Potential Insurance and Reinsurance Implications of Hurricane Sandy

January 30, 2013

Hurricane Sandy wreaked havoc on the East Coast of the United States. When it struck land, Sandy was approximately 950 miles wide.[1] The "Superstorm" is the second costliest storm in U.S. history.[2] It has been characterized as the costliest single event of 2012, causing approximately $65 billion in economic damage across the United States, the Caribbean, the Bahamas and Canada.[3] Sandy caused an estimated $28.2 billion in insured losses, combining private insurers and government-sponsored programs.[4] More than 642,000 homes and businesses were damaged in New York and New Jersey alone.[5] New York City Mayor Michael Bloomberg reported that Sandy caused upwards of $19 billion worth of damage to the nation's most populous city.[6] The storm damaged or destroyed 305,000 housing units and disrupted more than 265,000 businesses in New York.[7] Approximately $500 million in insurance claims related to Hurricane Sandy have been filed to date in New Jersey.[8] The New Jersey Department of Banking and Insurance reports that there have been approximately 36,000 commercial property damage claims made, with approximately $255.6 million in losses paid.[9] Business interruption claims in New Jersey, thus far, have totaled approximately 12,000 with $53.4

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1 Zack Schmiesing, *Sandy By the Numbers; Insurance Implications; Another Storm?*, Towers Watson CAT Convergence Zone (Nov. 5, 2012), http://blogs.towerswatson.com/cat/2012/11/05/sandy-by-the-numbers-insurance-implications-another-storm.

2 Aon Benfield, *Annual Global Climate and Catastrophe Report, Impact Forecasting – 2012,* at 24 (2013), *available at* http://thoughtleadership.aonbenfield.com/Documents/20130124_if_annual_global_climate_catastrophe_report.pdf.

3 *Id.* at 3.

4 *Id.*

5 *Id.* at 32.

6 David Seifman, *Mayor Bloomberg Estimates Hurricane Sandy Inflicted $19B in Damage to City*, N.Y. Post (Nov. 26, 2012), http://www.nypost.com/p/news/local/mayor_bloomberg_estimates_hurricane_ZIC9N5krKWv3jHWFPwo5OK

7 At A Glance: 3 Months Later, Sandy Losses Mount, Associated Press (Jan. 29, 2013), *available at* http://news.yahoo.com/glance-3-months-later-sandy-losses-mount-074624901.html.

8 Ed Besson, *Hurricane Sandy To Spawn Storm Of Insurance Lawsuits*, New Jersey Star Ledger (Jan. 20, 2013), *available at* http://www.nj.com/business/index.ssf/2013/01/hurricane_sandy_to_spawn_storm.html.

9 Nicquel Terry, *Year-round Businesses Struggle To Survive After Sandy*, Asbury Park Press (Jan. 24, 2013), *available at* http://www.usatoday.com/story/money/business/2013/01/24/superstorm-sandy-businesses-suffer/1861477/.

million paid.[10] As of January 22, 2013, insurers had reported a total of approximately $18.7 billion in reported losses from Hurricane Sandy.[11]

As families and businesses continue the rebuilding process, many of them have, and will continue to look to their insurers for funds to help rebuild and cover losses. Although courts grappled with many of these issues following the September 11 terrorist attack and recent natural catastrophes such as Hurricane Katrina, the body of law concerning these issues is limited because property claims are not frequently litigated and are often resolved through the appraisal process. Insurers, who have already faced pressure from federal, state and local government to quickly pay out claims, will be forced to confront difficult issues regarding the scope of their coverage for these losses.[12] Just three months after the storm, several lawsuits concerning insurance coverage related to Hurricane Sandy have already been filed.[13] This memorandum briefly addresses the types of insurance likely to impacted by claims arising out of the storm; potential insurance coverage issues that may be raised by those claims; and reinsurance issues that are likely to arise as a result. In light of the limited case law dealing with these issues, this memorandum references cases from courts throughout the country.

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10 *Id.*

11 Artemis, *PCS Ups Sandy Industry Loss Estimate To $18.75 Billion, Close To Current Reported Losses*, *available at* http://www.artemis.bm/blog/2013/01/22/pcs-ups-sandy-industry-loss-estimate-to-18-75-billion-close-to-current-reported-losses/. By way of example, Travelers has reported approximately $1 billion in reported losses; Swiss Re has reported approximately $900 million in reported losses; State Farm has reported approximately $644 million in reported losses, Allianz has reported approximately $590 million in reported losses; and Allstate has reported approximately $1.075 billion in reported losses from Hurricane Sandy. *Id.*

12 On January 28, 2013, the New Jersey Assembly approved a bill aimed at reducing confusion for homeowners' policyholders who suffered losses as a result of Sandy. The bill requires insurers to provide a one-page summary of the "notable coverages and exclusions" under the policy in "simple, clear, understandable and easily readable" terms. Joshua Alston, NJ Assembly Approves Post-Sandy Insurance Policy Bill, Law360 (Jan. 28, 2013). Some have warned that if the bill passes in the New Jersey State Senate, the one-page summary requirement may create additional issues of policy interpretation in litigation. *Id.*

13 *See, e.g.*, *Nat'l Interstate Ins. Co. of Hawaii, Inc. v. Int'l Motor Freight, Inc.*, Case No. 12-cv-07101, D.N.J., filed Nov. 15, 2012 (declaratory relief action concerning coverage for damage to automobiles under a commercial insurance policy); *Donnelly v. N.J. Re-Ins. Co.*, Case No. 2:12-cv-07629, D.N.J., filed Dec. 13, 2012 (putative class action related to damage arising out of Hurricanes Irene and Sandy and coverage under FEMA's "Write Your Own" program and the Standard Flood Insurance Policy); *New Sea Crest Healthcare Ctr., LLC v. Lexington Ins. Co.*, Case No. 12-cv-6414, E.D.N.Y., filed Dec. 28, 2012 (asserting bad faith claims against insurer that insured two nursing homes in Brooklyn, NY); *Cardolite Corp. v. Willis of New Jersey, Inc.*, Case No. ESXL00896212, N.J. Sup. Ct., filed Dec. 7, 2012 (malpractice action against insurance broker alleging failure to offer flood insurance to insured).

TYPES OF INSURANCE LIKELY TO BE IMPLICATED BY THE DAMAGE CAUSED BY HURRICANE SANDY

A. Property Policies

The most likely to be impacted source of potential insurance coverage for Hurricane Sandy is first-party property insurance, which provides coverage for damage to the policyholder's own property. Both commercial lines property policies and personal lines homeowners' policies are potentially implicated. First-party insurance coverage will typically cover physical damage to a policyholder's home or business.

B. Business Interruption Coverage

In addition to providing coverage for physical damage to property itself, most commercial property policies also provide "Business Interruption" coverage, which is intended to reimburse the policyholder for lost income when its business is interrupted by loss of property due to an insured peril. Business interruption insurance is designed to do for the insured what the business itself would have done had no interruption occurred.[14] Therefore, it is "intended to return the insured's business the amount of profit it would have earned had there been no interruption of the business."[15] A policyholder might look to its insurance policy's business interruption coverage if its business was forced to close for some period of time because of Hurricane Sandy.

