

## Insurance - European Union

### Central European floods: insurance implications

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#### Introduction

The recent severe flooding experienced in central Europe has had a significant cost for businesses in the affected area. Evacuations, property damage and infrastructure closures are among the challenges faced by those operating in a wide range of industries, including manufacturing, retail, transport, agriculture and tourism.

By way of illustration, some of the more notable effects of the floods have been as follows:

- In Prague, the Staropramen Brewery was temporarily closed as a protective measure, along with several major chemical factories.
- In Halle, the Handel Music Festival, one of the city's major sources of tourist income, was cancelled.
- In Zwickau, car production at the Volkswagen factory was stopped as damage to infrastructure raised fears that suppliers would be unable to deliver their products on time.
- In Deggendorf, car dealerships holding vehicles worth millions of euros were destroyed.
- Kronos, a bottling and packaging manufacturer, shut down production at two plants in Upper Bavaria, as workers were unable to get to work on inundated roads.
- All shipping was halted on the Austrian stretch of the Danube, as well as on extensive stretches of the Rhine, Elbe, Main and Neckar rivers.

All of these events and numerous similar ones have the potential to generate significant insurance and reinsurance claims. Those in the industry will be faced with complex factual and legal issues in dealing with such claims.

#### Property damage issues

The following questions are likely to arise in the context of property damage claims resulting from the flooding:

- Has the event triggered cover? There may be issues over, for example, whether the property damage was caused by the flooding itself (which is often excluded under the terms of property damage cover) or by wind-driven water (which is usually covered). Where flooding is covered, the use of different definitions (eg, 'flood', 'flooding' or 'storm damage') means that the scope of the protection can vary. In certain cases, policies may respond to flooding from rainfall (including flash flooding), but not to flooding from rising river levels or other breached watercourses. In some cases it will be obvious that the cause of the damage is flash flooding, but in other cases it may not. Where policies are subject to local law, it will be necessary to consider these issues from a local law perspective.
- Are there multiple events or occurrences and, if so, how will the loss be allocated between them? Although most of the rain which caused the flooding fell between May 30 and June 3 2013, subsequent sporadic rainfall continued to raise the risk of further flooding, with flash floods occurring in Warsaw on June 9 as a result of isolated thunderstorms. The flooding was caused in part by unusually heavy rainfall throughout May which resulted in the ground becoming saturated. Determination of the number of events and their respective impact can have consequences for both policyholders and underwriters. The issue can be exacerbated where there are complex multi-layer programmes with diverging interests across the layers. Notwithstanding the presence

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of hours clauses (see below), there are well-known difficulties in breaking down periods of sustained heavy weather (and the inter-relationship between different sequential weather patterns) into different events or occurrences to allocate and aggregate losses and to apply deductibles and policy limits. Synoptic analysis may be employed as a part of this exercise.

- To what extent will the cost of steps taken to mitigate loss (whether pre-emptive or reactionary), be covered (eg, under sue and labour clauses)? The answer to this will depend, in each individual case, on the terms of the contract.

### Business interruption issues

The damage to property, widespread evacuation and disruption of transport links experienced as a result of the flooding are highly likely to lead to claims in respect of business interruption. These are often the largest, most complex and most contentious claims, with many factors in play.

Considerations for policyholders, insurers and brokers, who may be required to assist in the preparation of claims, include the following:

