

A Practical Guide to Evaluating Contingent Business Interruption Losses

by

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I. INTRODUCTION

Contingent business interruption (“CBI”) insurance provides coverage to an insured when a supplier or a key customer suffers a direct physical loss that interrupts the insured’s own business (*e.g.*, revenue stream).¹ Just as property insurance generally restores damaged real or personal property, placing the insured in the same physical situation as if no loss had occurred, business interruption (“BI”) insurance is intended to restore profits lost as a result of an insured casualty event, placing the insured in the same financial situation as if the loss had not happened.² BI insurance protects against the loss of prospective earnings because of the interruption of the insured’s business caused by an insured peril to the insured’s own property. In contrast, CBI insurance protects against the loss of prospective earnings because of the interruption of the insured’s business caused by an insured peril to property that the insured does not own, operate, or control.³

CBI insurance is becoming a more prevalent component of property coverage as a result of converging economic and world events.⁴ Specifically, as companies move from vertical integration to outsourcing various operations (*e.g.*, ranging from the manufacture of component parts to services that include software development, accounting, etc.), their contingent business interruption risk is increased as a result of losing direct control of critical segments of their operations.⁵

Thus, companies routinely have supply chain interdependencies and/or technology dependencies that directly affect finished goods, services and/or revenue

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¹ Bruce R. Kaliner, *The Expanding Role of Contingent Business Interruption Insurance*, § 17 MEALEY’S BUSINESS INTERRUPTION INS. (Volume 3, 1st ed. 2003).

² Jess B. Millikan, *Practice Tips: Time Element Losses During Catastrophes*, 31 *The Brief* 52 (ABA Spring 2002).

³ *CII Carbon, L.L.C. v. National Union Fire Insurance Company of Louisiana, Inc.*, 918 So. 2d 1060, 1061 n.1 (La. Ct. App. 2005).

⁴ Bruce R. Kaliner, *The Expanding Role of Contingent Business Interruption Insurance*, § 17 MEALEY’S BUSINESS INTERRUPTION INS. (Volume 3, 1st ed. 2003).

⁵ *Id.*

dependence from key customers.⁶ Risk managers are increasingly becoming sensitive to the fact that world events such as terrorism or riots, regional incidents such as power blackouts or hurricanes, or local occurrences such as strikes, fires, floods or explosions can have far reaching effects on their company even if supply chain risk solutions, crisis management or business contingency plans are in place.⁷

II. FOCUS OF THIS ARTICLE

Calculating lost income is considerably more conceptual and theoretical than evaluating and determining replacement or repair of damaged property.⁸ Business interruption evaluation often involves theoretical calculations that require significant and difficult projections such as a projection of the period of interruption and of the business that would have been conducted during the period of interruption.⁹ Adjustment of a business interruption loss therefore often requires the parties to apply the terms of the policy against an estimate of what the business would have earned had the loss not occurred.¹⁰ The exercise is challenging because it requires "proof" of something which never occurred but what should have occurred but for an interrupting event.

Even where the loss affects a single insured with accurate and comprehensive financial records that suffers a distinct period of interruption, an adjuster may be engaged in an imaginary exercise to estimate what that business would have spent and would have earned had there been no loss.¹¹ This article is designed to recognize that CBI losses present difficult legal and adjustment issues and to assist professionals in materializing this often illusory concept in order to assist in more accurate determinations of these losses.

III. PURPOSE OF CONTINGENT BUSINESS INTERRUPTION

Some businesses lose income due to loss or damage to property at the insured's premises,¹² while many businesses suffer losses from damage to property of others on whom the businesses are dependent.¹³ "Others" may include suppliers, customers or customer magnets that, if their function is impaired by property loss, will have a detrimental impact on the insured's business.¹⁴ CBI coverage is

⁶ *Id.*

⁷ *Id.*

⁸ Jess B. Millikan, *Practice Tips: Time Element Losses During Catastrophes*, 31 *The Brief* 52 (ABA Spring 2002).

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² Paula B. Tarr, *Where have all the customers gone? Business interruption for Off Premises Events*, 30 *The Brief* 20 (ABA Winter 2001).

¹³ *Id.*

¹⁴ *Id.*

designed to insure the individual business or the individual whose income is largely *contingent or dependent on* the property of some other business entity;¹⁵ in other words, CBI protects insureds who sustain an interruption of their own business caused by an interruption in the flow of goods or services provided by other businesses.¹⁶

IV. COVERAGE LANGUAGE

ISO's Business Income from Dependent Properties—Broad Form contains the following grant of coverage:

We will pay for the actual loss of Business Income you sustain due to the necessary suspension of your operations during the "period of restoration." The suspension must be caused by the direct physical loss of or damage to "dependent property" at a premises described in the Schedule caused by or resulting from any Covered Cause of Loss.¹⁷

The kinds of properties appropriately considered "dependent" are those at which physical damage would directly affect the insured's business operations: those who supply materials for the insured, purchase the insured's goods, or attract customers to the insured's business. "Dependent properties" include contributing locations, recipient locations, manufacturing locations, and leader locations. Commonly, the supplier's property is called the "contributing location," the customer's property is called the "recipient location," the manufacturers' property is called the "manufacturing location," and the customer magnet property is called the "leader location." These are all businesses that are not owned, operated or controlled by the insured. There are, however, other kinds of properties that if physically damaged would affect the insured's employees — local restaurants where employees often purchase their meals, gas stations where employees fuel cars to drive to work, and the employees' own homes. Loss of these might have an indirect effect on the insured's bottom line by increasing absenteeism and tardiness and generally decreasing employee efficiency. However, these are not contingent or dependent properties for purposes of contingent business income coverage.¹⁸

V. PRACTICAL APPLICATIONS OF CONTINGENT BUSINESS INTERRUPTION CONCEPTS

Contingent business interruption losses measured by the above policy language may occur at a variety of locations: (1) physical damage or destruction may occur to an insured's supplier's real or personal property, which makes the supplier unable to provide the needed goods or services to the insured (a "Contributing

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Paula B. Tarr, *Where have all the customers gone? Business interruption for Off Premises Events*, 30 The Brief 20 (ABA Winter 2001).

