

# Chicago Fed Letter

## What is business interruption insurance and how is it related to the Covid-19 pandemic?

by Shanthi Ramnath, policy economist

After nonessential businesses shut down their operations to slow the spread of the Covid-19 virus in March 2020, many business owners looked to their property insurance policies for relief. Such policies often include business interruption (BI) insurance, which covers income losses if a business is forced to close. Given the shelter-in-place orders issued by state and local governments, BI coverage was assumed by many to apply. For example, Greg Wells, the chief executive of Atlantic Coast Athletic Clubs (ACAC), told the *Washington Post*: “That’s what you have this type of insurance for. If your business gets shut down, you can continue to employ people.”<sup>1</sup>

But, after closing all ACAC locations due to Covid-19, Wells was denied his claims for BI coverage. Rather than being compensated for lost revenue streams, many business owners, like Wells, have been told that losses from pandemics are generally not covered under standard BI policies. Some business owners have fought back by filing lawsuits, while legislators in a few states have talked about passing laws to mandate pandemic coverage, potentially retroactively. The outcomes of these actions

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may not be known for several years but are likely to be important, because the losses from the pandemic by businesses with BI insurance are very large and could leave some insurers insolvent after just a few months of payments.<sup>2</sup>

This *Chicago Fed Letter* explores business interruption insurance and the role it could play during the Covid-19 pandemic.

### What is business interruption insurance?

Commercial property insurance, similar to homeowners insurance, protects against damages to physical structures such as brick-and-mortar storefronts. Policies can cover (though are not limited to) risks such as fire, theft, natural disasters, and vandalism. Business interruption insurance, which is often bundled with property insurance, covers income losses and other expenses<sup>3</sup> for a specified period if a business is forced to close due to “physical loss or damage” from a covered peril. For example, if a store is destroyed by a fire, then commercial property insurance will cover the cost of repairing the physical damage to the store, while BI insurance will cover the resulting lost income from closing the store.

There are exceptions that state how BI insurance can be triggered without direct physical damage. In particular, most BI policies contain a “civil authority clause,” which covers income losses due to government closures. In this case the physical damage need not be to the policyholder’s structure, but policies state that the government closure must be due to physical damage of a nearby structure that is caused by a covered risk. This type of situation took place in Baltimore because of events following the death of Freddie Gray in April 2015. The city of Baltimore imposed a mandatory curfew to curtail rioting following Gray’s funeral that forced many restaurants and bars to close during their peak business hours. Businesses with BI insurance were eligible to recover some of the resulting income losses even if their storefront was not damaged because the closure was due to rioting, which is a covered peril.<sup>4</sup>

Throughout the Covid-19 crisis, insurers have maintained that unlike riots, pandemics are not covered under most BI policies.

Similar to the temporary curfew imposed in Baltimore, the current Covid-19 pandemic and resulting shelter-in-place orders have brought significant attention to BI insurance as a possible buffer for the substantial losses business owners are sustaining while their

premises remain closed. However, throughout the crisis, insurers have maintained that unlike riots, pandemics are not covered under most BI policies.

## Are pandemics covered in a typical business interruption insurance policy?

As much of the U.S. economy remains shut down long after shelter-in-place orders were first issued, business owners are likely poring over their respective policy’s language to determine their BI coverage. Insurers, on the other hand, are confident that pandemics are not covered mainly because losses from viruses—presumably including Covid-19—are explicitly excluded from most policies. This exclusion can be traced back to the 2002–03 severe acute respiratory syndrome (SARS) outbreak.

The first recorded case of SARS occurred in southern China in November 2002 and by December 2003 the disease had spread to 29 countries, with roughly 8,000 cases and 770 deaths.<sup>5</sup> At that time, the tourism industry in Hong Kong took a large hit. The Mandarin Oriental Hotel, whose business interruption policy included pandemic coverage, successfully sued their insurer for pandemic-related losses and received a payout of \$16 million.<sup>6</sup> This single loss served as a wake-up call for insurance companies that realized the extraordinary scope for damages should a pandemic occur. As a result, in 2006 the Insurance Services Office (ISO), a third-party organization that provides various services to insurers, created a business interruption policy template that included “an exception of loss due to virus or bacteria.” The ISO’s circular describing the change argued that pandemic coverage is not the intent of property insurance and as such, the new policy language would address any uncertainty. However, even for policies with no explicit virus exclusion, insurers argue that damage caused by a virus fails to meet any specified policy trigger (i.e., physical damage) for BI coverage.