- Establishing causation – business interruption cover is sometimes said to operate on a 'double trigger'. First, it requires property damage to be sustained by an insured peril. Second, it requires the interruption to the assured's business to result from that property damage, rather than from some other cause. In the context of flooding, issues may arise as to, for example, whether temporary inundation is sufficient to amount to 'damage' for these purposes. Assuming that there has been damage to the property, it will then be necessary to establish that the cause of that damage – in this case, flooding – was an insured peril. In a situation such as this where, as well as damage to property, factors such as evacuation and infrastructure closures are present, further causation issues may arise even where flooding is an insured peril. Where there are gaps in cover, these may be filled by appropriate extensions. Relevant extensions might include those providing cover in respect of losses caused by:
  - denial of access;
  - loss of attraction;
  - damage to a key supplier/customer; and
  - order of public/civil authorities.
- Nature and length of the indemnity period as defined by the policy – business interruption policies typically provide for a period of cover by reference to which the insured's loss is calculated. Where it may take a long time before trading conditions return to normal, it will be important to understand not only the triggers that cause the period to commence, but also the length of the period and any categories of loss that can be claimed outside the period – as is usually the case for increased costs of working.
- Presence and application of sub-limits – policies often provide for sub-limits to apply to loss from particular perils or loss of a particular nature, such as loss resulting from denial of access. The application of sub-limits, in particular whether they are cumulative (ie, whether they 'stack') or are exclusive, can have an important impact on the indemnity provided by the policy. Where, as here, loss may have been caused by a combination of different perils (eg, property damage and denial of access), issues could arise as to the different sub-limits applying to elements of a claim and the interaction between them.
- Operation and effect of adjustments clauses and/or special circumstances clauses for wide-scale area effects – in the aftermath of Hurricane Katrina, a hotel chain sought to rely on an adjustments clause in its insurance policy that required the insurer to provide for trends, variations and special circumstances to "represent, as nearly as may be reasonably practicable, the [hotel's trading] results, which but for the damage, would have been obtained [during the indemnity period]" (*Orient-Express Hotels Ltd v Assicurazioni General SpA*). The insured argued that this clause required the insurer to adjust its loss of income as if the hotel had been undamaged, without taking into account the effects of Hurricane Katrina on the wider New Orleans area. The insured's argument failed. The English court held that "but for the damage" to the insured's hotel, New Orleans would still have been devastated and so no one would have been able to visit the hotel in any event, even if they had wanted to, and that business interruption recovery was therefore limited to that available under denial of access and loss of attraction extensions. Before the US courts, an alternative approach was taken in a similar case, in which a casino argued that had it been the only undamaged building of its kind in an otherwise devastated city, it would in fact have been in a position to make huge profits, as it would have been the only facility open to those who did travel to the city, such as loss adjusters and others involved in dealing with the aftermath of the storm. However, the US court was not receptive to this argument and refused to award what it considered would have been a windfall to the assured resulting from the occurrence of the insured peril. Issues similar to these may arise in the present circumstances, where significant areas containing large numbers of businesses have been affected.
- Ability or otherwise to make up production at the affected or other locations – any ability to switch production/operations to unaffected areas and thereby continue to trade must be taken into account in calculating the level of any indemnity.
- Task of collecting and tracking information for the purpose of preparing or scrutinising a claim – business interruption claims usually require significant amounts of documentary evidence to demonstrate the impact of the insured damage on the business's profitability. This task is made even more onerous in circumstances in which records may have been destroyed by the property damage giving rise to the interruption.
- Calculation and ascertainment of increased cost of working and additional increased cost of

working claims – business interruption policies will usually cover the assured for the increased costs of working incurred as a consequence of the peril. In the absence of a contrary provision, these costs may be recovered in full, even though they extend beyond the indemnity period. It may also be necessary to take account of savings, such as reduced overheads, that may follow an interruption of business. This is in order to prevent an insured from being over-indemnified.

Contingent business interruption (CBI) has developed in recent years as businesses have become more aware of the risks and loss exposure from interruption to their supply chain or customer chain. CBI issues that could arise from the floods include the following:

- Is cover extended to include loss from denial of access and/or loss of attraction? The flooding has caused widespread closure to roads, railways and metro systems, as well as to waterways. This is likely to have had a severe effect on business in areas to which travel is impossible.
- Where CBI extensions are in place, do they nonetheless require damage to the insured's property in order for cover to respond?
- Identifying (whether generically or individually) suppliers and/or customers that fall within the scope of CBI extensions to cover – even if an assured does not suffer damage to its property resulting in business interruption, it may nonetheless experience an impact on its ability to trade as a consequence of damage suffered to a key supplier or customer. Just as it will be important for an insured and its advisers to be able to record and document the interruption suffered to the business, it will also be crucial to understand the effect and scope of any extensions to cover in respect of such interruption, which will itself involve a thorough understanding of the insured's chain of key suppliers and customers.
- Has an order of a public or civil authority been issued that is sufficient to trigger an extension providing cover for such circumstances? A number of public and civil authorities made orders providing for, among other things, evacuation in the aftermath of the flooding. Whether such an order will trigger cover will depend in each case on the wording of both the order and the extension.

### **Liability insurance issues**

After events such as these, it is not uncommon for there to be an enquiry into the losses, their extent and how they could have been avoided, and how such losses could be mitigated in future. Regardless of whether they become the subject of public scrutiny, businesses and public authorities may be exposed to liability claims depending on the adequacy and professionalism of their risk management, their preparation before the event and their disaster management during and following it. Exposures may arise, for example, from the following:

- Liabilities for contaminants or pollutants that escape from the premises as a result of flooding – for example, when similar flooding occurred in 2002, dangerous chemicals were accidentally released into the Elbe from nearby chemical factories.
- Failure to make effective contingency plans – businesses affected by the floods will consider how well their flood emergency preparations have performed as to, for example, their back-up communication facilities, document retention and safekeeping. In cases where the preparations are found to be lacking, as a result of which the business incurs greater loss, the responsible directors may consider notifying their directors and officers liability insurers.
- Design liabilities may arise where questions are raised about the adequacy of building and flood retention design, particularly where key services such as electrical and communications are located in basement areas prone to flooding.

### **Logistics issues**

Given the nature of the logistics business, where flexibility and problem solving are often the key attributes of the companies involved, many operators continued to provide services despite the flooding by re-routing cargo wherever possible and for as long as possible. However, it is inevitable that cargo will have been damaged and there will be delays resulting from the inescapable backlog, which is likely to take some time to recover fully. This gives rise to a number of potential issues for both the shippers and receivers of cargo and the companies involved in forwarding, transport, logistics and supply chain management.