¹⁸ *Id.*

Location”); (2) the insured’s customers cannot receive or use the insured’s goods or services because of physical destruction or damage to the customers’ real or personal property (the “Recipient Location”); (3) physical damage or destruction occurs to the property where products are manufactured for delivery to the insured’s customers under a contract of sale (the “Manufacturing Location”); or (4) physical damage or destruction occurs to the property of the nearby business that attracts customers to the insured business (the “Magnet Location”).¹⁹ An application of CBI coverage at each of these premises is discussed below.

A. Where Property Damage Occurs

1. Damage to a Contributing Location

The case of *CII Carbon, L.L.C. v. National Union Fire Insurance Company of Louisiana, Inc.*²⁰ provides a good illustration of the distinction between BI coverage and CBI coverage and demonstrates damage to a Contributing Location. The insured, CII Carbon, owned a coke²¹ plant that processed coke by heating petroleum coke in kilns to make it suitable for use in the aluminum smelting industry.²² The heat-treated coke was sold to CII Carbon’s customers.²³ CII captured the heat that escaped from the coke kilns during the heating process and used it to operate a boiler that generated steam.²⁴ CII Carbon either sold the steam to neighboring plant owners or used the steam to generate electricity which it also sold.²⁵

Kaiser Aluminum and Chemical Corporation (“Kaiser”) owned and operated a Bayer plant and a powerhouse, both of which were in the same location as the CII Carbon Coke plant.²⁶ The steam produced by CII was sold to Kaiser for use in the Bayer plant.²⁷ CII Carbon subleased equipment located in the Kaiser powerhouse that was necessary for CII Carbon to operate the boiler that produced the steam that CII Carbon sold.²⁸ The boiler could not operate unless the subleased equipment at the powerhouse supplied water to the boiler and accepted the

¹⁹ *Id.*

²⁰ *CII Carbon, L.L.C. v. Nat’l Union Fire Ins Co. of Louisiana, Inc. (“CII Carbon”),* 918 So. 2d 1060, 1061 at n.1 (La. Ct. App. 2005).

²¹ Coke is a solid carbonaceous material derived from destructive distillation of low-ash, low-sulfur bituminous coal. WIKIPEDIA, available at [http://en.wikipedia.org/wiki/Coke_\(fuel\)](http://en.wikipedia.org/wiki/Coke_(fuel)), last visited September 25, 2008.

²² *CII Carbon*, 918 So. 2d at 1061.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at 1061-62.

²⁸ *Id.* at 1062.

generated steam.²⁹

On July 5, 1999, a massive explosion at the Kaiser Bayer plant caused extensive damage to the powerhouse equipment that was subleased to CII Carbon.³⁰ Although the powerhouse equipment that CII Carbon subleased was repaired by November 15, 1999, the Bayer plant did not resume operations until December 31, 2000, and CII Carbon was unable to sell steam to Kaiser between July 5, 1999 and December 31, 2000.³¹

The CBI provision in the policy had a limit of \$500,000, while the BI provision offered a higher limit.³² The insured contended CII Carbon was entitled to coverage for its loss of steam sales from July 5, 1999 through November 15, 1999 under the BI clause of the policy.³³ The insurer took the position that CII Carbon's loss of steam sales for the period of November 16, 1999 through December 31, 2000 was covered solely by the CBI clause of the policy.³⁴ By contrast, the insured contended that the loss of steam sales for the period November 16, 1999 through December 31, 2000 should have been covered under both the BI and CBI clauses of the policy.

The trial court held that (a) CII Carbon sustained a BI loss from July 5, 1999 through November 15, 1999, when the repairs to the subleased equipment were completed and the equipment could have been operational; and (b) CII Carbon sustained a CBI loss between November 15, 1999 and December 31, 2000, when the Kaiser Bayer plant resumed its normal operations.³⁵

On appeal, the Louisiana Court of Appeals affirmed, ruling that coverage under the BI clause terminated at the time repairs to the sublease powerhouse equipment were completed and that coverage after that time for loss of steam sales was governed by the CBI provision.³⁶

CII Carbon demonstrates how CBI coverage operates to insure damage or destruction to a supplier's real or personal property, which makes the supplier unable to provide the needed goods or services to the insured.

2. Damage to a Recipient Location

The concept that CBI applies to afford coverage to the insured when a dependent property that the insured does not own, lease, or operate, and the direct physical damage or loss to the dependent property causes loss to the insured is

²⁹ *Id.*

³⁰ *Id.*

³¹ *Id.* at 1061.

