

Business Interruption Coverage Disputes – An Update

(April 13, 2020)

As economic deterioration caused by the Coronavirus crisis accelerates, the issue of business interruption (BI) coverage has come to the forefront. Some impacted businesses are beginning to seek compensation from their BI insurance policies, while insurers have largely argued that coverage under the current conditions does not apply. ALIRT has received many questions from clients seeking guidance on how the resolution of this issue could potentially impact the financial standing of U.S. property & casualty insurers, many of which write property insurance coverages.

What is Business Interruption (or Business Income) Coverage?

BI is a type of insurance, generally added as a policy provision to property insurance or business owner's policy (BOP), that reimburses a business for loss of income in the event of a forced closure. The coverage is generally triggered due to physical damage to a property by a covered peril (i.e. cause of loss). Traditionally, viral disease has been an excluded peril whether overtly (via a stated exclusion) or implicitly in that such an illness is not thought to create physical damage to a property.

BI can also be triggered under a civil authority order clause, which occurs when a government action restricts a business' ability to function. But again, this must be due to physical damage to the immediate environs of the business by a covered cause of loss.

Rising Disputes

Insurer Response

Some American businesses, especially those tied to the entertainment and hospitality sectors, have reacted to forced closure of their businesses (whether de jure or de facto) by seeking compensation under BI provisions of their property or BOP policies. Insurers in most cases have denied coverage, pointing to one or more of three principal factors:

- Explicit exclusion of viruses as a covered peril (as spelled out in a standard ISO policy form),
- The fact that no physical damage occurred to the properties of the businesses in question,
- The civil authority clause does not apply given, again, that no physical damage occurred to the immediate environs of the business, resulting in that establishment's closure.

More to the point, management of Society Insurance Inc., an insurer being sued for denying coverage of BI claims, had this to say:

“Insurance has always identified and excluded coverage for loss events that are so large, or are so unpredictable, that they outstrip the capacity of the industry to fund losses, or even price the exposure accurately. Exclusions for acts of war, nuclear incidents and flood are part of insurance policies for these reasons. These are the same reasons that coverages for pandemic events are excluded. The insurance industry combined does not have enough assets to fund these losses and still be able to meet past and future obligations. Only government has the financial power to respond to these types of events.”

In short, insurers are arguing that they cannot be expected to offer coverage for losses that could bankrupt their industry.

Insurance industry trade groups have responded in kind, with the American Property & Casualty Insurance Association (APCIA) taking the lead. With estimated monthly small business losses of \$250 billion to \$431 billion per month against roughly \$6 billion per month in premium income for property insurers, APCIA CEO David Sampson has reiterated in numerous releases that *“Pandemic outbreaks are uninsured because they are uninsurable.”*

Business Community Response

As can be expected, some in both the business community have disagreed, arguing that the policy language does provide for coverage. They point to the following:

- A virus does constitute ‘physical damage’ with a recent lawsuit claiming that a virus stays on hard surfaces for an extended time period and damages a property by putting at risk anyone who comes into contact with it.
- The civil authority clause pertains for the same reason, i.e., that the virus is a physical presence causing physical damage to the immediate environs of many businesses.

And lawsuits have followed, with a high-profile case involving a group of celebrity chefs seeking to force insurers to cover the business income losses from the closure of restaurants. The lawyer representing the plaintiffs was featured in a CNN interview, which served to further heighten awareness of the issue. And even insurance policies that include coverage for pandemics may not respond if Covid-19 is not a ‘listed disease’ on the policy form – just another element to be litigated, with a recent lawsuit against Lloyd’s of London arguing that Covid-19 is a variation of the SARS virus which is a named peril.

The outcome of this and other cases going before judges will be important in setting a precedent for what may or may not be covered, with any decision very likely to move through appeals courts.

State Regulatory Response

To further complicate matters, as of today legislators in six states (Louisiana, Massachusetts, New Jersey, New York, Ohio, and Pennsylvania) are either drafting or have introduced legislation that would require insurers to cover BI claims. In a recent Town Hall Webinar by the Target Markets Program Administrators Association (TMPAA)¹, a panelist explained that these legislative actions come in three primary varieties:

- Forcing insurers to retroactively cover BI losses irrespective of what the policy language says (essentially overriding the contractual language of the policy),
- Requiring insurers to “help to promote coverage” by expanding the definition of property damage to include virus-related events (a broadening of policy language interpretation),
- Requiring insurers to pay all BI claims but allowing them to seek reimbursement from state funds, possibly raised via assessments on other insurers operating in the state. In essence, insurers would be used to adjudicate and pay claims but would not ultimately assume the loss themselves. This is currently the case in each of the aforementioned states except in Louisiana.

All the above proposed regulation is targeted at BI policies owned by small businesses (i.e., those with under 100 or 150 employees), with the exception again of Louisiana which has no size restriction.

