

# K&LNG Bulletin

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## Insurance Coverage

### The Hurricane Season of 2005: Emerging Insurance Issues

By James R. Segerdahl

The toll in human life, injury and displacement exacted by the hurricane season of 2005 is still not subject to anything approaching precise quantification. This is certainly true of the economic consequences. Suffice to say that this hurricane season, headlined by Katrina, Rita and Wilma, will go down as the most costly in history. Some policyholders have been dealt huge economic bodyblows, some have incurred substantial losses, and others are still in the process of measuring the effects, which may be felt for many years. For several months now, business policyholders and their insurers have grappled with the aftermath of the storms, and have been engaged in what promises to be extensive, and at times contentious, adjustment and dispute resolution exercises.

The process is still relatively early; in many cases, issues in dispute between insureds and insurers are only now beginning to come into focus and take center stage. At least outside the homeowners' context, there has not yet been extensive filings of coverage claims in court by large commercial insureds. Indeed, property damage and related business interruption claims have a history of being more susceptible than large liability coverage claims to resolution short of litigation, and this may well be the case in this context as well. Nevertheless, the stakes for many policyholders are particularly high in light of the losses, and prudent insureds are likely to resist insurers' coverage limiting interpretations of their policies, the facts of their claims and of the applicable law. Indeed, steps and positions taken and not taken now in response to issues raised by insurers will undoubtedly have a significant impact on overall recoveries.

Although each policyholder, each policy and each specific factual scenario presents its own set of questions, some issues have begun to emerge in multiple cases as policyholders press their claims. This bulletin will review a few of the issues that have shown themselves in multiple cases and that promise to be the subject of ongoing dialogue, negotiation and litigation in the coming months and years.

#### SUBLIMITS

For business policyholders with large losses, a major potential issue is the extent to which sublimits apply. Most property programs insuring large corporate insureds do not contain overall aggregate limits, and the limits are often very large -- sufficient to cover the value of virtually all insured assets and associated business interruptions. For some risks, however, including typically "floods" and others that insurers may argue are implicated by the hurricanes, the policies impose "sublimits" purporting to limit coverage with respect to damage caused by specified perils. These sublimits are often much lower than the otherwise applicable overall limits. Thus, some policyholders have found that their insurers have taken the position that their large claims for property damage and related business interruption coverage are severely limited by sublimits. For these policyholders, the good news is that their insurers have not been denying coverage; the bad news is that their insurers have been busily building a case that the losses are subject to a sublimit that significantly lowers the insured's potential recovery.

The sublimit issue can arise in a number of different contexts and can implicate a number of different legal issues. For example, many property policies

have sublimits applicable to "flood." "Flood" may be defined in many different ways in the policies – in some cases, a policyholder may be able to argue that its particular circumstances do not amount to a "flood," given the specific facts and policy language at issue. In other cases, an insurer may at least have an argument that an insured's loss, or some part of it, was the result of "flood" as defined in the policy. Whether this is sufficient to bring hurricane-induced losses within a sublimit for "flood," however, may depend on the insurance coverage law of the governing jurisdiction.

For example, policyholders may argue that the "efficient proximate cause" doctrine, applicable in many states, provides that a loss ultimately caused by a covered peril (a hurricane) cannot be forced into a sublimit simply because the chain of loss-producing events essentially ended in a "flood" as defined in the policy. Just as the efficient proximate cause doctrine precludes an insurer from denying coverage for a loss ultimately covered by an insured risk just because an excluded peril is included in the causation chain, so too should the doctrine protect against shoehorning the loss into a sublimit. Policyholders can argue for a similar result under the law of states following a concurrent causation doctrine.

Some insurers have pointed to so-called "anti-concurrent cause" language, which purports to direct a policyholder's claim to a specific sublimit if any part of the causal chain involves the peril that is the subject of the sublimit. Although such clauses have not received extensive judicial attention in states like Mississippi and Louisiana, some courts in other jurisdictions have held that an insurer cannot "contract out of" the efficient proximate cause doctrine. Thus, policyholders are likely to have an argument that such anti-concurrent cause language should not end the inquiry as to whether a particular sublimit applies.