³² *Id.*

³³ *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

highlighted in *Zurich American Insurance Co. v. ABM Industries, Inc.*³⁷ In *ABM Industries*, ABM provided extensive janitorial and engineering services at the World Trade Center complex (“WTC”) in Manhattan.³⁸ ABM employed over 800 people at the WTC and, as part of its contract with the WTC management, was given space on the property and control over the freight elevators.³⁹ ABM provided exclusive services to the WTC common area and also had service contracts with nearly all of the WTC tenants. ABM derived a substantial part of its income from its operations at the WTC.⁴⁰ When the WTC was destroyed, ABM submitted a BI claim to Zurich for its lost income.⁴¹

Zurich brought a declaratory judgment action and argued that the claim was encompassed by the policy’s CBI coverage and therefore was subject to a \$10 million per-occurrence sub-limit.⁴² ABM responded that under the language of the Zurich policy, it had suffered a BI claim to which only the blanket one-occurrence limit of \$127,396,375 applied.⁴³ The Second Circuit agreed with ABM and held that the claim was one for BI.⁴⁴ The court found that ABM controlled and used a portion of the WTC, and in view of the policy’s extension of BI coverage to premises controlled, used, or leased or intended for use by the insured, concluded that ABM’s claim was one for BI to which no sub-limit applied.⁴⁵ Although the damage was to the property of another, CBI coverage was not applicable because the damage was to property operated by ABM, whereas the policy confined CBI coverage to the property “not operated by the insured.”⁴⁶ *ABM* exemplifies that CBI does not apply to a Recipient Location when the damage is to property operated by the insured.

3. Damage to a Manufacturing Location

In *Archer-Daniels Midland Co. v. Phoenix Assurance Company of New York*,⁴⁷ the insured, Archer Daniels Midland Company (“Archer Daniels”), a processor of farm products, claimed a CBI loss as the result of flooding of farmland from the Mississippi River.⁴⁸ Archer-Daniels contended that its losses were the result of increases in the cost of transportation because the Mississippi River was not

³⁷ *Zurich Am. Ins. Co. v. ABM Indus. Inc.*, 397 F.3d 158 (2d Cir. 2005).

³⁸ *Id.* at 161.

³⁹ *Id.* at 161-62.

⁴⁰ *Id.* at 162.

⁴¹ *Id.*

⁴² *Id.* at 163.

⁴³ *Id.*

⁴⁴ *Id.* at 168.

⁴⁵ *Id.*

⁴⁶ *Id.* at 168-69.

⁴⁷ *Archer-Daniels-Midland Co. v. Phoenix Assurance Co. of New York*, 936 F. Supp. 534 (S.D. Ill. 1996).

⁴⁸ *Id.* at 536.

navigable and that the cost of raw materials (*i.e.*, grain) increased appreciably from the flooding.⁴⁹

The CBI provision in the Archer-Daniels policy provided:

This policy covers against loss of earnings and necessary extra expense resulting from necessary interruption of business of the insured caused by damage to or destruction of real or personal property, by the perils insured against under this policy, of any supplier of goods or services which results in the inability of such supplier to supply [the insured].⁵⁰

As part of its claim, Archer-Daniels contended that it was entitled to coverage under the CBI and Extra Expense provisions of its policy because its losses were caused partially by damage to the property of the Midwest farmers who supplied it with grain and partially by damage to property of the Army Corps of Engineers, which provided navigable waterways.⁵¹

In addressing the transportation cost components of the claim, the *Archer-Daniels* court agreed with the insured and held that the Army Corps of Engineers did indeed provide services to the insured despite the absence of a contract between the Corps and the insured.⁵² The court also addressed issues concerning the “any supplier of goods and service” language and held that the Corps constituted a supplier of goods and services because the Corps designed and developed systems for the navigation of the river.⁵³ The court further ruled that the farmers who grew the crops ADM processed were “suppliers” within the meaning of the policy.⁵⁴

Turning to the raw materials component of the claim, the court held that although the farmers may have been only indirect suppliers of goods, inasmuch as the insured purchased the grain from intermediary grain dealers, the farmers were still considered suppliers.⁵⁵ Thus, to the extent the insured suffered a business income loss because of damage to property of the farmers, the insured was entitled to coverage under the CBI provision.⁵⁶

The *Archer-Daniels* ruling sets forth the requirement that for there to be CBI coverage afforded to a Manufacturing Location, physical damage must occur to the customer’s property, and there must be a causal connection between that damage and the insured’s business disruption (actual loss of income).⁵⁷ CBI

⁴⁹ *Id.*

⁵⁰ *Id.* at 540.

⁵¹ *Id.*

⁵² *Id.* at 543.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.* at 544.

⁵⁶ *Id.*

⁵⁷ Bruce R. Kaliner, *The Expanding Role of Contingent Business Interruption Insurance*, § 17

claims commonly fail because they do not meet the factors set forth in *Archer-Daniels*.⁵⁸

4. Damage to the Magnet Location

In *Philadelphia Parking Authority v. Federal Insurance Company*,⁵⁹ the Philadelphia Parking Authority (“PPA”) operated parking garages at Philadelphia International Airport. PPA filed an action against its property insurer for breach of contract and bad faith arising out of its coverage claim for losses arising from the order that grounded all civil aircraft after the September 11 terrorist attacks.⁶⁰ PPA sought recovery of business losses under the BI, CBI, and Civil Authority provisions of its policy.⁶¹

PPA claimed the phrase “direct physical loss or damage” was ambiguous because it was unclear whether the “direct physical” modified “damage” as well as “loss.”⁶² Therefore, PPA argued, the court should construe the phrase in PPA’s favor and read the word “damage” to include economic damage.⁶³ PPA’s insurer argued “direct physical” modified both “loss” and “damage,” and thus, purely economic damage was not covered under the policy.⁶⁴ The insurer further argued that because PPA had not alleged any physical damage to its insured property, recovery under any of the policy’s provisions would be precluded.⁶⁵

The court held that “direct physical loss or damage” was unambiguous and that it was clear that the CBI provision required that the interruption of operations take place “as a result of direct physical loss or damage.”⁶⁶ The court stated that because PPA made no allegation in its Complaint that the interruption of its business resulted from its economic damage, PPA failed to state a claim under the CBI provision.⁶⁷

The *PPA* decision stands for the requirement of establishing direct physical loss when seeking CBI coverage for physical damage that occurs to the property of the nearby business (here, the Philadelphia Airport) that attracts customers to the Magnet Location (here the PPA).