Notwithstanding the industry’s stance that pandemics are not covered, many business owners still believe Covid-19 is a covered risk. In a recent opinion article, Thomas Keller, a prominent chef and restaurateur, wrote:

But now, when restaurateurs are contacting our insurers, we’re being told that the civil authority shutdown orders are not covered. Why? They tell us that all policies exclude pandemics. We’ve read our policies; that is simply not true. At no time were we ever told that civil authority shutdowns from a global pandemic were excluded. The word pandemic does not appear in any of our policies.<sup>7</sup>

Keller and several other well-known chefs started the Business Interruption Group (BIG) in April 2020 to demand that insurers pay Covid-19 claims. Keller has also filed suit against his own insurer,

the Hartford Fire Insurance Company.<sup>8</sup> If Keller's policy indeed omits the pandemic exclusion, then the question of whether a virus can cause physical damage and trigger coverage will likely be settled by courts where past precedent could lead to different outcomes depending on jurisdiction.<sup>9</sup> For example, business owners in states in which courts have previously ruled that toxic gases do not constitute physical damage may have a harder time arguing that the pandemic caused physical damage. On the other hand, in *Gregory Packing, Inc. v. Travelers Property Cas. Co. of America*, a New Jersey court found physical property damage was caused by ammonia gas,<sup>10</sup> suggesting possible latitude for Covid-19 to be considered a covered risk.

## Potential costs of business interruption coverage

Insurers have argued that pandemics are generally not covered by business interruption insurance, but various state legislatures have stepped in and proposed laws that would retroactively force pandemic coverage under BI insurance.<sup>11</sup> These bills are generally geared toward small businesses with fewer than 150 employees and offer insurers the option to seek reimbursement from special state funds to be set up for this purpose. The propensity to have BI coverage tends to increase by business size, and approximately one-third of small businesses have BI coverage.<sup>12</sup> Although the proposed legislation does not apply to all businesses, if insurers have been operating under the assumption that pandemics are not covered, then they will likely not have adequate liquid assets to pay BI claims, which could lead to a selloff of less liquid assets and asset sales at potentially heavily discounted prices. In effect, the economic burden of the pandemic would simply shift from affected business owners to insurers that likely had not intended to provide such coverage.

One thing to note is that the proposed legislation could pose a contract clause issue and ultimately be deemed unconstitutional. A contract clause issue can occur under certain circumstances when a government entity passes legislation that invalidates or otherwise interferes with an existing private contract.<sup>13</sup> This suggests that if insurers were to challenge the state bills, it is unclear whether they would be upheld by a court. But, if such measures are enacted—or if courts rule that BI policies must cover pandemic-related losses—the consequences for insurers would be substantial. The American Property Casualty Insurance Association (APCIA) estimates income losses for all firms with 100 or fewer employees to be on the order of \$255–\$431 billion per month.<sup>14</sup> Given that the total losses in a typical year on all commercial property lines (including business interruption insurance) are about \$20 billion and the total *annual* losses on all policies for property and casualty insurers are about \$350 billion, being forced to pay for pandemic-related losses could dramatically increase losses for P&C insurers. The property and casualty insurance industry currently has about \$800 billion in equity; thus, even a few months of payments could leave some insurers insolvent. Indeed, these payments could rival the size of programs such as the federal Paycheck Protection Program within months.<sup>15</sup>

## The future of business interruption insurance

The Covid-19 crisis has highlighted some shortcomings in the private insurance market for pandemic coverage, and this raises the broader question of whether pandemics should be covered by business interruption insurance. According to David A. Sampson, president and CEO of the American Property Casualty Insurance Association, “pandemic outbreaks are uninsured because they are uninsurable.”<sup>16</sup> Insurers benefit from diversifying risk, but diversifying pandemic risk is particularly difficult as a large number of businesses and households are often affected at once, which in turn can create substantial losses. As such, products aimed specifically at providing pandemic coverage are often expensive and typically have low demand.<sup>17</sup> It is also unclear to what extent that low demand in the past was driven by misperceptions among business owners that pandemic losses would be covered by their standard BI policies.

