A Tempest over Named-Storm Deductibles, Loss of Business Income, and More

By James P. Steele

Understanding how some courts have interpreted certain insurance provisions may aid future courts and counsel deal with the emerging issues that it seems will increase as "super storms" swell.

As day follows night, so too do insurance coverage controversies follow big storms. Policyholders whose property is damaged submit their insurance claims, and the insurers decide whether or not the policies offer coverage along familiar lines. Did floodwater or wind damage an insured's property? Does a policy cover losses for the time that a business owner could not conduct business? Can an insured demonstrate that a claim is covered? Can an insurer demonstrate that a valid exclusion applies? Bigger storms mean greater damage, a higher volume of claims, and more chances of litigation when insureds and insurers don't see eye to eye.

Over 20 years ago, insureds and insurers litigated coverage issues concerning property damage caused by Hurricane Andrew. Almost a decade ago, such claims rose in the aftermath of Hurricane Katrina. More recently, we have seen coverage litigation over damage caused by Superstorm Sandy. This article will address some of the coverage issue disputes in the Superstorm Sandy cases, including disputes over hurricane or named-storm deductibles, loss of business income, flood or water exclusions, and more.

Hurricane or Named-Storm Deductibles

According to the National Association of Insurance Commissioners and the Center for Insurance Policy & Research, hurricane deductibles and named-storm deductibles grew out of insurers' efforts "to mitigate future losses in hurricane-prone areas," in the aftermath of Hurricane Andrew in 1992 and subsequent hurricanes. *Hurricane and Named Storm Deductibles*, http://www.naic.org/cipr_topics/topic_hurricane_deductibles.htm (last visited Mar. 24, 2015). As more people developed property near shorelines and property values increased, insurers needed ways to provide affordable coverage while limiting losses that might result from massive

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storms. *Id.* Of course, a given policy will define a hurricane or named-storm deductible. However, generally speaking, a hurricane deductible applies to damage solely from a storm that the National Weather Service or U.S. National Hurricane Center has categorized as a hurricane. *Id.* In contrast, a named-storm deductible applies to losses resulting from "a weather event declared as a hurricane, typhoon, tropical storm or cyclone by the U.S. National Weather Service, the U.S. National Hurricane Center or the U.S. National Oceanic and Atmosphere Administration, and where a number or 'name' has been applied (*e.g.*, Hurricane Andrew, Superstorm Sandy)." *Id.*

Whether a hurricane or a named-storm deductible applies has a great financial effect on a policyholder. A typical deductible is for a set, relatively modest, dollar amount, which a policyholder must pay before the policy's coverage kicks in. A hurricane or a named-storm deductible "can be expressed as a fixed dollar deductible or, more commonly, as a percentage of the home's insured value, which can vary from 1 percent to as high as 10 percent." *Id.* Thus, a hurricane or a named-storm deductible can impose a staggering financial burden on a policyholder.

Two cases involving Superstorm Sandy claims illustrate the issues that arise in cases involving hurricane or named-storm deductibles: *Wakefern Food Corp., et al. v. Lexington Insurance Company*, Docket No. MID-L-6483-13 (Superior Court of New Jersey Law Division: Middlesex County, 2014), and *AFP 104 Corp. v. Columbia Casualty Co.*, 2014 WL 793780 (Slip copy) (D.N.J. 2014). In *Wakefern*, the court granted the insurer's motion for partial summary judgment and applied the named-storm deductible. In *AFP 104 Corp.*, the court denied the insurer's motion to dismiss, finding that the insured sufficiently alleged facts that if assumed to be true, showed that the insurer improperly applied the named-storm deductible.

Wakefern Food Corp. is a buying cooperative of owners and operators of Shoprite and PriceRite supermarkets. Wakefern had a commercial property insurance policy with Lexington Insurance Co. After Superstorm Sandy, Wakefern claimed $50 million in damages, which were largely related to spoilage of food, but Lexington paid only about $22 million. Wakefern sued, arguing that the named-storm deductible in its policy did not apply and that even if it did apply, Lexington calculated the loss improperly. Lexington countered that the named-storm deductible applied and its valuation of the loss was proper. The parties' cross-motions for summary judgment were decided on October 29, 2014, by New Jersey Superior Court Judge Travis L. Francis.