MEALEY’S BUSINESS INTERRUPTION INS. (Volume 3, 1st ed. 2003).

⁵⁸ *Id.*

⁵⁹ *Philadelphia Parking Auth. v. Federal Ins. Co.*, 385 F. Supp. 2d 280, 286 (S.D.N.Y. 2005).

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at 287.

⁶⁶ *Id.*

⁶⁷ *Id.*

B. How the Property Loss Is Measured

1. The Period of Indemnity

The period of indemnity under CBI coverage is specified in policy forms and equates to the defined "period of restoration." Where the repairs cannot be effected, the period of restoration is extended.⁶⁸ Generally, the period is "the time necessary 'with due diligence and dispatch' to effect repairs and replacements *at the other property*."⁶⁹ Other forms have different definitions.⁷⁰ For instance, the 2002 ISO CBI forms state that the period of restoration:

begins 72 hours after the direct physical loss caused by a covered peril occurs to the dependent property premises, and ends on the date when such property should have been repaired, rebuilt, or replaced "with reasonable speed and similar quality."⁷¹

Importantly, the period of restoration is not cut short by the expiration date of the policy.⁷² Coverage does not require that operations be shut down at the dependent property location.⁷³ It is sufficient that a fire, storm, or other covered peril occurs at the dependent premises and the insured's business is interrupted as a result.⁷⁴

Thus, CBI insurance exists only during the period of interruption for the insured, supplier, or customer.⁷⁵ Although the beginning date of the interruption is usually easy to identify, at times, disputes arise as to the ending date of the interruption when the policy does not provide a time limitation on the period of interruption.⁷⁶

⁶⁸ Jess B. Millikan, *Practice Tips: Time Element Losses During Catastrophes*, 31 *The Brief* 52 (ABA Spring 2002).

⁶⁹ Stephen A. Cozen, *Insuring Real Property* § 3.03[2] (emphasis in original).

⁷⁰ Some policies provide for an additional 365 days of coverage when the property is not rebuilt, repaired, or replaced. Andrews et al., *The Essentials of Business Interruption Coverage in the Wake of September 11*, 2001, *Mealey's Bus. Interruption Ins.* (Feb. 2002).

⁷¹ *Id.* Note that the ISO CBI forms exclude from the period of restoration any increase in the period due to the enforcement of any ordinance or law that (1) regulates the repair, demolition, or construction of any property or (2) requires anyone to test, treat, or in any way respond to the effects of pollutants.

⁷² Millikan, *supra* note 68.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ Bruce R. Kaliner, *The Expanding Role of Contingent Business Interruption Insurance*, § 17 *MEALEY'S BUSINESS INTERRUPTION INS.* (Volume 3, 1st ed. 2003).

⁷⁶ *Id.* For example, in the context of claims arising out of the attacks of September 11, there is little doubt that the period of restoration commenced on or within 72 hours of September 11, 2001. Under the language contained in many business interruption policies, that period could continue until such time as the damaged property is rebuilt, repaired, or replaced. However, it is more likely that the period will end far short of that date because most if not all businesses that were located in or around the World Trade Center reestablished operations at a new location. Andrews, *supra* note

2. Experts Used in Determining Indemnity

In *Wyndham International, Inc. v. Ace American Insurance Co.*,⁷⁷ appellant Wyndham International Inc. (“Wyndham”) appealed the trial court’s judgment granting no-evidence motions for summary judgment in its suit brought against ten insurance companies and its insurance broker (“the Insurance Companies”).⁷⁸ Wyndham sought damages of over \$66 million in BI, CBI, and other losses alleged to be the result of the airline hijackings and terrorist attacks on the World Trade Center in New York City and the Pentagon in Washington, D.C., on September 11, 2001.⁷⁹

Orders issued by the United States government, in the wake of the September 11 attacks, halted all airline service, both commercial and private, for a matter of days.⁸⁰ Wyndham asserted that these orders, along with the significantly increased travel security measures, and the reaction of the world’s population, caused reservations to be canceled and inhibited the public from using its 163 hotel and resort properties for at least the balance of September and October 2001.⁸¹

After some discovery and several motions for summary judgment were filed, the Insurance Companies moved to exclude Wyndham’s sole damages expert, David A. Borghesi, a certified public accountant.⁸² The Insurance Companies contended that Borghesi’s opinions were unreliable and irrelevant, and asked the trial court to exercise its “gatekeeper” function pursuant to Texas Rule of Evidence 702.⁸³ In their motion to exclude, the Insurance Companies asserted several reasons Borghesi’s testimony did not meet the *Robinson* test.⁸⁴ (In Texas, under the *Robinson* test, the proponent of an expert witness’ testimony must not only show that the witness is qualified as an expert, but also that the expert’s proffered testimony is relevant to the issues in the case and is based upon a reliable foundation.) The trial court agreed, and excluded Borghesi’s opinion.⁸⁵ A few days after the order was signed excluding Borghesi, the trial court considered

70. See also *Retail Brand Alliance, Inc. v. Factory Mut. Ins. Co.*, 489 F. Supp. 2d 326 (S.D.N.Y. 2007) (holding that the period of indemnity for BI coverage was tied to the condition of the insured’s building and equipment, and not to the condition of its business and using CBI clause to interpret same).

⁷⁷ *Wyndham Int’l, Inc. v. Ace Am. Ins. Co.*, 186 S.W.3d 682, 683-84 (Tex. App.—Dallas 2006, no pet.).

⁷⁸ *Id.* at 684.

