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Uncharted Waters: Coverage Litigation After Superstorm Sandy

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The swirling mass of clouds could be seen by astronauts from the International Space Station as then Hurricane Sandy made its approach off the coast of the Eastern United States.[1] As the colossal storm was set to collide with the East Coast on Halloween weekend, the media coined the term "Frankenstorm" to describe how Sandy was on track to merge with a second storm coming from the Midwest.[2] Upping the stakes, Sandy was set to hit New York during high-tide and at full moon. When Sandy finally made landfall near Brigantine, New Jersey, on October 29, 2012, it was destined to be a storm for the ages.[3]

Nothing close to Sandy had hit the region in over 100 years. Experts estimate that damages in the United States are in the range of $50 billion, making it the second-costliest cyclone since modern record keeping began in 1900.[4] In

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[1] http://www.nasa.gov/multimedia/videogallery/index.html?media_id=154762221

[2] Brian K. Sullivan and Matthew Brown, *Worst Storm in 100 Years Seen for Northeast U.S.*, Bloomberg News, (Oct. 26, 2012, 8:44 AM), http://www.bloomberg.com/news/2012-10-25/u-s-east-from-washington-to-nyc-at-risk-from-hurricane-sandy.html.

[3] According to the formal technical report of February 12, 2013, issued by the National Hurricane Center on behalf of the National Oceanic Atmospheric Association (NOAA), Sandy was no longer a hurricane when it made landfall in New Jersey, but was instead a post-tropical cyclone. *See*, National Hurricane Center. *Tropical Cyclone Report Hurricane Sandy*, by Eric S. Blake, Todd B. Kimberlain, Robert J. Berg, John P. Cangialosi and John L. Beven II. (February 12, 2013). http://www.nhc.noaa.gov/data/tcr/AL182012_Sandy.pdf. Similarly, the governors of New York, New Jersey and Connecticut each classified Sandy as a *non*-hurricane. Thus exempting homeowners from paying policy hurricane deductibles.

[4] National Hurricane Center. *Tropical Cyclone Report Hurricane Sandy*, by Eric S. Blake, Todd B. Kimberlain, Robert J. Berg, John P. Cangialosi and John L. Beven II. (February 12, 2013). http://www.nhc.noaa.gov/data/tcr/AL182012_Sandy.pdf.

January, 2013, Fitch Ratings estimated that the insurance industry alone will see losses in excess of $20 billion.[5]

With such a staggering loss, and given the amount of people and businesses affected by Sandy, New York is certain to experience an unprecedented influx of insurance coverage litigation. This article examines some of the insurance coverage issues certain to arise in the aftermath of Sandy, and discusses the case law New York courts may look to for guidance when deciding how to best resolve the surge of insurance claims arising from Sandy.

I. OVERVIEW OF FIRST PARTY COVERAGE

Most individuals and businesses are protected by both third and first-party coverage. Each form protects wholly different interests.

In simple terms, third-party coverage (i.e. liability coverage) protects an insured against claims by third parties arising out of the insured's own conduct. The insurer has a contractual duty to defend and indemnify an insured against third-party claims, so long as the allegations fall within the terms of the policy. For example, a Commercial General Liability policy (otherwise known as a CGL policy) provides "coverage for tort liability for physical damage to others and not for contractual liability of the insured for economic loss because the product ... is

[5] Ben Fox Rubin, *UPDATE: Fitch Sees Insurance Losses From Sandy to be $20 Billion or More*, The Wall Street Journal, (Jan. 8, 2013, 11:28 AM), http://online.wsj.com/article/BT-CO-20130108-706934.html.

not what the damaged [party] bargained for."[6] Given the broad duty to defend under New York law, third-party coverage has often times been described as "litigation insurance."[7]

By contrast, first-party insurance coverage typically requires that the insurer pay proceeds *directly* to an insured for damage to that insured's *own* property. A first-party policy can be a valuable shield against losses arising out of natural disasters such as Sandy. First-party coverage creates a duty to indemnify (i.e. pay) the insured for damage within the coverage of the policy. This is an important point. The contract will set out what property is covered and under what circumstances.