Lexington's policy provided that the named-storm deductible applied when the National Weather Service declared a storm to be a hurricane, tropical cyclone, tropical storm, or tropical depression. *Wakefern*, Court's Order of October 29, 2014, at 20. By 7:00 p.m., on October 29, 2012, about an hour before Sandy made landfall in New Jersey, the National Weather Service had downgraded the storm to a "post-tropical cyclone." *Id.* at 6.

Thus, argued Wakefern, Sandy was not a hurricane, tropical cyclone, tropical storm, or tropical depression at the time of landfall, and the named-storm deductible did not apply. *Id.* at 7. Wakefern supported its position by citing New Jersey Governor Chris Christie's Executive Order 107, which prohibited insurers from imposing hurricane deductibles on homeowners. Governor Christie based this action in part on the fact that the NWC "categorized Sandy as a post-tropical storm prior to landfall in New Jersey." Exec. Order No. 107, November 2, 2012, at 2.

Wakefern asserted that the named-storm deductible did not apply to its spoilage losses. Even if the deductible did apply, Wakefern argued, the proper calculation of the deductible could not exceed $3 million under the policy.

Lexington disagreed, arguing that the damage began before landfall while Sandy was still a hurricane. Lexington argued that each of Wakefern's claimed locations was involved in loss or damage "arising out of" Hurricane Sandy, and that was true even for locations that sustained losses after Sandy was downgraded. *Wakefern*, Court's Order of October 29, 2014, at 7–8. Lexington pointed out that New Jersey law broadly defines the phrase "arising out of" in an insurance policy to mean "conduct 'originating from,' 'growing out of,' or having a 'substantial nexus' with the activity for which coverage is provided." *Id.* at 8.

Lexington argued that Wakefern's reliance on the time when the eye of the storm made landfall ignored the fact that other parts of the then-Hurricane Sandy had damaged land hours earlier. So "a loss arises out of a Named Storm so long as the Named Storm has a 'substantial nexus' to the loss and [Wakefern's claimed losses] would not have occurred but for Hurricane Sandy." *Id.* at 8–9. Lexington found Executive Order 107 to be irrelevant because, by its terms, it applied only to homeowner's insurance claims, and statewide uniform policy language governed the applicability of the deductible. *Id.* at 9.

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The court agreed with Lexington, concluding that the "[a]pplication of the Named Storm deductible for damage caused by Sandy is consistent with the clear and unambiguous language of the Policy." *Id.* at 20. Although the storm was a post-tropical cyclone at the time of landfall, "[i]t [was] undisputed that prior to 7:00 p.m. on October 29, 2012, Sandy was a hurricane." *Id.* The court likewise found it undisputed that "damage at some Wakefern locations occurred prior to 7:00 p.m.… [and] the Pre-700 p.m. damage while Sandy was still a hurricane created a substantial nexus between the storm and Wakefield's total losses." *Id.* at 20–21.

Finally, the court found that Executive Order 107 did not apply to this dispute, which involved a commercial policy, not over a homeowner's policy.

AFP 104 Corp. was a named insured under a Columbia Casualty Co. first-party property insurance policy issued to Ocean Place Resort and Spa in Long Branch, New Jersey. AFP sued Columbia in New Jersey state court for coverage for alleged damages that arose out of Hurricane Sandy. Colum-

bia removed the case to the United States District Court for the District of New Jersey and moved to dismiss the complaint. Judge Peter G. Sheridan denied the motion.

Columbia's policy insured against "risks of physical loss or damages to property," providing coverage for the damage at replacement value. *AFP 104 Corp.*, 2014 WL 793780, at *1 (D. N.J. 2014). The policy also provided "time element" coverages for "business interruption," "denial of access by civil authority," "ingress-egress" and "service interruption." *Id.* The policy contained two deductibles that were at issue in the dispute, a base deductible of $10,000, and a named-storm deductible of $1 million per occurrence. The named-storm deductible provided:

> As respect loss or damage due to wind or hail associated with a *Named Storm* occurring at all *Locations*, exception as may be further provided below, the deductible shall be… Three Percent (3 percent) for physical damage and Time Element combined…, subject to a minimum of $1,000,000 per occurrence.