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*; see *E.I. du Pont de Nemours and Co., Inc. v. Robinson* 923 S.W.2d 549 (Tex. 1995). The *Robinson* test is the Texas analog of the *Daubert* test. See *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579 (1993).

⁸⁵ *Id.*

the Insurance Companies' no-evidence motions for summary judgment.⁸⁶ Based on the exclusion of Wyndham's sole damage expert, these motions argued that there was no evidence to support Wyndham's claim on the policies of insurance, nor was there any evidence of damages.⁸⁷ These motions were granted.

In eight issues, Wyndham claimed the trial court erred in excluding its damage expert and then granting the no-evidence motions for summary judgment.⁸⁸ First, the Dallas Court of Appeals agreed with the trial court that Wyndham's internal business forecasts were not reliable because they were not prepared pursuant to any company-wide "hard and fast" rules.⁸⁹ Additionally, the August 2001 business forecasts, used by Borghesi as his basis for calculating lost income, were significantly flawed.⁹⁰ The record reflected that fewer than 1/3 of the August 2001 forecasts for 101 properties were within Wyndham's own liberal, 5% accuracy tolerance standard.⁹¹

Second, the extrapolations of revenue projections by Borghesi for 62 properties were drawn from the forecasts for the other 101 properties.⁹² The court noted that extrapolated projections premised upon unreliable and flawed forecasts merely compounded the unreliability of Borghesi's opinion.⁹³ Wyndham's explanation that the extrapolated projections only accounted for 13% of the \$66 million damage claim did not cure the unreliability of the damage calculation.⁹⁴ The court further noted that Wyndham did not offer the damage calculation in alternative pieces; rather, it urged one measure for the \$66 million.⁹⁵

Finally, the court held that Borghesi's failure to compensate for evidence of rebookings, or to compensate for any other causes which could have affected Wyndham's profitability other than the events of September 11, 2001, rendered his opinion little more than speculation, noting that an expert who is trying to find a cause of something should carefully consider alternative causes.⁹⁶

The *Wyndham* decision illustrates the need for careful and well-researched expert opinion when determining CBI loss evaluations.

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.*

3. Additional Considerations on the Presentation of Lay and Expert Opinion Testimony Regarding CBI Damages

It is beyond the scope of this paper to examine exhaustively *Daubert v. Merrill Dow Pharmaceuticals*⁹⁷ and its progeny, or to demonstrate that in the years since *Daubert* in both federal and state courts, additional attention and scrutiny has been paid to the basis of foundation for expert testimony.⁹⁸ The *Wyndham* case clearly demonstrates that to be true. In *Kumho Tire Company vs. Carmichael*,⁹⁹ the general holding of *Daubert* which sets forth the trial court's general "gatekeeping" function was applied not only to testimony based upon scientific knowledge, but also based upon testimony regarding technical or other specialized knowledge.¹⁰⁰ *Kumho* also made it clear that the test of reliability may be flexible and that *Daubert's* list of specific factors neither necessarily nor exclusively applies to all experts in every case.¹⁰¹

If the subject matter of proffered testimony consists of "scientific, technical, or other specialized knowledge" the witness must be qualified as an expert under 702 of the Federal Rules of Evidence or similar state rules. The practical effect of this is to require the party offering the expert opinion evidence to comply with the requirements of Federal Rule of Civil Procedure 26, with respect to identifying the foundations and the bases for the expert testimony. It is now well understood that the *Daubert/Kumho* gatekeeping function of a federal trial judge will extend to expert testimony pertaining to valuation of lost profits.¹⁰²

It follows then that expert opinion, when offered to support a contingent business interruption claim regarding the existence and measure of damages, should be properly supported factually, should employ appropriate accounting or economic methodology, and must be reasonable and reliable.

The same considerations which drove the decisions in *Daubert* and *Kumho* have been brought to bear on the foundation for lay opinions in federal and state court. Seven years following *Daubert*, Federal Rule of Evidence 701 was amended to eliminate the risk that the reliability requirement set forth in Federal Rule of Evidence 702 would be evaded by proffering an expert as a lay witness to the extent that the witness was providing testimony based upon scientific, technical or other specialized knowledge within the scope of Rule 702. The advisory committee notes to the 2000 amendments of Rule 701 currently provide:

That the witness is not testifying as an expert, the witness's testimony in the form of opinions or inferences is limited to those opinions or inferences which are (a)

⁹⁷ *Daubert v. Merrill Dow Pharm.*, 509 U.S. 579 (1993).

⁹⁸ *Id.*

⁹⁹ *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 141 (1999).

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Lifewise Master Funding v. Telebank*, 374 F.3d 917 (10th Cir. 2004) (testimony of plaintiff's expert witness on damages was excluded on the basis of the *Daubert* and *Kumho* decisions).

rationality based upon the perception of the witness, (b) helpful to a clear understanding of the witness's testimony or the determination of a fact and issue, and (c) not based on scientific, technical or other specialized knowledge within the scope of Rule 702.¹⁰³

Prior to the 2000 amendments to the Federal Rules of Evidence, the owner of a business was traditionally allowed to testify as to lost profits and damages as a lay witness.¹⁰⁴ Federal Rule of Evidence 701 does not change this procedure. As set forth in the advisory committee notes accompanying the 2000 amendments, "most courts have permitted the owner or officer of a business to testify to the value of projected profits of the business, without the necessity of qualifying the witness as an accountant, appraiser or similar expert."¹⁰⁵ The advisory committee notes further explain "[s]uch opinion testimony is not admitted because of experience, training or specialized knowledge within the realm of an expert, but because of the *particularized knowledge of the witness by virtue of his or her position in the business.*"¹⁰⁶ The advisory committee notes provide that the 2000 amendments were "not meant to change this analysis."¹⁰⁷

Courts have recognized that Rule 701 does not place any restrictions on the pre-amendment practice of allowing business owners or officers to testify based on particularized knowledge derived from their position.¹⁰⁸ Business owners or officers are not precluded by Rule 701 from testifying on matters that relate to their business affairs without first qualifying as an expert.¹⁰⁹ However, the business owner's or officer's lay opinion testimony must be based on the witness's own first-hand knowledge or observations.¹¹⁰ The business owner or officer must have the requisite first-hand personal knowledge about the business and the business' profits to qualify as a Rule 701 opinion witness.¹¹¹

¹⁰³ FED. R. EVID. 701.