First-Party insurance comes in many different forms, such as a stand-alone policy or as part of a portfolio policy. Specific types of first-party insurance include, commercial property insurance, business interruption coverage, homeowners insurance, automobile insurance, fire insurance and flood insurance.

Businesses and homeowners alike rely on property insurance to cover damage to their property following unexpected disaster. The insurers duty to indemnify is triggered under a property insurance policy when covered property is damaged. But often, as many can attest following Sandy, it is not always as easy

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[6] *Bonded Concrete, Inc. v. Transcon. Ins. Co.*, 12 A.D.3d 761, 762, 784 N.Y.S.2d 212, 213 (1st Dept. 2004), *quoting Hartford Acc. & Indem. Co. v. Reale & Sons*, 228 A.D.2d 935, 936, 644 N.Y.S.2d 442 (3d Dept. 1996).

[7] *See*, *Servidone Const. Corp. v. Sec. Ins. Co. of Hartford*, 64 N.Y.2d 419, 423, 477 N.E.2d 441, 444 (1985); *Hotel des Artistes, Inc. v. Gen. Acc. Ins. Co. of Am.*, 9 A.D.3d 181, 187, 775 N.Y.S.2d 262, 267 (1st Dept. 2004).

to determine whether the storm damage was indeed covered under the policy form.

II. GROUNDWATER, FLOOD AND SURGE COVERAGE

A. The Flood Exclusion

As insurance carriers confront Sandy-related claims, many disclaim coverage on the basis that damage was caused by flooding, and thus excluded under their policies. Many property insurance policies contain a "flood exclusion" that excludes coverage for damage caused by water damage. The typical flood exclusion provides that the insurance does not apply for losses "caused directly or indirectly by" water damage. "Water Damage" can have several different definitions, but a common insurance policy definition is loss caused by:

> flood, surface water, waves, tidal water, overflow of a body of water or spray from any of these whether wind driven or not;

While an insured bears the burden of demonstrating that a loss took place under the terms of the policy, an insurer bears the burden of demonstrating that a policy exclusion applies to bar coverage.[8] Because insurers are perceived to wield greater bargaining power, courts tend to give a narrow construction to

[8] *See*, *MBIA Inc. v. Fed. Ins. Co.*, 652 F.3d 152, 158 (2d Cir. 2011).

exclusionary clauses.[9] Any ambiguity in the policy is generally decided in the insured's favor.[10]

When the floodwaters receded after Katrina, insurers were faced with the threshold question of whether -- and to what extent -- there was property damage attributable to a "flood," and thus excluded. One of the first questions that arose in the post-Katrina litigation was what exactly constitutes a "flood."

In a seminal decision addressing the application of the flood exclusion, *In re Katrina Canal Breaches Litigation*, 495 F.3d 191 (5th Cir. 2007), the Fifth Circuit ruled that the flood exclusion was clear, unambiguous and enforceable. *In re Katrina Canal Breaches Litigation* involved a dispute between insureds and insurers regarding the embrace of the term "flood." The insureds argued that the term "flood" was ambiguous, as it could apply to both natural and unnatural flooding, and therefore it should only apply to natural occurrences. This distinction was of particular importance following Katrina because much of the flooding was the result of the levees giving way during the storm surge. The district court ruled in favor of the insureds.

In a much anticipated appeal, the Fifth Circuit reversed the district court and held that the "enormous and devastating inundation of water into the city… was a 'flood' within that term's generally prevailing meaning as used in common parlance, and [their] interpretation of the exclusions ends there." *Id*. at 221. The

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[9] *See, Inc. Vill. of Cedarhurst v. Hanover Ins. Co.*, 89 N.Y.2d 293, 675 N.E.2d 822 (1996).
[10] *See, White v. Continental Cas. Co.*, 9 N.Y.3d 264, 267, 848 N.Y.S.2d 603, 605 (2007).

Court of Appeals noted that a term is not ambiguous simply because it has multiple definitions. *Id*. at 211.