C. Contingent Business Interruption Coverage

If a business' suppliers or customers suffer loss or damage of the type insured by its property insurance policy, a business may look to its insurer for "contingent business interruption" coverage. These provisions generally provide coverage for loss of earnings at the insured's premises as a result of a supplier's or customer's inability to deliver or receive goods or supplies due to damage to its property. For example, many New York City restaurants were unable to receive their normal food deliveries from suppliers on the east coast who suffered damage from the storm. These restaurants, as a result, could not normally operate their businesses and experienced lost profits. They may consider pursuing claims for contingent business interruption coverage.

D. Extra Expense and Contingent Extra Expense Insurance Coverage

A policy's business interruption provision may also provide coverage for "extra expenses." Extra expense insurance indemnifies the insured for costs in excess of normal operating expenses that the business incurs in order to continue operations while its damaged property is repaired or replaced. Many downtown New York businesses were forced to close as a result of Hurricane Sandy, and had to rent temporary office space to continue to operate. Extra expense coverage may provide reimbursement for the expense of renting temporary office space.

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14 *Dictiomatic, Inc. v. U.S. Fid. & Guar. Co.*, 958 F. Supp. 594, 603 (S.D. Fla. 1997).

15 *Id.*

E. Civil Authority Coverage

When a governmental entity issues an order restricting access to a policyholder's property, the order may trigger a policy's "civil authority" coverage. During Hurricane Sandy, for example, Mayor Michael Bloomberg ordered evacuations of all people who lived or worked in certain "Zone 1" areas likely to flood in the storm. Airport and mass transit closures, beach and waterway closures and curfews are also types of civil authority orders that could lead to insurance claims.

F. Ingress/Egress Coverage

In addition to orders of civil authority that restrict access to property, physical damage as a result of Hurricane Sandy may also limit the ability of customers or employees to physically enter or exit a policyholder's property, resulting in a business loss for a business. Ingress/egress clauses may provide coverage where property damage in the area surrounding the policyholder's property restricts access to or egress from the policyholder's premises.

G. Event Cancellation Coverage

Event cancellation policies are designed to compensate policyholders for losses arising out of the cancellation, interruption, or postponement of specified events. These policies typically specify that coverage is triggered if the cancellation, interruption, or postponement is caused by factors that are beyond the policyholder's control. They typically insure a wide range of events, including concerts, sporting events, conventions, conferences, exhibitions, and trade shows.

H. General Liability Coverage

General liability insurance coverage may also be implicated, particularly if a policyholder's negligence is alleged to have caused damage or injury to another person or property. An example of such a circumstance might be if a policyholder's tree fell on his neighbor's home, and the neighbor claims the policyholder was aware the tree was diseased and was negligent in not cutting it down in advance of the storm. The policyholder in that circumstance might look to a general liability insurer for coverage.

COVERAGE ISSUES TO CONSIDER WHEN EVALUATING CLAIMS MADE FOR COVERAGE AFTER HURRICANE SANDY

While there are several ways a policy's coverage may be implicated by Hurricane Sandy's effects, there are also important considerations an insurer must evaluate in making a coverage determination for any policyholder's claim.

A. General Defenses

i. Insured Risks

An insurer must first determine whether the relevant policy is triggered by a policyholder's claim in the first instance. In other words, an insurer must consider whether the policyholder's

loss was caused by a peril against which the policyholder procured insurance. Many property insurance policies are sold on an "all risk" basis, meaning that they cover losses to real property caused by any peril not expressly excluded. There are, however, "named peril" policies, which cover only those perils expressly listed in the policy. It is important for an insurer, therefore, at the outset, to determine whether the policyholder's policy provided coverage for the peril that allegedly caused the damage for which the policyholder seeks coverage.

ii. Direct Physical Damage

Most property insurance policies also require direct physical damage for coverage to apply. Many businesses were closed as a result of Hurricane Sandy without incurring direct physical damage. Many courts have held that a policyholder cannot recover unless it has suffered direct physical damage.[16] *See infra* Section B.1.

iii. Policy Exclusions

An insurer facing a claim for losses resulting from Hurricane Sandy must examine precisely which peril(s) actually caused the property damage to determine whether the policy provides coverage for the policyholder's loss. This may be particularly challenging given that damages resulting from Hurricane Sandy may have been caused by many different perils, including wind, rain, storm surge, flooding, mold, power outages, or looting/vandalism. As temperatures in the Northeast get warmer, mold may present additional problems for policyholders, as many policies exclude coverage for mold or contain high mold deductibles.[17]

Many policies exclude coverage for certain perils. Common exclusions include loss resulting from "acts of God," flood, wind, mold, falling trees, electrical outages, or sewer backups. A careful analysis of the precise cause of the damage to a policyholder's property and the policy's exclusions will be necessary to determine whether the policyholder is entitled to coverage.

iv. Causation

Causation is likely to be a significant issue with regard to claims arising out of Hurricane Sandy. The law on proximate causation and the enforceability of anti-concurrent causation exclusions continues to develop in response to recent disasters and varies across jurisdictions.

Under the common law "efficient proximate causation" doctrine, a loss caused by two or more causes is not excluded if the covered cause was the "dominant and efficient cause" of the loss. *Leonard v. Nationwide Mut. Ins. Co.*, 499 F.3d 419, 431 (5th Cir. 2007).[18] Accordingly, under the

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16 *See* Barry R. Ostrager & Thomas R. Newman, Handbook on Insurance Coverage Disputes § 21.02 (16th ed. 2012).

17 Pete Brush, Post-Sandy Mold Caseload Set For Spring Growth Spurt In NY, Law360 (Jan. 29, 2013), *available at* http://www.law360.com/articles/411043/post-sandy-mold-caseload-set-for-spring-growth-spurt-in-ny.

18 *See also Parks Real Estate Purchasing Grp. v. St. Paul Fire & Marine Ins. Co.*, 472 F.3d 33, 48 (2d Cir. 2006) ("In a case where a covered and excluded peril combine to cause a covered loss, courts typically apply the efficient proximate cause rule—meaning, that the insured is entitled to

efficient proximate causation doctrine, if wind (a covered peril) and flood (an excluded peril) combined to create a loss, and a court found that the wind was the dominant or efficient cause of the loss, there would be coverage under the policy.[19]

Recently, however, many insurance policies contain "anti-concurrent causation" clauses, designed to limit the insurer's liability when an otherwise covered risk combines with an excluded peril to create a loss.[20] When an anti-concurrent causation clause is enforced, an insurer may be able to avoid liability for both the covered and the excluded perils depending on how a court interprets the exclusionary language. These clauses may become particularly relevant in the aftermath of Hurricane Sandy because there were several instances in which losses were caused by more than one peril. For example, in Breezy Point, Queens, flooding led to fires, and homes were destroyed as a result.