Id. at *1–2.

> The policy defined "named storm" as
> [a] storm that has been declared to be a named tropical storm or hurricane by the U.S. National Weather Service or other government authority including hurricane or tropical storm spawned tornado(s) or microburst(s). The named tropical storm or hurricane ends when the National Weather Service officially declares the named tropical storm or hurricane permanently downgraded to a tropical depression.

Id. at *2.

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In its complaint, AFP alleged that Sandy was a post-tropical storm when it made landfall and that it directly caused property and "time element" damages totaling $774,562.32, toward which AFP would apply the $10,000 base deductible. Columbia denied the claim in its entirety, saying that the claim amounted to less than the minimum named-storm deductible of $1,000,000.

The judge noted that under New Jersey law, the "plaintiff bears the initial burden of establishing that coverage exists under the policy." *Id.* at *3. The judge found that AFP had sustained its burden of stating plausible grounds for relief. *Id.* The judge noted the allegation that Sandy was a post-tropical storm at landfall and that AFP suffered direct physical property damage and consequent "time element" loss from Sandy.

In *Wakefern*, the insurer argued that the damages at issue began before the time that Sandy was downgraded and that even post-downgrade damages arose out of Sandy for the purposes of applying the named-storm deductible. In *AFP 104 Corp.,* the judge never addressed that argument, presumably because the issue in the case was whether AFP's allegations, if true, stated a cause of action. AFP would obviously not allege facts that would fit its claim into the named-storm deductible.

Loss of Business Income

Superstorm Sandy hammered lower Manhattan, which is teeming with businesses, insurance companies, and law firms. Many of these businesses were forced to evacuate before the storm made landfall and were kept from their offices for days. Consequently, many businesses filed claims for loss of business income.

A typical business income provision will cover loss of business income caused by "direct and physical loss of or damage to" covered premises, where the loss is caused by, or results from, a Covered Cause of Loss," as defined by the policy. *See, e.g.*, ISO Form CP 00 30 04 02 (2001). Business income will usually be defined as net profit or loss before taxes and continuing normal operating expenses incurred. *Id.*

Two cases decided in the U.S. District Court for the Southern District of New York show how courts have handled disputes over this coverage: *Johnson Gallagher Magliery, LLC v. Charter Oak Fire Insurance Company*, 2014 WL 1041831 (S.D.N.Y. 2014), and *Newman Myers Kreines Gross Harris, PC v. Great Northern Insurance Co.*, 17 F. Supp. 3d 323 (S.D.N.Y. 2014). Both cases involved law firms located in lower Manhattan.

In *Johnson Gallagher Magliery*, Sandy caused the law firm to suspend operations from October 28, 2012, to January 7, 2013. Johnson Gallagher Magliery sued Charter Oak after the insurer denied the firm's claim for lost business income.

The firm's business casualty policy covered "lost business income caused by the interruption of utility services." *Johnson Gallagher Magliery,* 2014 WL 1041831, at *1 (S.D.N.Y. 2014). The basic coverage provided that Charter Oak

> will pay for the actual loss of Business Income you sustain due to necessary "suspension" of your "operations" during the "period of restoration." The "suspension" must be caused by direct physical loss of or damage to property at the described premises. The loss or damage must be caused by or result from a Covered Cause of Loss.

Id.

A "lawyers endorsement" expanded the coverage to include a suspension due to the loss of utility services resulting from property damage not on the insured premises. *Id.* The endorsement provided that "*the interruption must result from direct physical loss or damage* by a Covered Cause of Loss to… *'Power Supply Services.'*" *Johnson Gallagher Magliery,* 2014 WL 1041831, at *2 (emphasis supplied). The policy defined "power supply services" to mean "the following types of property supplying electricity, steam, or gas to the described premises: (1) Utility generating plants; (2) Switching stations; (3) Substations; (4) Transformers; (5) Transmission lines [other than overhead transmission lines]." *Id.* The policy defined "covered cause of loss" to mean "risks of direct physical loss," unless, among other things, the loss is subject to an exclusion. *Id.*