Policyholders should carefully review insurer attempts to impose sublimits on their claims. These attempts may involve large chunks of a claim (as with respect to sublimits applicable to "flood") or smaller chunks, as with respect to an insurer's recharacterization of repair or replacement activities as activities subject to a sublimit--for example, debris removal. There may be multiple arguments available to insureds to avoid the effect of such sublimits depending on the law, the policy language and the facts. The first step, however, is to recognize the

issue and be in a position if appropriate, to challenge the insurer's position.

## DEDUCTIBLES

For many policyholders, among the most significant issues in terms of the amount of their recovery is the calculation of the applicable deductible or deductibles. Insurers have an interest in characterizing losses to maximize the deductible. Insureds obviously have the opposite incentive. There are a number of issues that can affect how deductibles are calculated – some are common to insurance claims in virtually any context and some are relatively unique to hurricane-related claims. Both sets of issues are being addressed by policyholders and insurers in the aftermath of the hurricanes of 2005.

Hurricanes typically present deductible issues that are not common to other kinds of claims. This is because deductibles potentially applicable to claims involving damage caused by wind (sometimes "named" windstorms) are often expressed in terms of percentages rather than in terms of an absolute dollar amount. Sometimes it is not clear what the "percentage" is supposed to be applied against. For property damage claims, is it the total value of all property insured under the contract? Or property values at particular locations? Property values as submitted when the policy was underwritten? Or current values? Or is it the repair or replacement cost (total claim) of the insured arising out of the windstorm rather than total property values? Some policies contain specific language addressing these issues. Many policies with percentage deductibles do not. The case law provides little or no guidance with respect to the specific issue, although it provides abundant guidance with respect to the general principles of insurance policy construction, including the generally accepted rule that ambiguous policy language should be construed in favor of the insured. Because the issue has the potential for huge swings in recoverable losses, policyholders should be aware of and carefully analyze the positions and arguments available to it in this regard.

As is commonly the case in most types of loss scenarios (not just wind-related losses), the amount of the applicable deductible often depends on whether more than one "occurrence" is deemed to have given rise to the losses. If the policy includes a per occurrence deductible, then more occurrences means more deductibles. Sometimes policy language

specifies a time period for differentiating between storms for purposes of identifying the number of occurrences. Nevertheless, oftentimes, policy language is often not very helpful in determining how many "occurrences" should be considered to have given rise to a loss. There typically is case law guidance, although it tends to be relatively fact specific.

Thus, insureds should be wary of accepting without question an insurer's determination as to the number of deductibles applicable to a claim. Insureds must also be careful to refrain from reflexively taking the position that there has been only one occurrence and therefore only one applicable deductible. In some cases, this may not be a coverage-maximizing position, because many property policies may have per occurrence limits applicable to policies generally (or applicable sublimits) but no aggregate limits. In those cases, it may be more advantageous to absorb multiple deductibles in order to secure the right to access multiple limits. In any event, the question of deductibles mixes policy, factual, legal and strategic issues, and should not be resolved without serious review by the policyholder or its counsel.

#### MOLD ISSUES

Many property policies purport to exclude losses related to mold even if they explicitly cover damage caused by hurricanes or even floods. Mold exclusions, particularly in property policies covering large commercial insureds, tend to vary significantly in wording and scope. Under some wordings, "mold" as an "ensuing loss" caused by an otherwise covered peril should not preclude coverage. Under other wordings, the issue may not be clear-cut. Some policies to include "anti-concurrent cause" language purporting to exclude losses arising from mold even if other covered perils contributed to the loss. In any event, many policyholders have found that insurers have identified "mold" as a potential coverage issue, and insurers may well attempt to limit or deny coverage based on mold exclusions.