Especially in the wake of Hurricanes Katrina and Rita, courts have been asked to determine whether the policy's language supersedes the common law doctrine of efficient proximate cause. The majority response has been that insurance companies may use anti-concurrent causation clauses to contract around the common law rule of efficient proximate cause. For example, in *Leonard v. Nationwide Mutual Insurance Co.*, the Fifth Circuit concluded that the anti-concurrent causation clause in the policy prohibited recovery when covered and excluded perils each contributed to the policyholder's loss. 499 F.3d at 430. The anti-concurrent causation clause at issue provided:

> [w]e do not cover loss to any property resulting directly or indirectly from any of the following. Such a loss is excluded even if another peril or event contributed concurrently or in any sequence to the loss. . . . Water or damage caused by water-borne material . . . flood, surface water, waves, tidal waves, overflow of a body of water, spray from these, whether or not driven by wind.

Id.

The policyholder in *Leonard* suffered losses caused by both wind and water. The trial court found that the anti-concurrent causation clause in the policy was ambiguous, and interpreted it to exclude coverage for damage caused by water (the excluded peril) but to allow for recovery for damage caused by wind (the covered peril). *Id.* The trial court awarded a small sum to the policyholder for the wind damage to the property, but excluded coverage for the water damage. On appeal, the Fifth Circuit held that the anti-concurrent causation clause was unambiguous and that there was "no interpretive leeway to conclude that recovery can be obtained for wind damage that occurred concurrently or in sequence with the excluded water damage." *Id.*

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coverage only if the covered peril is the predominant cause of the loss or damage.") (internal quotation omitted); *Ginsberg v. New York Pro. Ins. Co.*, 210 A.D.2d 130, 130-31 (N.Y. App. Div. 1994) (concluding the trial court properly charged jury that it must determine whether wind or flood "was the proximate, direct, dominant and efficient cause of the loss").

19 *See* Ostrager & Newman, § 21.02.

20 *Id.*

In the wake of Hurricane Sandy, the Consumer Federation of America has called on New York Governor Cuomo, New Jersey Governor Christie, New York City Mayor Michael Bloomberg and various departments of insurance to block the application of the anti-concurrent causation clauses to victims of the storm. The application of these clauses to Hurricane Sandy victims remains to be seen. In addition, any such action taken by the various politicians may lead to challenges in court on interference with contract grounds.

v. Ensuing Loss Clauses

Ensuing loss clauses act as exceptions to exclusions in the policy, and may provide coverage when a covered peril arises and causes damage as a result of an excluded peril. Ensuing loss clauses reaffirm "that what is not excluded is covered," and they "establish[] that chronologically later-in-time damages 'caused' by a 'peril not otherwise excluded' remain covered." *TMW Enters., Inc. v. Fed. Ins. Co.*, 619 F.3d 574, 577-79 (6th Cir. 2010). For an ensuing loss clause to apply, there must be a "subsequent ensuing cause of loss *separate and independent* from the initial excluded cause of loss." *Weeks v. Co-Operative Ins. Co.*, 817 A.2d 292, 296 (N.H. 2003) (emphasis added); *see also Rapid Park Indus. v. Great N. Ins. Co.*, No. 09 Civ. 8292, at *4 (S.D.N.Y. Oct. 15, 2010).[21] Ensuing loss clauses may be implicated by Hurricane Sandy, particularly in circumstances like those that occurred in Breezy Point, Queens. Ultimately, many homes in Breezy Point were destroyed because of a large fire. Fire is often covered by a property policy. But because the initial peril that impacted these homes was flood, and flood is often excluded by property policies, ensuing loss clauses may be implicated and become the source of conflict between policyholders and insurers.

vi. Sub-Limits and Deductibles

Most policies contain varying sub-limits and self-insured retentions varying depending on the cause of the loss. Therefore, for example, a policy's $25 million aggregate limit may not be available for all of the losses that have occurred if the policy offers, for example, only $2 million in coverage for flood and/or wind-related claims. In policies containing "Hurricane" coverage, it is important to note that Sandy was at sub-hurricane strength when it reached shore, so that lower sub-limits and/or higher deductibles may not apply.[22]

Many policies that provide hurricane coverage contain hurricane deductibles, which can be very expensive for a policyholder. Often, a hurricane deductible can be between two percent

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21 *See also* Ostrager & Newman, § 21.04.

22 On October 31, 2012, New York's Governor Cuomo announced that "homeowners should not have to pay hurricane deductibles for damage caused by the storm and insurers should understand the Department of Financial Services will be monitoring how claims are handled." *See* October 31, 2012 Press Release, *available at* http://www.governor.ny.gov/press/10312012Hurricane-Deductibles. Similarly, on November 2, 2012, New Jersey Governor Christie issued an Executive Order prohibiting insurers from applying hurricane deductibles to the payment of claims for property damage attributable to Hurricane Sandy. *See* Executive Order No. 107, *available at* http://nj.gov/infobank/circular/eocc107.pdf. Other states' governors have since followed suit.

and five percent of a home's value. Here, the applicability of hurricane deductibles to Sandy-related claims may be moot now that officials in eight states (New York, New Jersey, Connecticut, Maryland, Delaware, Pennsylvania, Rhode Island and Maine) and the District of Columbia have issued decrees prohibiting insurers from enforcing hurricane deductibles in the case of Hurricane Sandy, because the storm did not meet hurricane criteria at the time it made landfall.

vii. Multiple Occurrences vs. Single Occurrences

Insurance policies typically provide for a deductible for each "occurrence" that results in a loss, and often contain per occurrence limits that may be below the total aggregate limit of the policy. Because Sandy resulted in damage to such a broad geographic area, businesses may have experienced losses at more than one facility in different locations. In this case, an insurer may confront the question of whether the policyholder's losses resulting from Sandy are considered one occurrence (*i.e.*, one storm) or multiple occurrences (*i.e.*, multiple locations separately damaged, or damaged by multiple storms, or caused by different perils) depending on the specific facts involved.

While Hurricane Katrina was generally viewed to have been a single "occurrence" for insurance purposes, *Seacor Holdings Inc. v. Commonwealth Ins. Co.*, Civ. Action No. 06-4685, 2009 WL 901477, at *1 n.1 (E.D. La. Mar. 26, 2009), the large geographic area impacted by Hurricane Sandy may present new arguments for coverage where policyholders claim the storm was more than one occurrence under their policies. Indeed, policyholders may argue that Sandy merged with another weather system to suggest that the Storm was more than one occurrence.[23]

B. Business Interruption and Contingent Business Interruption Coverage Defenses

Given the significant damage that Hurricane Sandy caused, and that many businesses have been closed, it will be important to ascertain the precise reason for any storm-related closure when determining a policyholder's entitlement to business interruption coverage. Although many businesses were closed due to physical damage to their property, others were closed for other reasons (such as orders of evacuation) for which a policyholder may not have secured coverage.