The Louisiana Supreme Court likewise found the flood exclusion to be unambiguous, and thus enforceable in a post-Katrina decision. The case of *Sher v. Lafayette Ins. Co.*, 988 So. 2d 186 (La. 2008), involved a 92-year-old Holocaust survivor, who owned a five-unit apartment building in which she also lived. The owner-insured purchased a commercial all-risk policy from Lafayette Insurance Company to cover the building. The policy contained a typical flood exclusion. Lafayette conducted an inspection of the damage to the building following Katrina and determined that most of the damage was barred by the flood exclusion, or was not covered because the damage was pre-existing wear and tear.

The Louisiana Supreme Court reversed the lower court and held that the flood exclusion was clear and unambiguous. The Court adopted the ordinary understanding of the word "flood" as meaning "the overflow of a body of water causing a large amount of water to cover an area that is usually dry, including both man-made and natural disasters." The Court ruled that expert testimony demonstrated that the damage to the lower portion of the insured building was solely the result of flood damage.

Without clear guidance from the state courts, the Fifth Circuit routinely rejected arguments by policyholders attempting to limit the scope of the flood exclusion, declaring that the exclusion bars coverage for damage caused by wind-

driven storm surge. *See, Leonard v. Nationwide Mut. Ins. Co.*, 499 F.3d 419 (5th Cir. 2007); *Tuepker v. State Farm Fire & Casualty Co.*, 507 F.3d 346 (5th Cir. 2007).

New York courts have not squarely addressed the specific issues that arise when a powerful weather event -- such as Sandy -- causes damage. But several decisions have upheld the flood exclusion and offer some guidance.

In *E.B. Metal & Rubber Industries, Inc. v Federal Ins. Co.*, 84 A.D.2d 662, 444 N.Y.S.2d 321 (3d Dept. 1981), following days of heavy rain, a dike constructed to restrain the waters of the canal gave way, and water inundated the insured's facility. The property insurance policy covering the facility contained an exclusion for damage from "flood," which was defined as "waves, tidal water or tidal wave, rising (including overflowing or breaking of boundaries) of lakes, reservoirs, rivers, streams or other bodies of water, whether driven by wind or not." The Appellate Division, Third Department ruled that the exclusion was unambiguous, and precluded coverage for damage to the property resulting from the breach of the dike. The Court held that it was irrelevant whether a defect in the dike also contributed to the loss.

In *B & W Heat Treating Co., Inc. v. Hartford Fire Ins. Co.*, 23 A.D.3d 1102, 1103, 803 N.Y.S.2d 870 (4th Dept. 2005), the insured was covered for damage to its property "solely caused by water that backs up from a sewer or drain." The policy also contained a flood exclusion that defined a "flood" as

"overflow of surface water, streams or other bodies of water, or their spray, all whether driven by wind or not." The insured's property was damaged by flooding. The flood resulted in water from a clogged drain causing *further* damage. The Appellate Division, Fourth Department declared that the policy excluded coverage for the loss because it resulted from flooding. The court held that although the property was also damaged by water that backed up from a drain, the backup was not the *sole* cause of the damage, and therefore the entire claim was excluded.

An insurer successfully disclaimed coverage based on the flood exclusion in *K.J.D.E. Corp. v. Hartford Fire Ins. Co.*, 89 A.D.3d 1531, 932 N.Y.S.2d 778 (4th Dept. 2011), claiming that there was no coverage for the loss resulting from flooding of the insured's parcel of land. The policy defined "flood" as "[s]urface water or overflow of any natural or man[-]made body of water from its boundaries." After two days of heavy rain, the insured's property was "flooded" when road culverts, blocked by a build-up of debris, caused an abutting creek to overflow. The Appellate Division, Fourth Department held that the insurer satisfied its burden of proof that a flood caused the damage, and the insured's assertion that the clogged culverts actually caused the flooding did not raise a material issue of fact precluding summary judgment.

But where a policy contains a flood exclusion that only bars coverage for naturally occurring floods, New York courts will not enforce the exclusion when

water damage results from an artificial device. *See, e.g.*, *Rovelli v. Allstate Ins. Co.*, 38 A.D.3d 241, 831 N.Y.S.2d 150 (2007) (flood exclusion in homeowners' insurance policy was inapplicable where pipe burst); *Ender v. Nat'l Fire Ins. Co. of Hartford*, 169 A.D.2d 420, 421, 563 N.Y.S.2d 85 (1st Dept. 1991) (flood exclusion did not bar coverage for water damage caused by a break in the city's water main, where flood exclusion did not expressly preclude damages arising from artificial devices).