The court found two exclusions to be pertinent to the issue: the water exclusion and the "acts and decisions" exclusion. *Id.* The water exclusion applied to, among

other things, flood, surface water, waves, tides, overflow of any body of water and underground water that penetrates foundations, basements or doors, windows, and other openings. *Id.* Another endorsement negated the exclusion for water or sewage backups or overflows. *Id.*

The "acts and decisions" exclusion provided that Charter Oak would not pay for loss or damage caused by "[a]cts or decisions, including the failure to act or decide, of any person, group, organization, or government body," unless the act or decision resulted in a "covered cause of loss." *Id.*

The day before Sandy made landfall, New York City Mayor Michael Bloomberg declared a state of emergency and ordered a mandatory evacuation for part of the city, including where the law firm's offices were. When Sandy hit on October 29, 2012, Consolidated Edison observers noted that the storm surge appeared to be rising above protective barriers. *Id.* at *3.

Damage to Con Edison's networks would be more severe if water hit while they were operational, so at 6:42 p.m. on October 29, Con Edison preemptively shut down its Bowling Green Network, which serviced the area including the law firm's building. That network was reenergized on November 3, at 1:33 a.m. Firm employees reported being unable to enter the building from November 1 to 3. The law firm's building received electricity on November 11. Mayor Bloomberg permitted reoccupation of the area on November 14, but the law firm's landlord did not allow the firm to return until November 16. The firm's telephone and Internet service did not return until January 7, 2013. *Id.* at *3–4.

The firm made a claim on October 31, 2012. Charter Oak denied the claim on December 3, citing the water exclusion. *Id.* at *4.

Charter Oak moved for partial summary judgment, arguing three points. First, there was no "direct physical loss or damage" because the network was preemptively shut down, not damaged. Second, because the network was preemptively shut down, the loss of electrical service fell within the "acts or decisions" exclusion. Third, any damage to the network was caused by water, so there is no coverage under the water exclusion. *Id.* at *5. U.S. District Court Judge Denise Cote addressed these arguments in turn.

Judge Cote noted that while it was true that the loss of electrical service was initially due to Con Edison's preemptive shutdown of the network, Con Edison senior engineer Peter Turadek testified during a deposition that Sandy had caused extensive water damage to the network "in most locations." *Id.* Therefore, "Sandy caused 'direct physical loss or damage' to the Con Edison power supply services." *Id.* Charter Oak would therefore only be entitled to a summary judgment for the *de minimis* period between the shut down and when Sandy's water damaged the network. Likewise, the "acts or decisions" exclusions operated to negate coverage only for those few hours between Con Edison's preemptive shutdown and Sandy's water damage to the network. *Id.* at *5–6.

Con Edison's reports and Turadek's deposition testimony satisfied the judge that the network suffered water damage. She wrote, "Charter Oak has thus shown… that water caused 'direct and physical loss or damage' to the Bowling Green Network that prevented the reenergizing of the network until 1:33 a.m. on November 3. This is an excluded cause of loss from the Firm's insurance policy."

However, the judge found that the Charter Oak failed to show that Con Edison's failure to supply power to the building after energy was restored to the network on November 3 was caused by water damage. Therefore, the water exclusion did not apply and Charter Oak's motion for partial was denied for the period from November 3 to November 11, when electricity was restored to the firm's building.

Johnson Gallagher Magliery had better luck than Newman Myers Kreines Goss Harris, P.C. Newman Myers faced the same evacuation order and the same Con Edison preemptive shutdown of the Bowling Green Network. However, power was partially restored to Newman Myers' building, and elevator service to the eighth floor resumed on November 3. Full power and elevator service resumed the next day, November 4. Newman Myers resumed normal business operations on Monday, November 5. On November 12, Newman Myers submitted a loss of business income claim for the period of October 29 to November 3. On December 26, Great Northern denied the claim, saying that it was not a covered loss. The dispute ended up before U.S. District Court Judge Paul A. Engelmayer on cross-motions for summary judgment. *Newman Myers Kreines Gross Harris, PC v. Great Northern Insurance Co.*, 17 F. Supp. 3d 323, 325–26 (S.D.N.Y. 2014).