As an initial matter, an insurer must consider whether its policyholder's claimed loss triggers the policy. Generally, business interruption coverage will only be triggered if there was actual "direct" physical damage to or loss of use of insured property.[24] If the policyholder has not suffered a physical loss to insured property or if the policyholder's claimed physical loss is not covered by the policy in the first instance, then there can be no business interruption coverage under the policy. *See Parks Real Estate Purchasing Group v. St. Paul Fire & Marine Ins. Co.*, 472 F.3d 33, 48 (2d Cir. 2006) ("In order to obtain coverage under a first-party [insurance] policy, the insured must suffer a loss caused by a covered peril . . . or suffer a loss not caused by an excluded peril"); *see also Pentair, Inc. v. Am. Guar. & Liab. Ins. Co.*, 400 F.3d 613 (8th Cir. 2005)

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23 At A Glance: 3 Months Later, Sandy Losses Mount, Associated Press (Jan. 29, 2013), *available at* http://news.yahoo.com/glance-3-months-later-sandy-losses-mount-074624901.html.

24 *See generally*, Ostrager & Newman, § 21.02.

(loss of power in factories resulting in failure to manufacture products does not constitute a "direct physical loss" and is not covered).

i. No Coverage Without Physical Damage To Property

The overwhelming majority of courts throughout United States have required direct physical loss to insured property before allowing business interruption recovery. For example, in *Source Food Technology, Inc. v. United States Fidelity & Guaranty Co.*, 465 F.3d 834 (8th Cir. 2006), the insured argued that a loss arising from an embargo on meat due to potential (but not actual) contamination was covered under a business interruption policy because it resulted in a direct physical loss of property. *Id.* at 836-37. The Eighth Circuit rejected the insured's argument and distinguished cases where food products were actually damaged. The court concluded that the insured's inability to transport and sell its meat was not a "direct physical loss." *Id.* at 838.[25] Courts have required the same direct physical loss with respect to contingent business interruption provisions. A disruption to a supplier's ability to operate that is not caused by physical damage to the supplier's property will likely not fall within the scope of contingent business interruption coverage.[26]

ii. No Coverage Unless There Is A Complete Cessation Of Business

It is also important to recognize that courts have interpreted "suspension" of operations for purposes of evaluating business interruption coverage claims to mean "a temporary, but complete, cessation of activity." *Buxbaum v. Aetna Life & Cas. Co.*, 103 Cal. App. 4th 434, 444 (2d Dist. 2002). If there is no such complete cessation of activity, a policyholder may not be entitled to coverage. *Commstop v. Travelers Indem. Co. of Conn.*, 2012 WL 1883461, at *12-13 (W.D. La. May 17, 2012) (denying insured's motion for summary judgment because it did not demonstrate

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25 *See also Ramogreen, Inc. v. Travelers Indem. Co. of Am.*, 835 F.2d 812 (11th Cir. 1988) (where fire destroyed one building in a complex, there was no coverage for the reduction in income of surrounding buildings that were not physically damaged or did not suspend operations).

26 In *Pentair, Inc. v. American Guarantee & Liability Insurance Company*, 400 F.3d 613 (8th Cir. 2005) an earthquake struck Taiwan, disabling two electric power substations. Those substations provided power to two factories that manufactured products for a subsidiary of Pentair, Inc. *Id*. at 614. However, because the contingent business interruption provision extended coverage to losses incurred by Pentair as a result of "damage" to "property of a supplier of goods and/or services to the Insured," and the only damage that occurred was to the electric power substations (which did not supply power to Pentair itself), Pentair was not entitled to coverage under this provision. *Id.* at 614-15. At least one court, however, has broadly interpreted what constitutes a supplier of goods or services. In *Archer-Daniels-Midland Company v. Phoenix Assurance Company of New York*, 936 F. Supp. 534 (S.D. Ill. 1996), the court found that the U.S. Army Corps of Engineers, the U.S. Coast Guard, and a generic group of Midwest farmers all fell within the purview of "suppliers of goods and services" to the insured, a farm products processor, under the insured's contingent business interruption coverage. The insured sought coverage after the Mississippi River and its tributaries experienced unprecedented flooding in 1993. *Id.* at 536. Even though the farmers were "indirect suppliers," the court still found "they are suppliers nonetheless." *Id.* at 544. The court found the Corps of Engineers and Coast Guard were also suppliers because of their roles as service providers in constructing improvements to the Mississippi River that facilitate transportation. *Id.* at 541.

a complete cessation of business).[27]

iii. The "Period of Restoration"

Determining the appropriate "period of restoration" will be a critical factor in evaluating business interruption claims. The period of restoration has been defined as "the time of the direct physical damage to the time when, with due diligence and dispatch, the damage could be repaired or replaced and made ready for operations under the same or equivalent operating conditions that existed prior to such damage." *Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co.*, 411 F.3d 384, 387 (2d Cir. 2005). Simply put, the "period of interruption" or "period of restoration" is the reasonable amount of time it takes to get a business' operations back to normal following physical damage to property or equipment. Identifying the appropriate termination date is particularly challenging because it does not involve looking at when the insured did, in fact, repair, rebuild or replace its property, but rather looks to when the insured *could* have done so. *See S.R. Int'l Bus. Ins. Co., Ltd. v. World Trade Center Props., LLC*, No. 01 Civ. 9291 (MBM), 2005 WL 827074, at *6, *8 (S.D.N.Y. Feb. 15, 2005) (holding that the restoration period was a "theoretical one," even though the insured was rebuilding its property and explaining that the use of "should" in the definition of restoration period suggested a hypothetical period).[28] Some courts have "allowed a reasonable extension of that period where restoration delay was due to actions of the insurance company." *Hampton Foods, Inc. v. Aetna*, 787 F.2d 349, 355 (8th Cir. 1986).[29]

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27 *See also Am. States Ins. Co. v. Creative Walking, Inc.*, 16 F. Supp. 2d 1062, 1065-66 (E.D. Mo. 1998) ("necessary suspension" refers to "a total cessation of business activity" and "[i]f the insured is able to continue its business operations at a temporary facility, it has not suffered a 'necessary suspension' of its operations"); *Home Indem. Co. v. Hyplains Beef, L.C.*, 893 F. Supp. 987, 991-92 (D. Kan. 1995) ("The court's holding here, that a complete cessation of Hyplain's business was required to trigger coverage under the Business Interruption coverage provision, is consistent with the vast majority of cases from other jurisdictions").

28 *See also Beautytuft, Inc. v. Factory Ins. Ass'n*, 431 F.2d 1122, 1124 (6th Cir. 1970) (restoration period provision "provides a theoretical as opposed to an actual replacement time as the basic time standard for computation of business interruption loss"); *Midland Broadcasters, Inc. v. Ins. Co. of N. Am.*, 636 F. Supp. 165, 166 (D. Kan. 1986) (finding insured's "cut-off" date to recover for lost earning as a result of damage to its radio station's tower and antenna in a windstorm, was when the insured's business could have resumed operations); *Fireman's Fund Ins. Co. v. Mitchell-Peterson, Inc.*, 578 N.E.2d 851 (Ohio Ct. App. 1989) (upholding ruling that restoration end date, seven months after a fire, was unreasonable, rendering insured non-diligent in its efforts to restore its operations).

