

SUPERSTORM SANDY - INSURANCE AND REINSURANCE ISSUES



Introduction

Severe flooding, rampaging fires, explosions and downed power lines were just some of the consequences left in the wake of Superstorm Sandy, the post-tropical cyclone which battered more than 20 US states last week, having first wrought a trail of destruction through the Caribbean. Particularly severely hit were the states of New York and New Jersey, both of which have been declared disaster areas by the US Government.

Once again, the insurance market will be faced with complex factual and legal analysis to ascertain the nature and extent of coverage.

Property damage issues

The following issues are likely to arise in the context of insurance cover protecting loss resulting from Sandy:

- Has the event triggered cover? There may be issues over, for example, whether

property damage has been caused by flooding, which is often excluded under the terms of property damage cover, or by wind-driven water, which is usually covered. Those policy-holders with flood exclusions may be covered for such damage under the National Flood Insurance Programme operated through FEMA (Federal Emergency Management Agency), although it is thought that only 15 - 25% of at risk properties are so protected.

- Are there multiple events or occurrences and, if so, how will the loss be allocated between them? As the weather system moved inland and northwards, winter storms with freezing rain, snow and ice followed. Determination of the number of events, and their respective impact, can have consequences for both policyholders and underwriters. The issue can be exacerbated where there are complex multilayer programmes with diverging interests across the layers. Notwithstanding the presence of “hours



clauses” (see below), there are well known difficulties in breaking down periods of sustained heavy weather (and the inter-relationship between different sequential weather patterns) into different “events” or “occurrences” to allocate and aggregate losses, and to apply deductibles and policy limits. Synoptic analysis may be employed as a part of this exercise.

- To what extent will steps taken to mitigate loss, and sue and labour in prevention of damage (whether pre-emptive or reactionary) be covered? The answer to this will depend, in each individual case, upon the terms of the contract, but generally speaking New York law takes a similar approach to English law in considering sue and labour claims.

Business interruption (BI) issues

The damage to property, disruption of transport links and prolonged utility outages experienced as a result of the storm are highly likely to lead to claims in respect of consequential business interruption - often the largest, most complex and most contentious claims. Many factors may impact upon the calculation of loss. Considerations for policy-holders, insurers and also brokers who may be required to assist in the preparation of claims, include:

- **Establishing causation.** BI cover is sometimes said to operate on a “double trigger”. First, it requires property damage to be sustained by an insured peril. Secondly, it requires the interruption to the assured’s

business to result from that property damage rather than from some other cause. When there has also been serious disruption to transport links and utility supplies, as well as widespread damage to property, causation issues may arise. Where there are gaps in cover, these may be filled by appropriate extensions.

- **The nature and length of the indemnity period as defined by the policy.** BI policies typically provide for a period of cover by reference to which the Insured’s loss is calculated. Where it may take a long time before trading conditions return to normal, it will be important to understand not only the triggers that cause the period to commence, but also the length of the period and any categories of loss that can be claimed outside the period - as is usually the case for ICW (increased costs of working).
- **The presence and application of sub-limits.** Policies often provide for sub-limits to apply to loss from particular perils or loss of a particular nature, such as loss resulting from denial of access. The application of sub-limits, in particular whether they are cumulative (ie whether they “stack”) or are exclusive, can have an important impact on the indemnity provided by the policy. Sandy affected several parts of the Caribbean, as well as over 20 US states, with damage being caused, arguably, by a variety of different perils. Issues could arise as to the different sub-limits applying to elements of a claim and the interaction between them.

- **The operation and effect of Adjustments Clauses and/or special circumstances clauses for wide-scale area effects.** In the aftermath of Hurricane Katrina, a hotel chain sought to rely upon an Adjustments Clause, which required the insurer to provide for trends, variations and special circumstances to “represent, as nearly as may be reasonably practicable, the [hotel’s trading] results which but for the Damage would have been obtained [during the Indemnity Period]” (*Orient-Express Hotels Ltd v Assicurazioni General S.p.a*). The hotel argued this clause required the insurer to adjust its loss as if the hotel had been undamaged, without taking into account the effects of Hurricane Katrina on the wider New Orleans area. The hotel’s argument failed. The English court upheld the arbitration tribunal decision that OEH could only recover loss which would not have arisen “but for” the damage to the hotel. It was held that “special circumstances” in the Adjustments Clause could include the same event (insured peril) that gave rise to the Damage and, since the loss would have been suffered by OEH as a result of the damage to the surrounding area, even if the hotel itself had not been damaged, there could be no indemnity under the BI section of the policy. Recovery was available pursuant to the loss of attraction and prevention of access extensions, but a lower limit applied.

