BRIEFING NOTE

HURRICANES RITA AND KATRINA, THE THAI FLOODS, AND COVID-19 WHY IS IT SO IMPORTANT FOR THE INSURANCE INDUSTRY TO JOIN THE DOTS?

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Introduction

In 2005, Hurricanes Rita and Katrina battered the City of New Orleans. In 2011, widespread flooding devastated vast areas of the Kingdom of Thailand. In 2020, Covid-19 introduced a worldwide pandemic to much of the globe. In the insurance industry, what's the connection and why is it so important to join the dots, whether you are an Insurer or Coverholder?

Because there has been a seismic shift in the way in which the amount of the business interruption indemnity is calculated and that shift highlights the importance of buying B.I. insurance and significantly impacts the amount payable for the B.I. insurance that is bought.

Hurricanes Rita and Katrina: 2005

On 29 August 2005, Hurricane Katrina made landfall in Louisiana, bringing winds of 140 miles per hour and storm waters that flooded more than 80 percent of New Orleans. On 24 September 2005, Hurricane Rita extended the damage from eastern Texas to western Florida.

One of the most significant insurance law judgments to emerge from that devastation was Mr. Justice Hamblen's decision in *Orient-Express Hotels Ltd. v Assicurazioni General Spa [2010] EWHC 1186 (Comm).* In that case, the English Court was asked to consider the application of the Special Circumstances or Trends clause within the policy, a clause that was recently termed "*contractual quantification machinery*", when determining the amount of the indemnity payable for the financial loss suffered by the hotel as a result of the interruption to its business, in turn resulting from the property damage caused by the hurricanes.

In brief, the Court held that the amount of the indemnity was to be calculated by reference to the difference between the actual revenues of the hotel as against the hypothetical revenues that would have been achieved if the damage to the hotel had not occurred. Critically, in determining the hypothetical revenue, the Court ignored only the damage to the hotel. It assumed that the city remained under curfew or devastated by the hurricane. That assumption significantly depressed the hypothetical revenue that would have been earned if the hotel had not been damaged, and so reduced the amount of the indemnity payable.

Thai Floods: 2011

Between May and October 2011, a combination of tropical storms, monsoon rains and high tides brought widespread flooding across much of Thailand. Some 900 claims were presented by industrial all risk policy holders, amounting to a financial value of more than US$ 20 billion. The insurance industry rose to the challenge, and insurance professionals from companies such as MSIG, Tokio Marine Insurance and Sompo Insurance responded magnificently to the catastrophe, fully supported by the international reinsurance community.

One of the most notable hallmarks of the Thai floods was the absence of B.I. cover. Only one in four claims included a claim for B.I. cover and even then the amount of the B.I. cover purchased, measured by reference to the indemnity period covered, was only 12 weeks.

This meant that the indemnity payable for B.I. loss was significantly lower than the indemnity payable for the property damage, notwithstanding that in most cases it took the insured businesses well over a year to return to the pre-flood trading position. It also meant that whilst insurers and their cover holders still had to grapple with the *Orient-Express* decision in calculating the amount of the indemnity payable, by ignoring the flood damage but not the flood in arriving at the hypothetical revenue, the impact of *Orient-Express* was not as great as it would have been if more insureds had bought cover for longer indemnity periods.

COVID 19: 2020

In December 2019, COVID-19 emerged in Wuhan, China and then quickly erupted onto the world stage. The insurance and legal community reacted very promptly, with the English High Court and Supreme Court decisions in the *Financial Conduct Authority v Arch Insurance UK Ltd and Others (2020) EWHC 2448 and (2021) UKSC 1* providing very helpful guidance as to the application of 21 policy wordings that the Courts were asked to consider.

And perhaps the most important guidance that the English Court provided was that *Orient-Express Hotels* was no longer sound law. Specifically, that when considering the special circumstances clause, the trends clause or the "*contractual quantification machinery*" of a B.I. policy, it was necessary to calculate the hypothetical revenue by reference to the revenue that would have been earned if both the insured property damage **and** the peril giving rise to that damage, such as the hurricane, flood or pandemic, had not occurred. In other words, to return the cover holder to the position it would have been in had there been no disaster.

The Practical Impact is Huge

The practical impact of this legal U-Turn cannot be understated. In calculating the indemnity payable for B.I. loss by reference to the amounts that would have been earned if both the damage and the disaster, or peril, are ignored significantly increases the amount of the indemnity payable. For example, a resort is flattened by an island wide hurricane. Nobody will want to visit that resort until both the resort and the island are reinstated. So, if the indemnity is measured by reference to the hypothetical revenue of an undamaged resort in a damaged island, the indemnity will be depressed because nobody will go to that damaged resort. But if the indemnity is measured against an undamaged resort in an undamaged island the indemnity is hugely increased because tourists would want to visit the resort and the island.

What is the Cost? What is the Opportunity?

But if the indemnity amount increases, by changing how the quantification machinery works to the benefit of the Coverholder, then Insurers must increase the premium paid for B.I. cover. That is because the Coverholder is getting much broader cover. After all, you get what you pay for. This presents a tremendous opportunity for both the Insurer and the Coverholder.

The Insurer can properly price B.I. cover knowing that the indemnity payable will place the Coverholder in the position it would have enjoyed if the peril, and the damage, had not occurred. The Coverholder can decide whether it wants to pay that price, purchase cover and so lay off the risk of financial loss resulting from a catastrophe that causes damage not just to the Coverholder's insured property, but also wide area damage to the city, state or world.

Will this Opportunity be Lost?

In the short term, probably yes. In the long term, probably no.

We say that because we are still seeing B.I. claims being adjusted and quantified by reference to the *Orient-Express Hotels* principles, which is wrong because those principles have changed and those changes apply even if the loss occurred before the judicial decisions in *FCA.*

We also say that because the FCA decisions have overturned a universally unpopular approach to the calculation of B.I. indemnities, that introduced an artificial distinction between the damage and the peril causing the damage. Now that distinction is gone, the amount of the indemnity, and the premium payable for that indemnity can be properly priced.

And if it can be properly priced then it can be effectively sold to Coverholders as part of an industrial all risks and business interruption insurance policy, which policies are sorely needed as natural catastrophes, be they hurricane, flood or disease, occur ever more frequently.

The English Court's decision in *FCA v Arch* has brought much needed clarity to the calculation of the indemnity payable for loss resulting from B.I. losses. The insurance industry and its customers should now take advantage of the clarity provided. And be thankful to the talented lawyers acting on behalf of the Coverholders who develop such opportunities for the industry.

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