29 *See also United Land Investors, Inc. v. N. Ins. Co. of Am.*, 476 So. 2d 432, 438 (La. Ct. App. 1985) (holding that when delay in commencing repairs was partially caused by insurer, insurer could not insist that insured should have begun its repairs before it received the money it needed to complete the work); *Omaha Paper Stock Co. v. Harbor Ins. Co.*, 445 F. Supp. 179, 187-88 (D. Neb. 1978) (holding that insurer could not limit period of loss to theoretical time for replacement of damaged equipment when it was responsible for delay in resuming operations), *aff'd*, 596 F.2d 283 (8th Cir. 1979); *Eureka-Security Fire & Marine Ins. Co. v. Simon*, 401 P.2d 759, 763-64 (Ariz. Ct. App. 1965) (upholding ruling that delays caused by insured's negotiations with insurers and its landlord's repairs were reasonable delays that could extend period of coverage for business

The United States Court of Appeals for the Second Circuit, in *Duane Reade, Inc. v. St. Paul Fire & Marine Insurance Co.*, explained (with respect to September 11 claims) that courts have consistently construed restoration period clauses "as entitling the insured to continue to recover its lost profits until it can build a reasonably equivalent store in a reasonably equivalent location." 411 F.3d at 393. The court reasoned that otherwise, "insureds would lack any incentive to resume partial operations in temporary locations or under other inferior circumstances in order to mitigate damages if such actions would terminate their BI coverage." *Id.*

In *Duane Reade*, the parties disputed the length of the restoration period applicable to a drugstore that had operated in the retail concourse of the World Trade Center. Duane Reade argued that the restoration period consisted of "the *actual* time period that would, or will, be required to restore Duane Reade's operations to the kind, quality and level which existed at the WTC" prior to September 11 and that such period would be co-terminous with the time necessary to rebuild the World Trade Center complex's successor. *Duane Reade Inc. v. St. Paul Fire & Marine Ins. Co.*, 279 F. Supp. 2d 235, 238 (S.D.N.Y. 2003) (emphasis added). The insurer argued that the restoration period ended when Duane Reade could have restored operations at locations other than the World Trade Center. *Id.*

The Second Circuit rejected the notion that the restoration period should be tied to the rebuilding of the World Trade Center, stating "it would be entirely unreasonable to interpret the Restoration Period to include the time it would take for Duane Reade to resume operations in a store located at its former site where that site was neither the subject of the insurance policy nor expressly provided for in the calculus set forth in the Restoration Period." *Id.* at 396.[30]

The United States District Court for the Southern District of New York, in *Admiral Indemnity Company v. Bouley International Holding, LLC*, also addressed the appropriate length for a restoration period in a business interruption coverage dispute, but did so in the context of a business that was damaged, but not destroyed, in the September 11 attack. No. 02 Civ. 9696

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interruption loss). *But see Bard's Apparel Mfg., Inc. v. Bituminous Fire & Marine Ins. Co.*, 849 F.2d 245, 251 (6th Cir. 1988) (evaluating similar policy language and holding that the district court erred by allowing the jury to take the insured's financial condition into consideration when determining the restoration period).

[30] *See also Streamline Capital, L.L.C. v. Hartford Casualty Insurance Co.*, No. 02-cv-8123 (NRB), 2003 WL 22004888 at *8 (S.D.N.Y. Aug. 25, 2003) (rejecting notion that "insured premises" meant the World Trade Center site as a whole and concluding "[i]t is wholly unreasonable to think that the period of restoration should be tied to the rebuilding of real property over which neither the insured nor the insurer had any control, instead of tying it to a process that the plaintiff controlled: the acquisition of replacement office space and the installation of plaintiff's personal property in that space."); *Lava Trading, Inc. v. Hartford Fire Ins. Co.*, 365 F. Supp. 2d 434, 442 (S.D.N.Y. 2005) (agreeing with *Streamline* that the period of restoration is not tied to the rebuilding of the World Trade Center and that the phrase "property at the described premises" refers to property located in the insured's rented office suite). *But see Int'l Office Ctrs. Corp. v. Providence Washington Ins. Co.*, No. 3-04-CV-990 (JCH), 2005 WL 2258531 (D. Conn. Sept. 15, 2005) (interpreting policy's definitions of "operations" and "property at the described premises" to require payment for business income losses until insured had opportunity to resume operations at World Trade Center).

(HB), 2003 WL 22682273 (S.D.N.Y. Nov. 13, 2003). The case involved two restaurants—Bouley Bakery and Danube—that were "infiltrated by dust and debris" and had their food provisions contaminated as a result of the September 11 attack. *Id.* at *1. The restaurants were also closed for a period of time due to the shut-down of lower Manhattan. *Id.* For several weeks thereafter, chef David Bouley[31] used Bouley Bakery's facilities and employees to prepare meals for rescue workers at Ground Zero. *Id.* Danube reopened on September 28, 2001. *Id.*

In early October 2001, Bouley Consulting, Inc. ("Bouley Consulting")[32] entered into a contract with the American Red Cross to feed Ground Zero workers. *Id.* at *2. Bouley Bakery delayed its reopening, and when the Red Cross contract ended in January 2002, Bouley Consulting had earned almost $6 million from the contract. *Id.* Bouley Bakery ultimately reopened on February 9, 2002.

The policy in the *Bouley* case provided that Admiral Indemnity would "pay for the actual loss of Business Income you sustain due to the necessary 'suspension' of your 'operations' during the 'period of restoration,' which ends when the property "should be repaired, rebuilt or replaced with reasonable speed and similar quality." *Id.* at *1. The policy further stated that where an insured intends to continue its business operations after a loss, the insured "must resume all or part of [its] 'operations' as quickly as possible." *Id.* In interpreting this language, Admiral Indemnity argued that the period of restoration ended on September 28, 2001, the date Danube reopened. The court ruled in favor of the insurer:

> It is undisputed that although both restaurants suffered damage, this damage was not very extensive . . . . It is also undisputed that Danube, which is adjacent to and shares some facilities, including kitchen facilities, with Bouley Bakery, was reopened on September 28. As noted, defendants posit the end of the "period of restoration" as January 7, 2002 when the telephone reservation system, which was very important to the restaurants' operations, was restored. However, it appears that Mr. Bouley made a decision to keep Bouley Bakery closed on the belief that business would not support both restaurants . . . . Finally, the facilities at Bouley Bakery were operable given that they were used for the Red Cross contract.

Id. at *3.

Consequently, the court held that there was no genuine dispute "that the property was, or should have been, repaired by September 29, 2001, and accordingly this was the end of the 'period of restoration.'" *Id.*

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31 David Bouley also had an ownership interest in the companies organized for the operation of Bouley Bakery and Danube. 2003 WL 22682273 at *1.