B. Concurrent Causation Issues

When disaster strikes in the form of a catastrophic storm, it is often difficult to distinguish between damage that was caused by wind (covered) and damage caused by flooding (excluded). When a single cause is responsible for a loss, the evaluation is straightforward. But some policies offer no guidance as to whether an occurrence is covered when a covered cause and an excluded cause contribute to the same occurrence. This dilemma is known as the "concurrent causation" problem. Typically, hurricanes and tropical storms involve wind, storm surge and flood damage.

Many insureds seek to avoid the consequences of the flood exclusion by arguing that their property was not damaged by flood, but instead by severe winds that struck ahead of, or during, the weather event.

In an attempt to avoid potential ambiguity, many insurers link separate policy exclusions (including the flood exclusion) with what is termed the Anti-Concurrent Causation clause (the "ACC" clause). This clause typically provides:

> We do not insure for loss caused directly or indirectly by any of the following. . . *Such loss is excluded regardless of any other cause or event contributing concurrently or in any sequence to the loss.*

New York courts have generally upheld disclaimers of coverage based on ACC clauses, finding that such clauses are unambiguous. *See*, *Alamia v. Nationwide Mut. Fire Ins. Co.*, 495 F. Supp. 2d 362, 368 (S.D.N.Y. 2007) (pursuant to an anti-concurrent provision, no coverage for damages resulting from earth movement even though the movement was caused at least in part by a covered peril): *ABI Asset Corp. v. Twin City Fire Ins. Co.*, No. 96 CIV.2067, 1997 WL 724568, at *2 (S.D.N.Y. Nov. 18, 1997) ("New York courts have interpreted similar clauses to mean that where a loss results from multiple contributing causes, coverage is excluded if the insurer can demonstrate that any of the concurrent or contributing causes of loss are excluded by the policy").

An emerging issue in insurance coverage litigation focuses on what circumstances will trigger ACC clauses, especially following catastrophic events where damage was caused to covered property by both wind and flood. While the Gulf Coast States have had to grapple with these issues, New York, until recently, has been spared.

In one of the few reported decisions, *Steve's Pier One, Inc. v. Ins. Co. of N. Am.*, 131 A.D.2d 834, 517 N.Y.S.2d 194 (2d Dept. 1987), a building on Long Island Sound was damaged when wind-driven water from the Sound propelled objects into the building. The insurer contended that the loss was barred by the property insurance policy's flood exclusion, which defined "flooding" as "the overflow from a stream or any other body of water," and "surface water, waves, tidal waves, movements, or spray from any of these, whether driven by wind or not." Agreeing with the insurer, the Appellate Division, Second Department declared that the flood exclusion barred coverage for the loss because the water was the "proximate cause" of the damage.

Yet, because few New York cases address the concurrent causation issue, New York may turn to Gulf Coast precedent for guidance (for example, Louisiana, Mississippi or Florida).

In a seminal decision by the Court of Appeals for the Fifth Circuit following Hurricane Katrina, *Leonard v. Nationwide Mutual Ins. Co.*, 499 F.3d 419 (5th Cir. 2007), the court upheld the application of the ACC clause under Mississippi law. In *Leonard*, the insured's residence was damaged by both storm surge and wind arising out of Katrina. The Fifth Circuit first explained that the flood exclusion precludes coverage for "storm surge" whether or not expressly stated in the exclusion. The Court further held that "[t]he [ACC] clause unambiguously excludes coverage for water damage 'even if another peril' -- e.g.,

wind -- ‘contributed concurrently or in any sequence to cause the loss.” The court ruled that the ACC clause precluded coverage for damage caused exclusively by water, or wind damage caused “concurrently or in any sequence” with water.

But the Mississippi Supreme Court weighed in on the concurrent causation issue in its post-Hurricane Katrina decision, *Corbann v. USAA*, 20 So. 3d 601 (Miss. 2009), and rebuked the Fifth Circuit’s decision in *Leonard*.