Policy language is important, as it always is. Nevertheless, as a general matter, policyholders are likely to argue that mold issues at most represent but one of the many negative impacts experienced by their damaged property in the event that repair and replacement is not promptly undertaken. To the extent mold issues currently exist, in many cases they represent one of many reasons that affected property must be repaired or replaced. Under these circumstances, insureds should have solid arguments

that, for example, a building or portion of a building that needs to be demolished or drywall that needs to be repaired is not rendered outside the scope of the coverage of the policy simply because, among its several problems, it has accumulated mold or might accumulate mold. Thus, insureds should be careful to understand and document the multiple reasons that repair or replacement may be necessary, especially when "mold" might be argued to be in the mix. If the reasons for repair and replacement are carefully and comprehensively presented in the first instance, coverage disputes may be limited.

Mold exclusions with "anti-concurrent cause" language may be susceptible to the same sort of legal attacks as discussed above in connection with insurer attempts to shoehorn losses into sublimits. In particular, policyholders may be able to argue that policyholder-friendly rules, such as the concurrent cause doctrines or efficient proximate cause, cannot be swept aside by such language.

#### BUSINESS INTERRUPTION ISSUES

Many of the disputed issues arising out of the hurricane-related losses are likely to relate to the business interruption claims. Again, some policies are quite explicit in terms of how such losses are to be calculated, and some are not. In virtually all cases, prior experience and projected earnings and expenses will of course be highly relevant. The services of a forensic accountant, working with counsel, are often required or advisable in formulating such a claim. Positions taken early on can have ramifications for years to come.

Many insureds are already finding that their insurers are questioning business interruption claims on a variety of factual bases mixed with restrictive interpretations of policy language. For example, some insurers have argued that insureds should have taken additional or different steps toward resumption of ordinary business activities or that certain steps should have been taken more expeditiously. Sometimes these arguments ignore basic business realities. Sometimes they appear to be nothing more than makeweights to create leverage in negotiations or to delay advancement of the adjustment process. Insurers sometimes ignore key policy provisions bearing on these issues, including policy language clearly designed to provide a insureds reasonable latitude to deal with the realities of such disasters and the flexibility to tailor reasonable responses consistent with business imperatives. Some policy

language provides for "extended" business interruption coverage – coverage that continues for a specified period even after most operations are back up and running.

In this area, there is no substitute for policyholder vigilance. Insureds need to understand their rights under the policy, and their options for repair and replacement, all of which can affect the amount and length of compensable business interruptions. In cases in which liability is clear, insurers often attempt to limit exposure by questioning damages or losses -- business interruption claims represent an area in which insurers will raise numerous questions in an effort to negotiate losses. The sooner insureds challenge their insurers on these issues, with support from the policy language and law as necessary, the better position they will be in to resist such insurer efforts.

**ADVANCE PAYMENTS AND RELATED PROCESS ISSUES**

At the end of the day, the main thing most policyholders want from their insurers is payment satisfying their claims for all losses actually incurred and covered by the policy. Most policyholders cannot, however, wait for the end of the day -- for the insurance to have its full value, it must be paid promptly, as losses are verified. Policies typically require insurers to make advance payments as losses are incurred and verified, even if many adjustment questions remain outstanding. Many insureds are currently in the process of attempting to enforce these provisions with insurers, as many insurers are moving slowly in response to claims and have attempted to delay payments by raising questions on unrelated matters.

Insurance policies typically contain language requiring payments on a certain schedule, and almost always provide for advance payments while the full extent of the loss is adjusted. Withholding payment can be a negotiating tactic employed by some insurers. Insurers that employ this tactic, however, run the risk of bad faith and related extra-contractual claims. Policyholders should be aware of their rights to advance payments under the policy language and state law, and should not allow this issue to become part of a "negotiation" of the overall claim.

In some cases, the active involvement of counsel for the insured in the adjustment process can help expedite payment and resolution of issues. In other cases, it is more appropriate and effective for counsel to remain in the background, as an advisor to

the insured, as issues are raised. While there is no blanket answer to the question of the extent to which counsel should be openly engaged with insurers in the adjustment process, the decision should be a conscious one in light of all of the facts and circumstances. In addition, policyholders should keep in mind that insurers typically engage their own coverage counsel very early in the adjustment process, particularly where a claim involves large losses such as those related to the 2005 hurricanes.