¹⁰⁴ *Lightning Lube Inc. v. Whitco Corp.*, 4 F.3d 1153 (3d Cir. 1993) (allowing Rule 701 testimony by the owner of a corporation as to the amount of lost profits); *In re Merritt Logan, Inc.*, 901 F.2d 349, 359 (3d Cir. 1990) (allowing 701 testimony by the principal shareholder of the plaintiff concerning the company's lost profits); *Teen-Ed, Inc. v. Kimball Int'l, Inc.*, 620 F.2d 399, 403 (3d Cir. 1980) (allowing testimony by the plaintiff's accountant and bookkeeper regarding lost profits); *Securitron Magnilock Corp. v. Schnalbook*, 65 F.3d 256, 265 (2d Cir. 1995) (stating that the president of the company has personal knowledge of his business sufficient to make him eligible under 701 to testify as to how lost profits could be calculated).

¹⁰⁵ FED. R. EVID. 701 advisory committee's note at ¶ 4.

¹⁰⁶ *Id.* (emphasis added).

¹⁰⁷ *Id.*

¹⁰⁸ *Texas A&M Research Found. v. Magna Transp., Inc.*, 338 F.3d 394, 403 at n.12 (5th Cir. 2003) (citing *Tampa Bay Shipbuilding & Repair Co. v. Cedar Shipping Co.*, 320 F.3d 1213, 1222-23 (11th Cir. 2003)).

¹⁰⁹ *Magna Transp.*, 338 F.3d at 403.

¹¹⁰ *DIJO, Inc. v. Hilton Hotels Corp.*, 351 F.3d 679, 685 (5th Cir. 2003).

¹¹¹ *Id.* at 686.

In *Lifewise Master Funding v. Telebank*,¹¹² the Tenth Circuit concluded that the plaintiff corporation's CEO's testimony as to lost profits was inadmissible as a lay opinion because the CEO was not an expert in damages analysis or in any of the techniques used to create the damages model it was based on.¹¹³ The court separated the cases allowing a business owner to opine as to value into two groups.¹¹⁴ In the first group of cases, the business owner's testimony was admissible under Rule 701 because the owner had sufficient personal knowledge of the owner's business and of the factors on which the owner relied to estimate lost profits.¹¹⁵ In the second group of cases, the owner's testimony was based on straightforward, common-sense calculations.¹¹⁶ Although the witness was the CEO of the company, he did not have personal knowledge of the factors used in the damages model to calculate lost profits; therefore, the court held that his testimony was inadmissible under Rule 701.¹¹⁷

Opinion testimony as to lost profits may be further scrutinized under state law. In order to recover for lost profits under Texas law, the loss amount must be shown by reasonable certainty with competent evidence, either from the testimony of an expert or the owner.¹¹⁸ Opinion testimony regarding lost profits must be based on objective facts, figures, or data from which the lost profits amount may be ascertained.¹¹⁹ Under New York law, lost profits as damage for breach of contract are only allowed if it can be demonstrated that the lost profits were caused by the breach, the lost profits can be proved with reasonable certainty, and the particular damages were within the contemplation of the contracting parties.¹²⁰

In summary, a plaintiff may prove lost profits by competent evidence and the opinion testimony can come from an expert or by the owner.¹²¹ The witness must

¹¹² 374 F.3d 917 (10th Cir. 2004).

¹¹³ *Id.* at 928.

¹¹⁴ *Id.* at 929.

¹¹⁵ *Id.* (citing *Malloy v. Monahan*, 73 F.3d 1012, 1015-16 (10th Cir. 1996); *Lightning Lube Inc. v. Whitco Corp.*, 4 F.3d 1153, 1174-75 (3d Cir. 1993); *In re Merritt Logan, Inc.*, 901 F.2d 349, 360 (3d Cir. 1990); and *MCI Telecomms Corp. v. Wanzer*, 897 F.2d 703, 706 (4th Cir. 1990)).

¹¹⁶ *Lifewise Master Funding v. Telebank*, 374 F.3d 917, 929-30 (10th Cir. 2004) (citing *Securitron Magnilock Corp. v. Schnalbook*, 65 F.3d 256, 265 (2d Cir. 1995) (business owner calculated past lost profit damages for defamation based on actual decrease in sales); *State Office Sys., Inc. v. Olivetti Corp. of Am.*, 762 F.2d 843, 847 (10th Cir. 1985) (owner of a computer dealership calculated that its lost profits equaled its lost profit per computer multiplied by the number of lost sales); *Teen-Ed, Inc. v. Kimball Int'l, Inc.*, 620 F.2d 399, 402-03 (3d Cir. 1980) (plaintiff, an authorized dealer of defendant's product for five years, used historical gross profit margin and historical gross sales to determine lost profits)).

¹¹⁷ *Lifewise Master Funding v. Telebank*, 374 F.3d 917, 930 (10th Cir. 2004).

¹¹⁸ *Szczepanik v. First S. Trust Co.*, 883 S.W.2d 648, 649 (Tex. 1994).

¹¹⁹ *Holt Atherton Ind., Inc. v. Heine*, 835 S.W.2d 80, 84 (Tex. 1992).