Many business owners clearly believed their BI insurance would cover losses due to Covid-19. Widespread dissatisfaction with how insurers have been handling the crisis may ultimately hurt the industry's

bottom line through lowered demand for products. For example, in the UK, there are reports of unhappy business owners declining to purchase future BI coverage after having their Covid-19 claims turned down.<sup>18</sup> Forgoing BI insurance is especially problematic if businesses are left exposed to risks, such as fire and theft, that would be covered. This also suggests that regardless of whether or not Covid-19 claims are ultimately covered by insurers, the crisis may have permanently altered the market for BI insurance.

## Conclusion

The role that BI insurance will play during the Covid-19 pandemic remains to be determined. Nonetheless, the crisis has brought to light a large gap between the coverage business owners believe they have and the coverage insurers are actually willing to provide. Moving beyond Covid-19, to insure against future pandemic risks, private insurers and government entities may need to consider new arrangements, such as the formation of partnerships, in order to balance the need for comprehensive coverage against the high cost to private insurers of covering an “uninsurable” risk.

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### Notes

<sup>1</sup> More details available online, <https://www.washingtonpost.com/business/2020/04/22/businesses-insurance-coverage-coronavirus/>.

<sup>2</sup> More details available online, <https://www.cnbc.com/2020/04/20/insurers-are-denying-coronavirus-claims-restaurants-are-fighting-back.html>.

<sup>3</sup> Other expenses can include operating expenses, a move to a temporary location, payroll (usually for a year), taxes, and loan payments.

<sup>4</sup> More details available online, <https://www.baltimoresun.com/business/bs-bz-riot-insurance-20150501-story.html>.

<sup>5</sup> More details available online, <https://www.cdc.gov/about/history/sars/timeline.htm>.

<sup>6</sup> More details available online, <https://www.whiteandwilliams.com/resources/alerts-ISO-Excluded-Coronavirus-Coverage-15-Years-Ago.html>.

<sup>7</sup> Available online, <https://www.nbcnews.com/think/opinion/coronavirus-restaurant-closures-are-devastating-we-thought-we-had-insurance-ncna1184521>.

<sup>8</sup> Details online, <https://www.insurancebusinessmag.com/us/news/hospitality/chef-thomas-keller-sues-insurer-over-coronavirus-business-interruption-claims-218397.aspx>.

<sup>9</sup> Details online, <https://www.businessinsurance.com/article/20200414/NEWS06/912334019/Legal-experts-prepare-for-battles-over-business-interruption-cover-COVID-19-coro>.

<sup>10</sup> Details online, <https://www.businessinsurance.com/article/20200316/NEWS06/912333554/Coronavirus-coverage-tied-to-physical-damage-definition-Experts>.

<sup>11</sup> More detailed information on state proposals available online, <https://www.natlawreview.com/article/covid-19-states-attempt-to-shift-economic-burden-to-insurance-industry-new>.

<sup>12</sup> Details online, <https://money.usnews.com/money/personal-finance/saving-and-budgeting/articles/what-is-business-interruption-insurance>.

<sup>13</sup> Details online, <https://www.law.cornell.edu/constitution-conan/article-1/section-10/clause-1>.

<sup>14</sup> More details online, <http://www.pciaa.net/pciwebsite/cms/content/viewpage?sitePageId=60052>. Note that the estimate applies to the U.S., whereas insurers would only pay losses in states that pass laws to retroactively cover pandemic losses. States with proposed legislation comprise roughly 20% of total commercial property insurance premiums in the U.S.

<sup>15</sup> More information on the Paycheck Protection Program available online, <https://home.treasury.gov/system/files/136/PPP-Fact-Sheet.pdf>.

<sup>16</sup> See online, <http://www.pciaa.net/pciwebsite/cms/content/viewpage?sitePageId=60052>.

<sup>17</sup>More information available online, <https://www.cnn.com/2020/03/19/business/pandemic-insurance-coronavirus/index.html>.

<sup>18</sup>More information available online (by subscription), <https://www.ft.com/content/ba7b8321-73a0-442d-ac85-74ad09019223>.

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