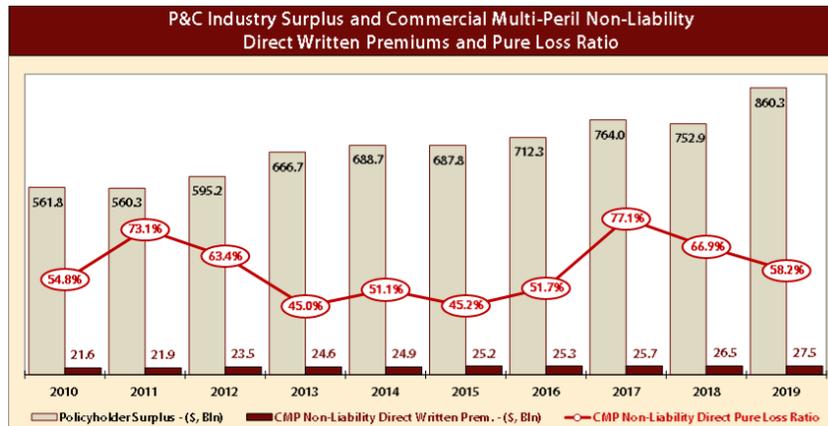
We note that as of April 10, 2020, no state has yet passed any of the proposed legislation.

¹ For an excellent discussion on the legal aspects of this BI dispute, please visit the TMPAA webinar which is found at <https://www.targetmkt.com/events/item/2793-program-administrator-town-hall-webinar> beginning around the 30 minute mark.

Potential Credit Impact on P&C Insurers

There could be a significant impact on the financial health of commercial P&C insurers – including potential insolvencies – if they were made, retroactively, to pay BI claims that they did not price or underwrite to cover.

At 12/31/2019, the U.S. property & casualty industry held approximately \$860 billion of surplus, which exists to help offset operating losses, liability shortfalls or investment losses across all lines of P&C business. While BI premiums are not differentiated separately in insurers' statutory financial statements, the chart below shows total premiums for the property portion of commercial multi-peril (CMP), where most BI coverage resides².



Approximately one half of total industry premium is in personal lines (home and auto) business, so using very rough math, only half of the \$860 billion is theoretically intended to cover all commercial lines risks, of which CMP/BI is only a relatively small part. If estimates of multi-\$100 billion monthly BI losses for small businesses are accurate, the industry's capitalization could quickly buckle under the demands of this unexpected coverage.

Even if states are willing to reimburse insurers for these losses, the financial burden on commercial lines insurers could be significant. This is for several reasons:

- It is yet unclear what the state funding mechanisms for such repayments would be (general taxation of state residents, premium assessments, federal aid, etc.), how quickly they could be put in place and administered, and the ultimate reimbursements allowed (full, partial, etc.).
- If there is a significant lag time between the payment of claims and state reimbursements, insurers could experience significant liquidity/cash flow problems.
- If state vehicles were to be funded with premium assessments, this could weigh on the earnings of all P&C companies should they be unable – or not allowed – to pass on the full impact of these premium levies to insureds.
- Even assuming full reimbursement for claims, insurers would face increased operating expenses as administering and paying BI claims could prove a significant drain on internal resources.

Lastly, we point out that even if insurers are successful in defending against lawsuits seeking BI coverage, their legal costs will likely rise, putting pressure on underwriting profitability.

Conclusion

Federal and state governments are currently struggling with ways to help build a “liquidity bridge” for small businesses that have been significantly impacted by efforts to combat the Coronavirus pandemic, including wide-spread closures which have resulted in significant lost income. While coverage for lost business income is often included in traditional property insurance policies, most insurers have long excluded infectious disease epidemics as a covered cause of loss. Businesses – and a small number of state legislatures – are now seeking to challenge (or simply override) that policy language and force coverage of BI claims.

² Standalone property coverages, which can include BI provisions, can also be reported in statutory statements under Fire and Allied Lines.

The issue will surely be litigated, as evidenced by a number of lawsuits already filed against insurers. As with most policy disputes, the outcome will depend on the interpretation of policy wording and appeals are likely. In addition to lawsuits, insurers are also contending with a small group of states seeking to mandate BI coverage for small businesses via legislation, though most would allow reimbursement from as yet undetermined state funding mechanisms.

Whatever the outcome, insurers have argued that pandemics were never intended to be a covered cause of loss, for BI purposes, in property policies, unless explicitly included. In their view, the private insurance industry cannot be expected to protect against perils that produce massive, solvency-threatening losses. For this reason, coverage for losses arising from war, terrorism, flood, and pandemics are for the most part specifically excluded and instead depend – or should depend – on government-backed programs.

Compelling insurers to pay for BI claims tied to the current pandemic – whether through a liberal interpretation of policy language or via legislative fiat – could prove extremely detrimental to the U.S. property & casualty industry, including possible insurer insolvencies. That said, the degree of financial damage would be partially offset by any state reimbursement programs depending on how they were structured and how quickly disbursements were made.

It is hoped that the federal government's fiscal and monetary response to the economic crisis attendant upon the pandemic outbreak in this country – including the CARES Act (which includes \$350 billion in forgivable loans to small businesses) as well as the Small Business Administration's Economic Injury Disaster Loan program (which offers \$10K in grants) – will offset some of the pressure on small businesses to pursue BI lawsuits. It is too early to tell if this is indeed the case as all these state and federal responses are occurring concurrently.

ALIRT will continue to monitor developments on this issue.

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