¹²⁰ *Kenford Co. v. County of Erie*, 493 N.E.2d 234, 235 (N.Y. 1986).

¹²¹ *See Community Public Serv. Co. v. Gray*, 107 S.W.2d 495 (Tex. App.—El Paso 1937, no writ).

be familiar with the business.¹²² It is not necessary to prove lost profits with exact calculation. The foundation for opinions that estimate lost profits must be based upon objective data.¹²³ If the witness does not have direct knowledge of the business accounts underlying the profit calculation, the witness's opinion testimony could be found inadmissible because it is not sufficiently reliable under *Daubert*. Expert testimony is admissible if (1) the expert is qualified to testify on the topic at issue, (2) the methodology used by the expert is sufficiently reliable, and (3) the testimony will assist the trier of fact.¹²⁴ A business owner's or officer's testimony regarding lost profits should be allowed if it is based on personal knowledge and experience or it is a straightforward opinion as to lost profits using conventional methods based on the business's actual operating history. The requirement for lay witness testimony can be simply stated that lay witnesses may give opinions on the amount of damages as long as the opinion testimony is based upon personal knowledge.¹²⁵ Similarly, in order for the owner of a business to testify concerning the market value of his property, he must show some qualification to support the opinion which generally includes a statement that the owner knows the market and the value of the property within that market.¹²⁶

In a properly presented case both lay and expert witness testimony may be presented and the testimony of both lay and expert witnesses may support each other's opinions.

C. Limitations on Contingent Business Interruption Coverage

Although a finite amount of case law exists with respect to CBI losses, several jurisdictions have set limitations that curtail the circumstances when coverage exists for these losses. For instance, while the direct physical loss or damage need not shut down the dependent property for a CBI loss to be covered, if the damaged dependent property is at a premises other than a scheduled location, the coverage is generally very limited.¹²⁷ Further, a business interruption loss to the insured does not afford contingent business interruption coverage if the business interruption loss is to a subsidiary of the insured rather than the insured. Finally, CBI coverage is also limited or otherwise unavailable when the property damaged is not the property of one who supplied or received merchandise from the insured.¹²⁸

¹²² *Id.*

¹²³ See *Hole Afterton Indus. v. Heine*, 835 S.W.2d 80 (Tex. 1992).

¹²⁴ FED. R. EVID. 702; *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579 (1993).

¹²⁵ *Coker v. Burghardt*, 833 S.W.2d 306, 309 (Tex. App.—Dallas 1992, writ denied).

¹²⁶ See *Town East Ford Sales v. Gray*, 730 S.W.2d 796, 802 (Tex. App.—Dallas, 1987, no writ).

¹²⁷ Paula B. Tarr, *Where have all the customers gone? Business interruption for Off Premises Events*, 30 The Brief 20 (ABA Winter 2001); *Pentair, Inc. v. American Guar. & Liab. Ins. Co.*, 400 F.3d 613 (8th Cir. 2005).

¹²⁸ *Pentair*, 400 F.3d at 613.

1. The Direct Physical Loss or Damage to Dependent Property Must Result From a Covered Peril at the Requisite Location

CBI coverage requires that the direct physical loss must be to the supplier's or customer's property. Although the insured will have its own physical damage or pecuniary loss, the actual direct physical loss or damage must be sustained by the supplier or customer — which distinguishes BI coverage from CBI coverage.¹²⁹

Some courts extend the direct physical loss requirement to situations where products, premises or locations become unsafe or unsuitable,¹³⁰ while other courts require structural damage to the property.¹³¹

Further, there must be a suspension of the insured's operations. Coverage does not apply if the insured's operations were unaffected by the physical loss or damage to dependent property.¹³²

Third, the suspension of the insured's operation must be caused by the physical loss or damage to dependent property.¹³³ Coverage does not apply if the insured's business would have been inoperable anyway; for example, if the same storm caused suspension of the insured's operations and damaged a dependent property as well, damage to the dependent property would not be covered.¹³⁴

Finally, an insured must sustain an actual loss of business income during the period of restoration.¹³⁵ If the insured's cash-flow is not affected by the physical

¹²⁹ Bruce R. Kaliner, *The Expanding Role of Contingent Business Interruption Insurance*, § 17 MEALEY'S BUSINESS INTERRUPTION INS. (Volume 3, 1st ed. 2003).

¹³⁰ *Farmers Ins. Co. of Oregon v. Trutanich*, 858 P.2d 1332 (Or. Ct. App. 1993) (odors from methamphetamine cooking were deemed to be a direct physical loss); *Western Fire Ins. Co. v. First Presbyterian Church*, 437 P.2d 52 (Colo. 1968) (infiltration and contamination of the church from gasoline vapors is a direct physical loss); *Matxner v. Seaco Ins. Co.*, No. Civ. A. 96-0498-B (Mass. Super. Ct. Aug. 12, 1998) (carbon monoxide in apartment building rendering it uninhabitable is a direct physical loss); *Datatab, Inc. v. St. Paul Fire & Marine Ins. Co.*, 347 F. Supp. 36, 38 (S.D.N.Y. 1972) (computer equipment shutdown following a water main break constituted damage to the equipment); *Sentinel Mgmt. Co. v. New Hampshire Ins. Co.*, 563 N.W.2d 296, 300 (Minn. Ct. App. 1997) (direct physical loss can exist without destruction of structural damage to property; sufficient to say that the insured property is injured in some way).

