the event that caused the loss. I also know that an arbitration after the 2004 tsunami disallowed the insurer's adjustment to exclude the de-population effect from the BI claim. Neither of these has value as a legal precedent but they do suggest that the principles that I have outlined above are not universally accepted. I might add that the insurer only accepted the claim for the transit hotel in Nadi after it obtained an opinion from a Queens Counsel that endorsed my arguments.

Finally I want to comment briefly on the interdependency of businesses that arises primarily from the supplier and customer relationships.

Given the widespread nature of earthquakes and floods and the interdependency of businesses, each policy-holder is not only vulnerable to its business being interrupted by damage to its own property but is also vulnerable to the possibility that its suppliers or

customers are damaged, or there are access problems because of damage in the vicinity including damage to roads, bridges, and airports or there is power failure.

The conservative policy-holder, who wants to be fully insured, might be tempted to believe that with all the available extensions, this has been done. But it is important to recognise that these policy extensions are each very specific. For example, the utilities clause does not insure the all BI losses consequent upon failure of supply of, for example, electricity. It insures the loss consequent upon Damage as defined, to specific property (not excluded property), which causes failure of supply.

Similarly, you will recall that the Customers & Suppliers extensions also refer to the loss consequent upon Damage, as does the Prevention of Access clause.

Therefore, while these extensions do add to the scope of BI loss that can be claimed they do not comprise a “catch-all” in the policy and in respect of each extension the standard against which the loss will be measured is the results that would have been achieved but for the damage, which does not include “de-population”, “loss of attraction” or regional economic downturn.

My next paper in this series will examine in detail, the distinction between insured and excluded categories of property as it affects BI claims in situations of widespread damage.

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October 2004 (updated 2009)