Of immediate concern to the cargo interests will be the fact that while most cargo policies will cover physical loss or damage of the cargo, they do not generally cover damage caused by delay, even if the delay has been caused by an insured risk. Cargo interests may therefore find themselves uninsured under traditional cargo policies. Such claims may then be passed on to the service providers, who will doubtless look to applicable international conventions or contractual conditions to limit or exclude such liability where appropriate.

Often contract terms will seek to exclude liability for failing to adhere to the agreed departure or arrival dates, contain a *force majeure* clause and will in any event limit liability (insofar as liability attaches). *Force majeure* clauses will apply only where the *force majeure* event is the sole cause of the loss. Potential claimants will therefore be looking closely at whether there has been an intervening event caused by the service provider that was the actual cause of their loss. This might arise where, for example, the service provider fails to store perishable cargo in an appropriate environment, or where it can be argued that there were other means by which the cargo could have been carried. Each case will turn on its own facts.

## Reinsurance and retrocession issues

At present, the insured loss estimates for the floods range from €3 billion to €5.8 billion (\$4 billion to \$7 billion) and are well into property catastrophe programmes. The prospect of liability losses in addition to property losses may lead to issues arising as to whether the former are non-elemental rather than elemental losses in circumstances in which reinsurance towers are split.

It will take some time to assess whether industry loss warranties are triggered by industry losses, but the usual issues are expected to arise, such as whether loss sustained by captives should be included or whether uninsured losses that are picked up by insurers due to state decree are included.

Other issues that are likely to arise in a reinsurance context include the following:

- Issues surrounding triggers, aggregation, excess/attachment points and reinstatements;
- Regarding aggregation, property catastrophe excess-of-loss contracts usually contain an 'hours' clause that defines a 'loss occurrence' as all losses arising out of and directly occasioned by one catastrophe. Depending on the wording of the hours clause, losses caused by flood may be aggregated for 72 hours or 168 hours. It is generally up to the reinsured to choose the time and date when the applicable hours period commences and it is usually not before the reinsured's first reported losses. Issues may also arise as to how cedants' aggregations are to be verified and whether they fall within the aggregation language of the corresponding reinsurance contracts. Fact patterns, definitions and full contract wordings should be reviewed carefully;
- Follow-the-settlements and follow-the-fortunes obligations;
- Claims control clauses, which may allow reinsurers to deny claims following insurers' loss settlements that reinsurers have not controlled – this may even be the case where compliance with the clause is not strictly described as a condition precedent and where the reinsured can show that it was actually liable to pay the claim in question. Reinsureds must proceed with caution where such clauses are present. Where there is a captive or fronting arrangement, similar issues may arise as to the extent of the captive/front's role in claim investigation and negotiation;
- Cover not being 'back to back' and involving the law of different jurisdictions so that important terms may be defined differently in the direct or master insurance policy as against the reinsurance policy (eg, aggregation terms such as the definition of 'flood') – other such issues might include the reinsurance excluding floods when the original policy does not do so or a discrepancy in the period of cover. Issues may therefore arise as to how many losses or loss occurrences can be aggregated and significantly affect the number of insurance and reinsurance deductibles that may apply;
- Payments on account and how these should be managed, particularly where there is a reinsurance programme with multiple layers and potentially non-aligned interests; and
- The exclusion by some leading property reinsurers of CBI because it is difficult to underwrite on an informed basis and the risk is too difficult to price.

Moreover, reinsurers may wish to consider judicious use of inspection or records clauses in view of potential issues concerning the limited amount of claims information and documentation available, particularly in the early stages of the adjustment process.

## Key questions

The following questions are likely to arise across the spectrum of policy types:

- How are deductibles and co-insurance warranties in original policies to be applied?
- Under what law are the relevant policy obligations to be construed and in which forum are disputes to be decided? There may be significant differences in coverage positions, depending on the answers to these questions.
- To what extent will there be a waiver of claims documentation to support claims? Similarly, to what extent will any *ex gratia* settlements be recoverable from reinsurers?
- In light of the Association of Insurance and Risk Managers in Industry and Commerce guidelines, are reservations of rights off limits or are they a necessary protection while information is scarce – even if only as an interim protection? Will potential differences in practice between Europe and the United Kingdom regarding the use of reservation of rights language cause friction?
- Will Lloyd's step in and urge the London market to deal with claims in a particular way?
- Will there be cooperation between Lloyd's and London companies markets and other international markets – such as Bermuda, Japan and the Far East – so that cedants receive a consistent message, or will each market work on its own, thereby risking mixed responses by an international group that has participations on several platforms? What lessons are to be learned from the recent Queensland floods, Japan and New Zealand earthquakes, Thai floods, Japanese wind/weather events and Superstorm Sandy?

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