¹³¹ Bruce R. Kaliner, *The Expanding Role of Contingent Business Interruption Insurance*, § 17 MEALEY'S BUSINESS INTERRUPTION INS. (Volume 3, 1st ed. 2003) (citing *Great Northern Ins. Co. v. Benjamin Franklin Fed. Sav. and Loan Ass'n*, 793 F. Supp. 259 (D. Or. 1990) (no direct physical loss from discovery of asbestos insulation material in building if building is intact and undamaged and loss is solely economic); *Pentair v. American Guar. & Liab. Ins. Co.*, No. Civ 02-3696, 2003 U.S. Dist. LEXIS 13521 (D. Minn. July 31, 2003) (no direct physical loss or damage under the policy when loss involved damage to a power company's substation that provided electricity to the insured; this was not a recoverable CBI claim).

¹³² Paula B. Tarr, *Where have all the customers gone? Business interruption for Off Premises Events*, 30 *The Brief* 20 (ABA Winter 2001).

¹³³ *Id.*

¹³⁴ *Id.*

¹³⁵ *Id.*

loss or damage to the dependent property because the insured has sufficient inventory to meet orders during the period of restoration, there is no recovery.¹³⁶ Loss of sales after the period of restoration is not recoverable.¹³⁷

Moreover, actual loss of business income must be caused by the suspension that resulted from the physical loss or damage to dependent property.¹³⁸ There can be a reduction in business income caused by the peril that is not caused by a suspension of the insured's operations that resulted from physical loss or damage to dependent properties.¹³⁹ For example, if the peril is storm damage and bad weather simply influences people to stay home, or people are too occupied with their own storm-related problems, potential customers may choose not to patronize the insured business.¹⁴⁰ Falloff in business income resulting from such factors is not the consequence of suspension of the insured's operations and would not be indemnified under contingent business interruption coverage.¹⁴¹

2. No Contingent Business Interruption Coverage If the Business Interruption Loss Is to a Subsidiary of the Insured Rather Than the Insured

*Pentair, Inc. v. American Guarantee and Liability Insurance Company*¹⁴² addressed contingent business interruption coverage and the limitations that arise when the loss occurs to an entity that is not the entity named or otherwise insured under the policy but is in some way affiliated with the insured. In *Pentair*, an earthquake struck Taiwan, disabling a substation that provided power to two Taiwanese factories. The two factories, without power, could not manufacture products that they supplied to a subsidiary of Pentair, the insured.¹⁴³ Pentair sought to recover under the contingent business interruption clause of its policy.¹⁴⁴ The trial court held there was no coverage, and the Eighth Circuit Court of Appeals affirmed.¹⁴⁵

First, although the two factories were suppliers of Pentair, the substation that was physically damaged was not a supplier of Pentair.¹⁴⁶ The court of appeals explained that although the substation provided power to the two factories, it did

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² *Pentair*, 400 F.3d at 613.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ *Id.*

¹⁴⁶ *Id.* at 615.

not provide a product or service ultimately used by Pentair.¹⁴⁷ Second, the court rejected Pentair's argument that the power outage caused direct physical loss or damage to the two factories because the factories were unable to perform or produce products.¹⁴⁸ The court held that mere loss of function does not constitute direct physical loss or damage. As the court explained, if Pentair's argument were adopted it "would mean that direct physical loss or damage is established whenever property cannot be used for its intended purpose."¹⁴⁹

3. No Contingent Business Interruption Coverage If the Contingent Property Did Not Supply or Receive Merchandise from the Insured

In *Royal Indemnity Company v. Retail Brand Alliance, Inc.*,¹⁵⁰ the court ruled that the insured, which owned a Brooks Brothers store near the World Trade Center, could not recover contingent business interruption coverage. The court held that although Brooks Brothers contended it depended on the World Trade Center for its income stream, it was not a "dependent" property because the businesses in the World Trade Center (*i.e.*, the properties that suffered the direct physical loss or damage) did not supply or receive merchandise from Brooks Brothers. As the court summarized, "[t]he fact that individuals that worked in the WTC also purchased clothing at Brooks Brothers does not render the WTC a 'dependent' property."

VI. CONCLUSION

As John F. Kennedy said, "I dream of things that never were," the authors similarly acknowledge that calculating lost income is, by definition, speculative.¹⁵¹ Most policies expressly provide for consideration for the past history of the business and its profit, had not loss occurred.¹⁵² Where the calculation of business income is too speculative, however, recovery will be denied.¹⁵³ Likewise, where the business is losing money, recovery will be allowed under most policy forms only to the extent that the business would have earned its operating expenses.¹⁵⁴

When encountering future CBI losses, we anticipate this excerpt will assist professionals estimating contingent business interruption losses and will educate insureds when interruption of their own business is caused by an interruption in

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.* at 616.

¹⁵⁰ *Royal Indemn. Co. v. Retail Brand Alliance, Inc.*, 33 A.D.3d 392, 822 N.Y.S.2d 268 (2006).

¹⁵¹ Jess B. Millikan, *Practice Tips: Time Element Losses During Catastrophes*, 31 *The Brief* 52 (ABA Spring 2002).

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.*

the flow of goods or services. Additionally, we hope that this article clarifies that the 2000 amendments to Federal Rule of Evidence 701 rendered a somewhat fuzzy distinction between "specialized" knowledge that must be cited by an expert and "particularized" knowledge that must be borne by a lay witness. By requiring a business owner's knowledge to be "particularized," this rule of convenience for business owners could allow a business owner to testify about a loss she has suffered, provided that the foundation of her testimony arises from her experience in her respective business. While the practical application of the "particularized" knowledge requirement will no doubt heighten the scrutiny given to business owners as they use their "experience" to support their claim of contingent business interruption losses, the 2000 amendments allowing "particularized" knowledge seem to embody the oft-remembered statement of the great justice Oliver Wendell Holmes: "The life of the law has not been logic; it has been experience."