Module 7: Property Risk Management

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Case Study 01: Business Interruption with and without Direct Physical Loss

Business Interruption with and without Direct Physical Loss

When there is a direct physical loss, insurance coverage for business interruption is more likely to exist than when the interruption is not from direct physical loss. The New Orleans hotels that suffered damage due to flooding and wind caused by Hurricane Katrina on August 30, 2005, are more likely to have had business interruption coverage. The oil industry, including its refineries and rigs that were shut down as both hurricanes Katrina and Rita ripped through the Gulf Coast, also had insurance coverage for business interruption. The stop in oil production was associated with a physical loss. Not all business interruptions are covered by insurance. The economic losses suffered by many New York businesses during the New York City transportation strike of December 2005 were not a direct loss from physical damage. As such, these businesses did not have insurance to cover the losses. Nonrelated causes of loss that affect the continued viability of businesses usually do not have insurance remedies. The avian flu pandemic is expected to disrupt many businesses' activities indirectly. Employees are expected to be afraid to show up for work, and some industries—such as shipping—will be vulnerable. A key problem in these cases would be lack of insurance coverage.

In the past, some policyholders submitted business-interruption claims for nondirect economic loss. They were not successful in court. A case in point is the lawsuit filed in August 2002 by the luxury hotel chain Wyndham International against half a dozen of its insurers and the brokerage firm Marsh & McLennan. Wyndham claimed that it had suffered $44 million in lost revenue following the terrorist acts of September 11, 2001, and that the insurers had acted in bad faith in failing to pay the corporation's business-interruption claims. The Wyndham properties that reported September 11-related losses included hotels in Chicago and Philadelphia and three Puerto Rico beach resorts. Wyndham owns no properties in downtown New York City.

September 11 was the wake-up call. It’s estimated that some $10 billion in claims have been filed for business-interruption losses, much of them far away from Ground Zero. With the Federal Aviation Administration—ordered closing of airports nationwide, the travel industry bore major losses. Resort hotels like Wyndham’s saw business fall dramatically.

Are losses recoverable if the business sustained no physical damage? It depends, of course, on the policy. Most small and midsize businesses have commercial policies based on standard forms developed by the Insurance Services Office (ISO). The ISO’s customary phrase is that the suspension of business to which the income loss relates must be caused by “direct physical loss of or damage to property at the premises described in the Declarations.” Larger companies often have custom-written manuscript policies that may not be so restrictive. Whatever the wording is, it is likely to be debated in court.

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Unit 2: Property Risks

Case Study 02: From Coast to Coast: Who Is Responsible for Earthquake and Flood Losses?

From Coast to Coast: Who Is Responsible for Earthquake and Flood Losses?

No region of the United States is safe from environmental catastrophes. Floods and flash floods, the most common of all natural disasters, occur in every state. The Midwest's designated Tornado Alley ranges from Texas to the Dakotas, though twisters feel free to land just about anywhere. The Pacific Rim states of Hawaii, Alaska, Washington, Oregon, and California are hosts to volcanic activity, most famously the May n1980 eruption of Mount St. Helens in southwestern Washington, which took the lives of more than fifty- eight people. California is also home to the San Andreas Fault, whose seismic movements have caused nine major earthquakes in the past one hundred years; the January 1994 Northridge quake was the most costly in U.S. history, causing an estimated $20 billion in total property damage. (By comparison, the famous San Francisco earthquake of 1906 caused direct losses of $24 million, which would be about $10 billion in today's dollars.) Along the Gulf and Atlantic coasts, *natural disaster* means hurricanes. Insurers paid out more money for Hurricane Katrina in 2005 than they collected in premiums in twenty-five years from Louisiana insureds. California insurers paid out more in Northridge claims than they had collected in earthquake premiums over the previous thirty years. The year 2005 saw an unprecedented number of losses because of hurricanes Katrina, Rita, and Wilma. The record number of hurricanes included twenty- seven named storms. The insured losses from Hurricane Katrina alone were estimated between $40 and $60 billion, while the economic losses were estimated to be more than $100 billion. Theses losses are the largest catastrophic losses in U.S. history, surpassing Hurricane Andrew's record cost to the industry of $20.9 billion in 2004 dollars. This record also surpasses the worst human-made catastrophe of September 11, 2001, which stands at $34.7 billion in losses in 2004 dollars.

Fearing that the suffering housing, construction, and related industries would impair economic growth, state government stepped in. The state-run California Earthquake Authority was established in 1996 to provide coverage to residential property owners in high-risk areas. Disaster insurance then went to the federal level. In the aftermath of Katrina, in December 2005, a proposal for a national catastrophe insurance program was pushed by four big state regulators during the National Insurance Commissioners meeting in Chicago. The idea was to change the exclusion in the policies and allow for flood coverage, while calling for a private-state-federal partnership to fund megacatastrophe losses and the creation of a new all-perils homeowners policy that would cover the cost of flood losses.

<u>Questions for Discussion</u>

1. Lee is in favor of government-supported disaster reinsurance because it encourages economic growth and development. Chris believes that it encourages overgrowth and overdevelopment in environmentally fragile areas. Whose argument do you support?
2. The Gulf Coast town you live in has passed a building code requiring that new beachfront property be built on stilts. If your house is destroyed by a hurricane, rebuilding it on stilts will cost an extra $25,000. The standard homeowners policy excludes costs caused by ordinance or laws regulating the construction of buildings. Is this fair? Who should pay the extra expense?
3. Jupiter Island, located off the coast of south Florida, is the wealthiest town in the country. Its 620 year-round residents earn an average of just over $200,000 per year, per person. Thus, a typical household of two adults, two children, a housekeeper, a gardener/chauffeur, and a cook boasts an annual income of some $1.4 million. What is the reasoning for subsidizing hurricane insurance for residents of Jupiter Island?
4. In light of your understanding of the uninsurable nature of catastrophes, who should bear the financial burden of natural disasters?

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