There is also a substantial body of US case law on this issue.



For example, in the most recent of these listed cases, *Catlin Syndicate Ltd v Imperial Palace of Mississippi, Inc (2010)*, the court upheld an insurer's calculation of business interruption loss based only on the insured's pre-catastrophe sale figures, without taking into account the insured's significantly higher, post-interruption sales figures. In this case, 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 by the hurricane. The insured contended that its loss of earnings should be measured by assuming a hypothetical scenario in which Hurricane Katrina struck, causing damage to other casinos, but causing no loss to the insured. The insurer argued that the appropriate hypothetical was one in which Hurricane Katrina never struck in the first place. The court agreed with the insurer, stating (at page 7) that:

"Without language in the policy instructing us to do so, we decline to interpret the business interruption provision in such a way that the loss caused by Hurricane Katrina can be distinguished from the occurrence of Hurricane Katrina itself".

- The ability or otherwise to make up production at the affected or other locations. Although the damage and disruption has been

widespread, some areas, such as certain parts of Manhattan, have been relatively unscathed. Any ability to switch production/operations to unaffected areas and thereby continue to trade will have to be taken into account in calculating the level of any indemnity.

- The task of collecting and tracking information for the purpose of preparing or scrutinising a claim. BI claims usually require significant amounts of documentary evidence to demonstrate the impact of the insured damage upon the business's profitability. This task is made even more onerous in circumstances in which records may have been destroyed by the property damage giving rise to the interruption.
- The calculation and ascertainment of increased cost of working, and additional increased cost of working claims. BI policies will usually cover the assured for the increased costs of working incurred as a consequence of the peril. In the absence of contrary provision, these costs may be recovered in full, even though they extend beyond the indemnity period. It may also be necessary to take account of savings, such as reduced overheads, that may follow an interruption of business. This is to prevent an insured being over indemnified.

Contingent Business Interruption (CBI) has developed in recent years as businesses' loss exposure from interruption to their supply chain or

customer chain has become more clearly appreciated. CBI issues that may arise from Sandy include:

- Is cover extended by expanding the concept of "damage" to include loss from denial of access and/or loss of attraction? The widespread disruption to the New York City subway has severely hindered accessibility and is likely to have had a severe effect upon business in areas to which people are unable to travel.
- The nature and effect of identifying (whether generically or individually) suppliers and/or customers in the CBI extensions to cover. Even if an assured does not suffer damage to their property, resulting in business interruption, they may nonetheless experience an impact upon their ability to trade as a consequence of damage suffered to a key supplier or customer. Just as it will be important for an insured and their advisors to be able to record and document the interruption suffered to the business, it will also be crucial to understand the effect and scope of any extensions to cover in respect of such interruption, which will itself involve a thorough understanding of the assured's chain of key suppliers and customers.

Liability insurance issues

After catastrophes such as Sandy, it is not uncommon for there to be enquiry into the loss, the extent to which and how it could have been avoided, and how such loss may be mitigated in future. Whether or



not they become the subject of public scrutiny, businesses and public authorities may be exposed to liability depending upon the adequacy and professionalism of their risk management, preparation prior to the storm, and their disaster management during and following it. Exposures may arise, for example, from:

- Liabilities for contaminants or pollutants that escape from premises on to third parties' property, as a result of flooding.
- Liability for damage attributable to inadequate insulation or safety precautions.
- Failure to make contingency plans in respect of interrupted utility supply.
- Design liabilities may arise where questions are raised about the adequacy of building and flood retention design, particularly in the case where key services such as electrical and communications are located in basement areas prone to flooding.

Marine insurance issues

As well as causing widespread damage to property, Sandy also damaged or destroyed large numbers of vessels, both commercial and recreational, which found themselves in its path. Marine insurers and reinsurers can therefore expect to receive claims arising out this damage, and should be alive to issues such as, for example, whether yacht policies contain "named tropical storms" clauses, which might only cover the vessel where is it 'appropriately prepared' for a named

tropical storm in a marina berth - there could be doubt as to what this means exactly and whether this requirement has been fulfilled.