The facts in *Corbann* are relatively straightforward; Katrina destroyed a large home along the Gulf Coast. The insured’s home was covered under a homeowners insurance policy issued by the United Services Automobile Association Insurance Agency (“USAA”). USAA inspected the property and obtained an engineering report to ascertain whether the loss was caused by “wind damage ... versus flood damage.” USAA disclaimed coverage under the flood exclusion because the engineers report demonstrated that the majority of physical damage to their property was due to flooding. The trial court ruled in USAA’s favor, finding that the policy’s flood exclusion and ACC clause were unambiguous and, “thereby barr[ed] coverage under the homeowner's policy for any damage caused by water as defined in the policy or caused concurrently or sequentially by wind and water in combination.”

In reversing, the Mississippi Supreme Court placed the burden on the insurance carrier to prove that the ACC clause applies by demonstrating that the excluded peril (flooding) caused the damage *before* the covered peril (wind).

Under this markedly liberal approach, an insured need only demonstrate that it suffered a "loss." The burden then shifts to the insurer to establish the percentage of damage caused by flooding, and thus excluded under its policy. In addition, *Corbann* held that where covered property sustains wind damage, the insured's right to indemnity "vests" immediately, and cannot be usurped by the ACC clause even if there was a subsequent flood causing damage to the property. Accordingly, under Mississippi law, so long as the wind first causes damage to the property, it is of no moment that flooding further damages the property.

Since wind invariably hits before a storm surge, *Corbann* is a nettlesome holding for insurance carriers post-Sandy. But, to be sure, it is an open question whether New York courts will adopt the reasoning of the Mississippi Supreme Court or instead follow a more literal construction.

The Court of Appeals for the Fifth Circuit appears to have adopted a middle ground approach in another post-Katrina case, in which the court applied Louisiana law. *See*, *Bayle v. Allstate Ins. Co.*, 615 F.3d 350 (5th Cir. 2010). In *Bayle*, when Katrina made landfall off the Gulf Coast the insured's home suffered extensive damage. The insurer and insured agreed that some combination of wind (a covered risk) and flood (an excluded risk) caused the overall damage to the insured's home. As such, the insurer compensated the insured for damage to property caused by wind, but did not compensate the insured for damage caused by flood.

Applying Louisiana law, the Fifth Circuit ruled that when an insurer moves for summary judgment, it bears the burden of demonstrating that the cause of damage was excluded from coverage. Allstate put forward a ***prima facie*** case for summary judgment by producing evidence that demonstrated that most of the damage to the insured's property was caused by flooding, and thus excluded. The Fifth Circuit held that the burden shifted to the insured to create a material question of fact regarding whether any of the property damage that the insurer refused to pay for was in fact caused by wind (a covered peril). The insured's expert did not identify any specific property that was damaged as a result of wind. Thus, the court found that the insured failed to rebut the insurer's prima facie entitlement to summary judgment.

While New York courts have not yet delved into the complex issues presented with concurrent causation, it is equally unclear whether New York courts will be persuaded by sister courts from the South. As such, insurers and policyholders alike should be circumspect about the application of this precedent to Sandy claims.

C. Mediation program for Homeowners

With Sandy coverage issues just beginning to take shape, New York State has implemented a mandatory mediation program for homeowners seeking coverage for Sandy-related damage. The New York State Department of

Financial Services has created a program wherein insureds can choose to mediate disputes with their homeowner insurance carriers over claims arising out of Sandy.[11]

The American Arbitration Association will administer New York's non-binding mediation program. While New York's program is voluntary (and free) for insureds, insurance carriers will be required -- not only participate -- but to also *pay* for the costs of the mediation.

According to the new regulation, 11 NYCRR 216.13 entitled "Mediation," the program will handle disputed real and personal property claims that arose "between October 26, 2012, and November 15, 2012, in the counties of Bronx, Kings, Nassau, New York, Orange, Queens, Richmond, Rockland, Suffolk or Westchester." § 216.13(a). The program will exclude claims for damage to automobiles.