32 David Bouley wholly owned Bouley Consulting and owned fifty-percent of Bouley International Holding, LLC, which wholly owned Bouley Bakery Operating, LLC, and Danube Operating, LLC. *Id.*

C. Civil Authority Coverage Defenses

The scope of civil authority coverage can vary based upon the language of the policy. Some civil authority provisions require the order of the government authority to have been issued as a direct result of damage to insured property, while others require the damage to be to adjacent property, and still others do not contain that requirement at all but are concerned instead that the order be a direct result of a *peril* insured against. In the post-Sandy arena, this distinction may be particularly important to the extent that orders of civil authority prohibited access beyond areas that actually sustained damage from the hurricane for safety reasons or to prevent looting. Additionally, some policyholders may seek civil authority coverage as a result of orders that affected (but did not actually prohibit) access to their property, for example, by prohibiting access to surrounding areas. Although there are a significant number of cases that require a complete denial of access in order for civil authority coverage to be implicated, there is some case law, particularly in the curfew context, that construes the denial of access requirement more liberally.

i. *No Coverage Unless Access Completely Denied*

Many courts have held that civil authority coverage does not apply unless access to the premises is completely denied. In *Abner, Herrman & Brock, Inc. v. Great Northern Insurance Co.*, the insured, a lower Manhattan investment advisory firm, sought coverage for September 11-related losses under the civil authority provision even though both pedestrian access and public transit were available, on the grounds that "traffic restrictions made it difficult for the plaintiff's employees to get to the premises as well as attend meetings around the downtown area, which was [plaintiff's] usual business practice." 308 F. Supp. 2d 331, 333 (S.D.N.Y. 2004). The civil authority provision of the policy covered "actual business income loss you incur due to the actual impairment of your operations; and extra expense you incur due to the actual or potential impairment of your operations, when a civil authority prohibits access to your premises or a dependent premises." *Id.* at 334. The court granted summary judgment to the insurer, holding that:

> In this case, the language of the insurance policy is unambiguous. The relevant part of the Civil Authority insurance provision states that Great Northern will pay for a loss "when a civil authority prohibits access to [the] premises." Because access was prohibited by civil authority from September 11, 2001, through September 14, 2001, the coverage applies only to these four days. The coverage does not extend through September 17, 2001, despite any confusion that [plaintiff's] employees may have had about access to the premises and despite and difficulties [plaintiff's] Chairman or his driver may have had in getting around the city. The record is clear that as of September 17, 2002, no civil authority prohibited access to [plaintiff's] premises.

Id. at 336 (citation omitted).[33]

Given the prevailing authority to date that an order of civil authority must deny—not just restrict—access to implicate civil authority coverage, a business that is more difficult to access because of roadblocks, an inoperable transit system or other similar limitations may not be entitled to benefits under civil authority coverage.

This case law may also apply to claims for stores that have been permitted to reopen in certain portions of the New Jersey Shore, Long Island and Staten Island, but which have suffered reduced business in light of the fact that many residents in those areas have not been permitted to return. Similarly, these cases my apply to claims made by Manhattan businesses that were closed during the week after the storm, or whose employees were unable to get to work because the transit system was shut down.

ii. *No Coverage Unless Access Denied To Covered Property*

As a general matter, access must be denied to the covered property itself for civil authority coverage to apply. For example, in *730 Bienville Partners, Ltd. v. Assurance Company of America*, where an insured hotel sought business interruption coverage for losses claimed to be attributable to the cancellation of flights that prevented guests from reaching the insured's hotels, a federal court in Louisiana refused to find coverage under the civil authority provision because the FAA did not prohibit access to the hotels themselves. No. Civ. A. 02-106, 2002 WL 31996014, at *2 (E.D. La. Sept. 30, 2002).[34]

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[33] *See also Kean, Miller, Hawthorne, D'Armond McGown & Jarman, LLP v. Nat'l Fire Ins. Co.*, 2007 WL 2489711 (M.D. La. 2007) (advisories and recommendations issued by the governor of Louisiana and other authorities "asking" and "encouraging" residents to stay off street immediately prior to Hurricane Katrina coming ashore did not "prohibit access" to the insured premises); *54th St. Ltd. Partners, L.P. v. Fid. & Guar. Ins. Co.*, 306 A.D.2d 67, 67 (N.Y. App. Div. 2003) (limiting insured's civil authority coverage for the period of time when access to the insured's premises was denied by order of civil authority; after that, although vehicle and pedestrian traffic was "diverted," the insured's employees and its vendors had access to the restaurant, and civil authority coverage did not apply); *Dixson Produce, LLC v. Nat'l Fire Ins. Co. of Hartford*, 99 P.3d 725, 726-27, 729 (Okla. Civ. App. 2004) (concluding that after tornado, when streets were closed but access was not prohibited to the insured's business, civil authority provision did not apply because "[t]he fact that insured business reopened and resumed operations alone establishes that access to the insured premises was not prohibited by either storm damage or civil authority"); *S. Hospitality, Inc. v. Zurich Am. Ins. Co.*, 393 F.3d 1137, 1141 (10th Cir. 2004) (holding that the civil authority provision did not apply because the FAA's order grounding flights after 9/11 did not itself "prevent, bar, or hinder access to [the insured's] hotels in a manner contemplated by the policies"); *St. Paul Mercury Ins. Co. v. Magnolia Lady, Inc.*, No. CIV. A. 297CV153BB, 1999 WL 33537191 (N.D. Miss. Nov. 4, 1999) (casino-hotel was not entitled to civil authority coverage despite closure of the Mississippi River bridge because there was no denial of access to the casino-hotel).

[34] *See also S. Hospitality Inc.*, 393 F.3d at 1141 (same); *Philadelphia Parking Auth. v. Fed. Ins. Co.*, No. 03 Civ. 6748 DAB, 2005 WL 78783, at *9 (S.D.N.Y. Jan. 14, 2005) (denying civil authority coverage

iii. *Curfews*

Hurricane Sandy led to the imposition of mandatory curfews in various towns in New Jersey and New York. Courts have been reluctant to find that curfews implicate civil authority coverage, particularly where the curfews were not a direct result of property damage on or near the insured's property. For example, in *Syufy Enterprises v. Home Insurance Company of Indiana*, where the policy required that the civil authority deny access as a "direct result" of damage or destruction to adjacent property, a federal court found that a dawn-to-dusk curfew (following the post-Rodney King verdict rioting and looting) did not implicate civil authority coverage because the damage occurred at least two blocks away from the insured's movie theater, and the civil authority did not specifically deny access to the theater. 94-0756 FMS, 1995 WL 129229, at *2 (N.D. Cal. Mar. 21, 1995).[35]

Some courts have declined to require physical damage for civil authority coverage to be implicated. For example, in *Sloan v. Phoenix of Hartford Insurance Company*, owners and operators of movie theaters in Detroit sought to recover losses as a result of an executive order imposing a curfew and closing places of amusement in response to "widespread riots." 207 N.W.2d 434, 435 (Mich. Ct. App. 1973). Although the theaters were not physically damaged, the court found 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 payable when, as a result of one of the perils insured against, access to the insured premises was prohibited by order of civil authority." *Id.* at 436-37.[36]

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because FAA ground stop order following the September 11 terrorist hijackings did not prohibit access to insured's garage).