The firm's policy provided for "loss of business income and extra expenses in the event of 'direct physical loss or damage by a covered peril to property.'" *Id.* at 328. The firm claimed coverage under additional business impairment provisions for "ingress and egress" and "loss of utilities." *Id.* While conceding that Sandy did not cause any structural damage to its building, the firm nonetheless argued that the building and Con Edison's facilities suffered "direct physical loss or damage" under the policy. The firm contended that "the phrase 'direct physical loss or damage,' construed in line with the reasonable expectations of the insured, does not require actual structural damage to the covered premises." *Id.* at 329. In essence, the firm equated "loss of" with "loss of use of." *Id.* at 331.

The judge examined a similar New York case, *Roundabout Theatre Co. v. Continental Cas. Co.*, 302 A.D.2d 1 (1st Dep't 2002), in which the appellate court repudiated a lower court's ruling that "loss of" necessarily includes "loss of use of" the insured premises. *Newman Myers Kreines Gross Harris, PC*, 17 F. Supp. 3d at 330–31 (citing *Roundabout Theatre Co.*, 302 A.D.2d at 7).

Therefore,

> [t]he critical policy language here—"direct physical loss or damage"—similarly, and unambiguously, requires some form of actual, physical damage to the insured premises to trigger loss of business income and extra expense coverage. Newman Myers simply cannot show any such loss or damage to [its building] as a result of either (1) its inability to access its office form October 29 to November 3, 2012, or (2) Con Ed's decision to shut off the power to the Bowling Green network.

Newman Myers Kreines Gross Harris, PC, 17 F. Supp. 3d at 331.

The firm failed to meet its burden of proving coverage in the first instance, and Great Northern was therefore entitled to a summary judgment. The judge went one step further and analyzed Great Northern's argument that the claim was barred

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by the flood exclusion. Just as the firm had the burden of establishing coverage in the first place, Great Northern had the burden to show that any exclusion applied.

Great Northern argued that although Con Edison shut down the Bowling Green Network, it did so because of imminent flooding caused by Sandy. The judge addressed that argument:

> Here, it is undisputed that Con Ed preemptively shut down power to the Bowling Green Network as Hurricane Sandy made its approach, before any flood damage was actually sustained at its Bowling Green facility. Con Ed's was a precautionary measure, to maintain the integrity of the utility network in the event of *future* flooding. Thus, the power outage Newman Myers complains of was not directly *caused by* flood, as that term is commonly understood. Construing the flood exclusion narrowly, as the court must, Great Northern cannot meet its burden of proving that Newman Myers's losses would not be covered. Therefore, in the event the Court's ruling were overturned, the Court's judgment would be that Newman Myers would prevail in this lawsuit.

Id. at 333–34 (citations omitted).

How did Johnson Gallagher Magliery walk away with some coverage while Newman Myers received none? One difference was that Newman Myers was operational on Monday, November 5, 2012, the first business day after the Bowling Green Network was reenergized on November 3, whereas Johnson Gallagher Magliery's building resumed power on November 11. Charter Oak, Johnson Gallagher Magliery's insurer, failed to show that Con Edison's inability to restore power to the covered building between November 3 and 11 was due to water, so the Water exclusion did not apply for that period.

Conclusion

"What's past is prologue," wrote William Shakespeare in *The Tempest*. Coverage disputes trailed in the wake of Hurricanes Andrew and Katrina and Superstorm Sandy, and they will certainly follow future storms. Courts will have to decide not just the familiar flood *versus* wind issue, but also issues pertaining to hurricane or named-storm deductibles, loss of business provisions, "acts or decisions" and water exclusions, and other variables. The cases discussed in this article show how some courts have dealt with them. These cases, and other Superstorm Sandy cases dealing with alleged breaches of covenants of good faith and fair dealing and discovery disputes over draft expert reports, may aid courts in the future to resolve such disputes. *See, e.g., Beekman v. Excelsior Ins. Co.*, 2014 WL 674042 (D.N.J. 2014); *433 Main Street Realty, LLC v. Darwin National Assurance Co.*, 2014 WL 1622103 (E.D.N.Y. 2014); *Raimey v. Wright National Flood Ins. Co.*, ___ F. Supp. 3d___ , 2014 WL 7399179 (E.D.N.Y. 2014). FD