For commercial vessels, un-seaworthiness issues could arise, both for hull & machinery coverage and for owners' responsibility to cargo owners where cargo is lost or damaged. Generally, commercial vessels will be covered for both hull damage and liabilities arising from Sandy. Potential liabilities might include, for example, significant pollution damages following contact after breaking free from moorings.

There is also the possibility of loss or damage to spares held in storage onshore, and in this case the "parts removed" clause extension to the Institute clauses might operate, assuming that these are not replacement parts and assuming they have in fact been removed from an insured vessel. None of the standard cargo exclusions refer to hurricanes.

In respect of marinas, their liability policies will usually cover vessels in their care, custody and control, but will only respond where they have a liability for the loss, which is unlikely in this case. Generally, direct marine policies will cover most losses arising from the storm, but clearly this will not always be the case.

Logistics issues

Transport and logistics operations were inevitably hit hard by the arrival of Sandy, which resulted in the closure of a number of major East Coast ports and caused massive disruption to air transportation, as well as the inland road and rail infrastructure, resulting in damage to

or delay in the delivery of millions of dollars worth of cargo due to arrive for the Christmas season.

Commentators have speculated as to the likely cost of the cargo disruptions, with some predicting that they would not be as significant as Hurricane Katrina, whose impact on the transport and logistics sector was heavily felt.

Logistics companies and supply chain managers closed distribution centres along the East Coast, but given the nature of the logistics business, where flexibility and problem solving are often the key attributes of the companies involved, many operators continued to provide services, by re-routing cargo wherever possible and for as long as possible. That said, it is inevitable that cargo will have been damaged and there will be delays resulting from the inescapable backlog, which is likely to take some time to recover fully.

This gives rise to a number of potential issues for both the shippers and receivers of cargo as well as the companies involved in forwarding, transport, logistics and supply chain management.

Of immediate concern to the cargo interests will be the fact that whilst most cargo policies will cover physical loss or damage of, or to, the cargo, they do not generally cover damage caused by delay, even if the delay has been caused by a risk insured against. Cargo interests may therefore find themselves uninsured under traditional "cargo" policies. Such claims may then be passed onto to the service providers, who will doubtless look to applicable



international conventions or contractual conditions to limit or exclude such liability, wherever it is appropriate.

Often, contract terms will seek to exclude liability for failing to adhere to agreed departure or arrival dates; contain a force majeure clause and will in any event limit liability (insofar as liability attaches).

Force majeure clauses will only apply where the force majeure event is the sole cause of the loss. Potential claimants will therefore be looking closely at whether there has been an intervening event caused by the service provider, which was in fact the actual cause of their loss. This might arise, where, for example, the service provider fails to store perishable cargo in an appropriate environment, or where it can be argued that there were other means by which the cargo could have been carried. Each case will of course turn on its own facts.

It is probably too early to assess the overall impact upon the transport and logistics industry, and its customers, both in relation to potential claims for cargo loss, damage or delay, but also in respect of the BI claims faced both by the industry and by its customers, but it will likely run into hundreds of millions of dollars.

Reinsurance and retrocession issues

At the time of writing, insured loss estimates are rising beyond US\$20 billion and are well into property catastrophe programmes. With some states dictating that larger hurricane deductibles on household policies are not triggered, reinsurers may consider

coverage arguments to the effect that such deductibles should, in law, be applied. The prospect of liability losses in addition to property losses may lead to issues about whether the former are non-elemental rather than elemental losses, in circumstances in which reinsurance towers are split.

It will take some time to assess whether industry loss warranties are triggered by industry losses, but expect the usual issues about whether loss sustained by captives should be included, or whether uninsured losses which are picked up by insurers due to state decree are included. It is understood that trigger points for responsive ILW covers range from US\$5 billion to US\$50 billion. Aggregate ILW covers are now common, for example responding to the industry loss across the entire hurricane season.