There are additional adjustment process issues of which insureds must be aware. These include proof of loss, appraisal and suit limitation issues. The policy may set forth a specific time frame for completion of a "proof of loss." Although insurers sometimes do not rigidly enforce such deadlines in ordinary, consensual adjustment processes, the deadlines sometimes reemerge as defenses to coverage in the event there are unresolved issues and litigation or other aggressive policyholder action becomes necessary. Thus, especially when there is a potential dispute, policyholders should be careful not to miss purported policy deadlines -- which sometimes means filing "partial" proofs of loss or securing insurer agreement to waive otherwise applicable deadlines.

Some policies contain "suit limitation" provisions, which purport to limit the time period in which suit may be brought to enforce a coverage claim in the event a claim is not amicably resolved. These provisions sometimes try to limit the period to periods as short as one year after the loss commenced, even if the applicable statute of limitations provides for a much longer period. Again, a policyholder must be aware of such deadlines and take appropriate steps in the event that it needs to preserve its option to litigate its coverage claim. Short of actually filing suit, this may mean negotiating a tolling agreement with the insurers to toll the running of any contractual limitations period.

## CONCLUSION

Policyholders and insurers alike can and undoubtedly do agree that the consequences of the hurricanes have indeed been tragic. The risks associated with the economic consequences, at least theoretically, have been allocated according to the insurance contracts and controlling insurance coverage law. The past few months have seen insurers and large commercial insureds begin the process of quantifying that allocation of risk by applying policy language and coverage law to numerous individual fact scenarios.

While many additional issues undoubtedly will arise as the claims are adjusted, the issues identified above have shown themselves to be prominent ones in many claims. To be sure, numerous other issues and fact-based disputes will surface as insurer-appointed claims adjusters look for ways to minimize insurer losses. In many instances, the issues and questions raised by such adjusters will be perfectly legitimate; in some cases, they will be based on questionable interpretations of policy language, coverage law and the facts and calculated to generate negotiating points

designed to create leverage and discount opportunities for insurers. The challenge for policyholders is to recognize the difference, and to navigate the adjustment and legal process such that it concludes, one way or another, with full payment of all insured losses.

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**James R. Segerdahl**  
jsegerdahl@klng.com  
412.355.6784

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If you have questions or would like more information about K&LNG's Insurance Coverage Practice, please contact one of our lawyers listed below.

International Contact	Peter J. Kalis	pkalis@klng.com	+1.412.355.6562	Fax +1.412.355.6501
Boston	John M. Edwards	jedwards@klng.com	+1.617.261.3123	Fax +1.617.261.3175
Dallas	Robert Everett Wolin	rwolin@klng.com	+1.214.939.4909	Fax +1.214.939.4949
Harrisburg	Carleton O. Strouss	cstrouss@klng.com	+1.717.231.4503	Fax +1.717.231.4501
London	Jane V. Harte-Lovelace	jharte-lovelace@klng.com	+44 (0) 20 7648 8172	Fax +44 (0) 20 7648 9001
Los Angeles	David P. Schack	dschack@klng.com	+1.310.552.5061	Fax +1.310.552.5001
Miami	Daniel A. Casey	dcasey@klng.com	+1.305.539.3324	Fax +1.305.358.7095
Newark	Anthony P. La Rocco	alarocco@klng.com	+1.973.848.4014	Fax +1.973.848.4001
New York	Peter J. Kalis	pkalis@klng.com	+1.212.536.4828	Fax +1.212.536.3901
Pittsburgh	Thomas M. Reiter	treiter@klng.com	+1.412.355.8274	Fax +1.412.355.6501
San Francisco	Edward P. Sangster	esangster@klng.com	+1.415.249.1028	Fax +1.415.249.1001
Washington	Matthew L. Jacobs	mjacobs@klng.com	+1.202.778.9393	Fax +1.202.778.9100



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