[35] *See also Two Caesars Corp. v. Jefferson Ins. Co.*, 280 A.2d 305, 307 (D.C. Ct. App. 1971) (concluding insurer was not liable for restaurant's loss of income following curfew imposed after Martin Luther King, Jr.'s assassination because access was not prohibited to the restaurant because of damage to or destruction of the insured's property); *Adelman Laundry & Cleaners, Inc. v. Factory Ins. Ass'n*, 207 N.W.2d 646, 647 (Wis. 1973) (finding no coverage for civil authority claim arising from curfew where there was no damage to insured's property because the civil authority extension "is not an extension of coverage to delete the requirement of damage or destruction"); *Bros., Inc. v. Liberty Mut. Fire Ins. Co.*, 268 A.2d 611, 614 (D.C. Ct. App. 1970) (finding that civil authority provision did not apply to insured's loss because curfew and municipal regulations did not prohibit access to insured's premises because of destruction or damage to adjacent property).

[36] The civil authority provision in *Sloan* extended coverage to include "the period of time . . . when as a direct result of the peril(s) insured against, access to the premises described is prohibited by order of civil authority." 207 N.W.2d at 436. In that case, "one of the perils insured against was riot." *Id.* at 437. *See also Southlanes Bowl, Inc. v. Lumberman's Mut. Ins. Co.*, 208 N.W.2d 569, 570 (Mich. Ct. App. 1973) (finding that physical damage to insured's property was not prerequisite for civil authority coverage and insured was entitled to coverage for losses incurred when curfew was imposed after assassination of Martin Luther King, Jr.).

iv. *No Coverage When Order Of Civil Authority Is Preventative Rather Than A Direct Result Of Property Damage*

To the extent that cities and towns were evacuated pre-hurricane in anticipation of potential property damage, policyholders may not be entitled to civil authority coverage for that period of time. In *Assurance Company of America v. BBB Service Company, Inc.*, a Georgia appellate court refused to grant coverage in precisely that situation. In that case, the insured closed its restaurants in Brevard County, Florida, in preparation for Hurricane Floyd, and because of state of emergency and evacuation orders. 576 S.E.2d 38, 39 (Ga. Ct. App. 2002). The civil authority provision covered "actual loss of 'business income' . . . and necessary 'extra expense' caused by action of civil authority that prohibits access to your premises due to direct physical loss of or damage to property, other than at the 'covered premises,' caused by or resulting from any Covered Cause of Loss." *Id.* The court held that a state of emergency was not declared because property had been damaged, as the civil authority clause required, but because of the *threat* that property would be damaged. *Id.* at 40-41.[37]

Where, by contrast, a state of emergency was declared following property damage caused by Hurricane Sandy, a court may be more likely to find civil authority coverage applicable. In *Narricot Industries, Inc. v. Fireman's Fund Insurance Co.*, for example, the mayor of the town of Tarboro, North Carolina declared a state of emergency and suspended operations of all plants, including the insured's, following Hurricane Floyd. No. CIV. A. 01-4679, 2002 WL 31247972 (E.D. Pa. Sept. 30, 2002). The court held that the orders of civil authority stemmed directly from damage to property, such as the electrical lines, a waste water treatment plant, and a raw water pump station. *Id.* at *5. It also rejected the insurer's argument that the insured's losses were not covered because the civil authority's actions were preventative. *Id.*

D. Ingress/Egress Coverage Defenses

There is little case law that interprets ingress/egress coverage in the commercial first-party insurance context. The scant case law that exists resulted in differing outcomes, indicating that the availability of ingress/egress coverage may be highly dependent on the specific policy language at issue and the facts unique to a given claim.

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[37] *See also Cleland Simpson Co. v. Firemen's Ins. Co. of Newark, N.J.*, 140 A.2d 41, 43-44 (Pa. 1958) ("[b]y no process of logic can we read into the policy that the risk includes prohibition of access because of apprehension of either the possibility or probability of a fire which never occurred"). *But see U.S. Airways, Inc. v. Commonwealth Ins. Co.*, No. 03-587, 2004 WL 1637139 (Va. Cir. Ct. Jul. 23, 2004) (civil authority order issued as a direct result of damage to insured property was sufficient to implicate coverage); *U.S. Airways, Inc. v. Commonwealth Ins. Co.*, No. 03-587, 2004 WL 1094684 (Va. Cir. Ct. May 14, 2004) (finding order of civil authority alone, without property damage, triggered coverage). At least one decision by the United States District Court for the Southern District of New York suggests that preventative safety measures do not implicate civil authority coverage. *United Airlines, Inc. v. Ins. Co. of the State of Penn.*, No. 03 Civ. 5189 (RMB), 2005 WL 756883 at *9 (S.D.N.Y. Apr. 1, 2005) (denying coverage for claim under civil authority provision for losses resulting from closure of Reagan airport after September 11 because Reagan Airport was not adjacent to the Pentagon and that access to the airport was not barred as a direct result of damage to the Pentagon, but rather as a result of security measures).

Some courts have required direct physical property damage to the insured's own property in order to find ingress/egress coverage. For example, in *City of Chicago v. Factory Mutual Insurance Co.*, the City of Chicago, in seeking ingress/egress coverage for losses incurred following a purported airport closure order by the FAA following the September 11 terrorist attack, adopted the position that the prevention of ingress to and/or egress from its property resulted from physical damage at the Pentagon and/or the World Trade Center. No. 02 C 7023, 2004 WL 549447, *3 (N.D. Ill. Mar. 18, 2004). The court upheld the insurer's denial of coverage, finding that "although ingress to and egress from the airport were prevented by the FAA's order and were indirectly caused by terrorist-inflicted damage, this damage is one of the types of damage excluded by this policy in that it was indirect and remote damage." *Id.*[38]

In contrast, a federal court in North Carolina, in *Fountain Powerboat Industries, Inc. v. Reliance Insurance Company*, found that the insured's ingress/egress provision did not require damage to insured property, and thus loss sustained by the insured due to its inability to access its facility following a hurricane was covered under the provision. 119 F. Supp. 2d 552, 557 (E.D.N.C. 2000). The ingress/egress provision in *Fountain Powerboat* differed somewhat from the provision in *City of Chicago*, granting coverage for "loss sustained during the period of time when, as a direct result of a peril not excluded, ingress to or egress from real and personal property not excluded hereunder, is thereby prevented." *Id.* at 556.

E. Mitigation Expense Coverage

Policyholders may have a duty to mitigate damages in some instances, and some property policies contain an affirmative requirement that a policyholder do so. Typically, "[m]itigation cost is recoverable so long as it is reasonable and less than the damages would have been without it." *Metalmasters of Minneapolis, Inc. v. Liberty Mut. Ins. Co.*, 461 N.W.2d 496, 501 (Minn. 1990).

REINSURANCE ISSUES LIKELY TO BE IMPLICATED BY HURRICANE SANDY

Hurricane Sandy's impact on the insurance industry is likely to extend to the reinsurance market. Reinsurers facing claims from ceding companies are likely to face difficult questions regarding, among other potential issues, aggregation of claims and the impact of the "follow the fortunes" doctrine.

A. Aggregation Issues

The issue of number of occurrences is likely to be an issue for reinsurers as well. Whether Hurricane Sandy is considered to be one loss or more than one loss under reinsurance contracts

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[38] The court in *City of Chicago* concluded that the City of Chicago was not entitled to civil authority coverage because the ground stop order at issue was not issued as a direct result of property damage at or within 1000 feet of the described location, as required by the policy. 2004 WL 549447 at *4. Rather, the "ground stop order was ultimately imposed to protect against any further terrorist attacks like those that damaged and/or destroyed the World Trade Center and the Pentagon." *Id.*

is likely to depend on the "loss occurrence" language in excess of loss treaties, the interpretation of which may in turn depend on the governing law and jurisdiction of those treaties.