Other issues likely to arise in a reinsurance context include:

- Issues surrounding triggers, aggregation, excess/attachment points, and reinstatements.
- As to aggregation, property catastrophe excess of loss contracts usually contain an “hours” clause containing a definition of a “loss occurrence”, as meaning all losses arising out of and directly occasioned by one catastrophe. However, the duration of any “loss occurrence” is usually limited where the losses are caused by a named peril (e.g. hurricane where a 72 hours limit applies) or where they are caused by a non named peril (where a 168 hours limit may apply). There are various different wordings of such clauses, but

they generally provide that losses caused by a hurricane or a typhoon or windstorm, and occurring within the specified number of hours (say, 72 hours), can be aggregated. Furthermore, depending on the wording of the hours clause, losses caused by flood may be aggregated for 72 hours or 168 hours. Some clauses also provide for aggregation of such storm losses, with losses arising from flooding. It is generally for the reinsured to choose the time and date when the applicable hours period commences, and it is usually not before their first reported losses. Subject to reinstatement of the reinsurance cover, it may be possible for a reinsured to recover in respect of two or more loss occurrences within the same hurricane catastrophe, although they usually cannot overlap. Issues may also arise as to how cedants’ aggregations are to be verified, and whether they fall within the aggregation language of the corresponding reinsurance contracts. Fact patterns, definitions, and full contract wordings need to be reviewed carefully.

- Follow the settlements/follow the fortunes obligations will need to be considered.
- Claims control clauses, which may allow reinsurers to deny claims following insurers’ loss settlements which they (reinsurers) have not controlled. This may even be the case where compliance with the clause is not strictly described as a condition precedent and where the reinsured can show that they were actually liable to pay the



claim in question. Reinsureds must proceed with caution where such clauses are present. Where there is a captive or fronting arrangement, similar issues may arise as to the extent of the captive/front's role in claim investigation and negotiation.

- Cover not being “back to back”, and involving the law of different jurisdictions, so that important terms may be defined differently in the direct or master insurance policy, as against the reinsurance policy (e.g. aggregation terms, definition of “flood”, “storm” etc). Other such issues might include, for example, the reinsurance excluding flood when the original policy does not do so, or the period of cover differing. Issues may therefore arise as to how many “losses” or “loss occurrences” can be aggregated and significantly how many insurance and reinsurance deductibles may apply.
- Payments on account and how these should be managed, particularly where there is a reinsurance programme with multiple layers and potentially non-aligned interests.
- The exclusion by some leading property reinsurers of CBI, because it is difficult to underwrite on an informed basis and the risk is too difficult to price.
- Reinsurers may wish to consider judicious use of inspection of records clauses, in view of potential issues concerning the limited amount of claims information/documentation

available, particularly in the early stages of the adjustment process.

Key questions

Certain broader issues are likely to arise across the spectrum of policy types. These include:

- How are deductibles and co-insurance warranties in original policies to be applied?
- Under what law are the relevant policy obligations to be construed and in which forum are disputes to be decided? There may be significant differences in coverage positions depending upon the answers to these questions.
- To what extent will there be waiver of claims documentation to support claims. This may be encouraged by broker and US political pressure to get losses compensated as soon as possible, but may cause issues in the context of recoveries from reinsurers. Similarly, to what extent will any ex-gratia settlements be recoverable from reinsurers?
- In light of AIRMIC guidelines, are reservations of rights off limits, or a necessary protection whilst information is scarce - even if only as an interim protection? Will potential differences in practice between US and UK regarding the use of reservation of rights language cause friction?
- Will Lloyd's step in and “urge” the London market to deal with claims in a particular Lloyd's way?

- Will there be co-operation between Lloyd's and London companies markets, and other international markets such as, for example, Bermuda, Japan and the Far East, so that cedants get a consistent message - or will each market work on its own, thereby risking mixed responses by an international group which has participations on several platforms?
- What lessons are to be learnt from the recent Queensland floods, Japan and New Zealand earthquakes, Thai floods and Japanese wind/weather events?

Our team

Our team includes specialist lawyers who have advised on and managed large and complex insurance and reinsurance claims including major PD, BI, liability, marine, logistics and aviation claims arising out of all of the recent major natural catastrophes globally, including for example Hurricanes Katrina, Rita & Wilma, Thailand and Queensland flooding. Our previous briefings on these events can be found here <http://www.hfw.com/publications/briefings>.

HFW will continue to follow the issues we have outlined in this briefing. For more information, please contact **Paul Wordley**, Partner on +44 (0)20 7264 8438 or paul.wordley@hfw.com, or your usual HFW contact.



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