Many property treaties contain "hours" clauses which may impact the scope of coverage. An "hours clause treats all losses associated with a specific peril as one event or occurrence, provided that the losses took place within a specified time-period. Thus, an hours clause might read: 'All losses arising from a hurricane, flood, or earthquake shall be considered one occurrence if they were sustained within a seventy-two hour period.'" *S.R. Int'l Bus. Ins. Co., Ltd. v. World Trade Ctr. Props., LLC*, 467 F.3d 107, 132 n.7 (2d Cir. 2006). Hours clauses sometimes allow a cedant to divide an event longer than seventy-two hours into two or more loss occurrences, for some or all perils, which results in a *de facto* reinstatement, for some or all perils.

Because the damage caused by Hurricane Sandy is widespread and prolonged, the hours clause may impact the manner in which claims may or may not be aggregated. The inclusion of a clause limiting an occurrence to 72 hours, for example, might mean that Hurricane Sandy losses in the Caribbean—occurring more than 72 hours before landfall in the United States—could not be aggregated with US losses.

Some treaties may also include geographic limitations that may be relevant to aggregation issues. In the case of Hurricane Sandy, because the damage caused by the storm spread over a large geographic region, the inclusion of such a geographic limitation in a treaty could have a potentially significant impact on the ability to aggregate claims.

B. "Sole Judge" Provisions

Some reinsurance treaties may contain language providing that the cedant is the "sole judge" with respect to certain coverage issues. These clauses are intended to vest the cedant with broad discretion in deciding coverage issues to which it applies and to prevent the reinsurer from disputing the cedant's coverage determination. These clauses have not often been interpreted by United States courts. The English Court of Appeals, however, concluded that the "sole judge" clause evidenced an intention by the parties to the reinsurance contract that the cedant have broad discretion, limited only by reasonableness "to decide whether losses (or a series of losses) for which he had to accept liability as primary insurer arose out of a single event." *Brown v. GIO Ins. Ltd.*, [1998] Lloyd's Rep. IR 201, [1998] E.W.J. No. 134 (U.K. Ct. App. Feb. 6, 1998). Accordingly, a reinsurer must carefully examine its treaties to determine whether it includes a "sole judge" provision. *See* Barry R. Ostrager & Mary Kay Vyskocil, Modern Reinsurance Law and Practice, § 2.03 (2d ed. 2001).

C. Follow The Fortunes Doctrine

An area of potential uncertainty may be created by the fact that each underlying policy will be subject to its own governing law and jurisdiction. Given that damage has been inflicted in a number of different states, insurers could be exposed to differing rulings on coverage. In addition, insurers are sure to face pressure to enter into early settlements with their policyholders. Reinsurers will need to consider carefully whether "follow the fortunes" or

"follow the settlements" principles obligate them to indemnify their cedants for early settlements.

While the follow the fortunes doctrine restricts the ability of a reinsurer to contest payment of a reinsurance claim, it is generally recognized that, unless the reinsurance contract provides otherwise, a reinsurer will not be obligated to provide reinsurance for a payment by the cedant for a loss falling squarely outside the scope of the coverage afforded by the reinsured policy. *North River Ins. Co. v. CIGNA Reins. Co.*, 52 F.3d 1194, 1999 (3d Cir. 1995). In general, a reinsurer must indemnify a cedant for payments made (1) in good faith and after a reasonable and businesslike investigation, (2) on claims arguably encompassed within the scope of the underlying insurance policy, and (3) to the extent that the claims also are encompassed within the terms, conditions, and limits of the reinsurance contract. Ostrager & Vyskocil, at §§ 9.01-9.03. Accordingly, if a cedant pays claims despite the fact that coverage is debatable—as may be the case with early settlements entered after Hurricane Sandy—the follow the fortunes doctrine is likely to play a significant role in potential subsequent disputes between cedants and their reinsurers.

For the follow the fortunes doctrine to be implicated a cedant is required to investigate each claim and make a good faith determination as to whether a claim should be paid and whether the claim is covered by the underlying policy. *North River Ins. Co. v. Cigna Reins. Co.*, 52 F.3d 1194, 1204 (3d Cir. 1995) ("[a] reinsurer is bound to follow its cedent's fortunes in settling claims unless the reinsurer can show that the cedent did not act in good faith or after conducting a reasonable investigation . . . Only if the ceding company pays a claim that is clearly outside the scope of its policy, would the reinsurer's challenge be sustained."). While the underlying claim must be covered by both the underlying policy and the reinsurance contract, different courts have chosen to put more emphasis on one factor over the other in varying contexts. Some courts have focused heavily on whether there is coverage under the underlying policy. *See, e.g.*, *Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268, 280 (2d Cir. 1992); *Unigard Sec. Ins. Co. v. N. River Ins. Co.*, 762 F. Supp. 566, 586 (S.D.N.Y. 1991), *aff'd in part, rev'd in part*, 4 F.3d 1049 (2d Cir. 1993); *Mentor Ins. Co. v. Brankasse*, 996 F.2d 506, 517 (2d Cir. 1993) (holding that the follow the fortunes doctrine requires reinsurers to reimburse cedants for good faith payments that are at least arguably within the scope of insurance coverage that is reinsured). Other courts have put more emphasis on whether the ceded claims fall outside the risks covered by the reinsurance contract. *Am. Marine Ins. Group v. Neptunia Ins. Co.*, 775 F. Supp. 703, 708-09 (S.D.N.Y. 1991), *aff'd*, 961 F.2d 372 (2d Cir. 1992). Indeed, there may also be exclusions in reinsurance treaties that will require careful analysis. Finally, reinsurers should also conduct a thorough analysis to determine the number of occurrences at issue in a ceded loss. Treaties may contain occurrence language that differs from the direct policies pursuant to which a loss is ceded.

Given this framework, it would seem that if ceding insurers conduct rigorous analyses of tendered losses, giving due regard to specific policy provisions, their settlements are likely to be subject to a follow the fortunes analysis. However, if ceding insurers simply cave in to pressure to quickly pay claims without sufficient analysis or reduce their usual claims adjusting standards, the applicability of the follow the fortunes doctrine is likely to be tested.

CONCLUSION

Hurricane Sandy caused enormous damage to property, and a significant number of those affected by the storm are likely to submit claims to their insurance carriers for coverage. Insurers may then, in turn, look to their reinsurers. The validity of these claims will largely depend on the particular circumstances of each claim and the language of the insurance or reinsurance contracts at issue. Accordingly, insurers and reinsurers must be prepared to analyze substantial claims in a sophisticated fashion in a legal context where there is some, but not extensive developed law.

If you have any questions concerning this memorandum, please contact Mary Kay Vyskocil (212-455-3093, mvyskocil@stblaw.com) or Meghan E. Cannella (mcannella@stblaw.com).

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This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

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