Although an insurer must act in "good faith" an "insurer that does not alter its original decision on the claim is not, on that basis alone, failing to act in good faith if it provides a reasonable explanation for its action." § 216.13(f)(4). But, similarly, the insured is not bound by the outcome of the mediation, as the insured may still employ any other legal remedy at his or her disposal, including bringing a civil action. § 216.13(h).

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[11] New Jersey's Department of Banking and Insurance created a similar mediation program for Sandy coverage disputes with a value in excess of $1,000.

The new regulation requires that the insurance carrier provide notice to the insured of this new right to mediation with the AAA. It remains to be seen whether this mandatory mediation will prove fruitful or simply drive up the already mounting costs for many insurance carriers.

III. BUSINESS INTERRUPTION INSURANCE

A. Generally

When a business suffers loss to its physical property it is typically a straightforward task to assess its loss. But weather events, such as Sandy, typically wreak havoc of a different sort; the inability to conduct business as usual.

To protect against such catastrophe many businesses purchase "business interruption" coverage to indemnify the business for losses stemming from the inability to operate normally. Most businesses operate on tight budgets, and therefore lack the means to continue to operate without receiving insurance proceeds.[12] But not every interruption of business is covered under business interruption coverage.

The typical insuring agreement for business interruption coverage provides as follows:

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[12] *See, e.g. Bi-Econ. Mkt., Inc. v. Harleysville Ins. Co. of New York*, 10 N.Y.3d 187, 195, 886 N.E.2d 127, 131 (2008).

> "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 direct physical loss of or damage to property at premises which are described in the Declarations and for which a Business Income Limit of Insurance is shown in the Declarations. The loss or damage must be caused by or result from a Covered Cause of Loss…"

(ISO CP 00 30 06 07 (2007)).

Accordingly, an insured must establish each element of a Business Interruption claim in order for the claim to be covered. Those elements are as follows:

> a) actual loss of business income;
>
> b) due to the necessary suspension of operations
>
> c) during the "period of restoration" ("POR"); and
>
> d) the suspension of operations must be caused by direct physical loss to Covered Property as a result of a covered cause of loss.

It is imperative that no chain in the link between each element be broken. Otherwise, the policyholder is not entitled to coverage. In fact, most policyholders are surprised to find that their business interruption coverage is actually quite limited.

1. Actual Business Income

One of the more difficult and fact-sensitive inquires is how to evaluate what (if any) "actual loss of business income" the insured suffered.

Under New York law, business income does not include any loss incurred by the insured beyond scheduled repairs, even if the Covered Cause of Loss has depressed business in the area. For example, in *Admiral Indem. Co. v. Bouley Int'l Holding, LLC*, 02 CIV. 9696 (HB), 2003 WL 22682273 (S.D.N.Y. Nov. 13, 2003), an insured bakery was slightly damaged as a result of the terrorist attacks on September 11th. Although the bakery could operate as normal, it did not reopen purportedly because business had decreased substantially in lower Manhattan and the owner of the bakery could not support the bakery and another restaurant simultaneously. The district court ruled that the POR ends when the property was, or should have been, repaired regardless of any decrease in customers. Put simply, the insured could not recover additional business income losses based on a decrease in area business.

Recent amendments to ISO policy forms attempt to limit coverage where the business can open, or has opened, but unfavorable business conditions persist following a catastrophic event. One such wording reads as follows; "… Extended Business Income does not apply to loss of Business Income incurred as a result of unfavorable business conditions caused by the impact of the Covered Cause of

Loss in the area where the described premises are located." ISO CP 00 30 06 07 (2007).

Often the exact opposite is true -- if the insured's business was operating normally it would have earned *more* income because of an increase in area business due to the Covered Cause of Loss. Courts across the country are split on whether an insured can take advantage of increased demand created by a catastrophe. *See, Finger Furniture Co., Inc. v. Commonwealth Ins. Co.*, 404 F.3d 312, 314 (5th Cir.2005) ("The strongest and most reliable evidence of what a business would have done had the catastrophe not occurred is what it had been doing in the period just before the interruption"); *Prudential LMI Commercial v. Colleton Enterprises, Inc.*, 976 F.2d 727 (4th Cir. 1992) (court held that business interruption insurance was not intended to provide an insured hotel with a "windfall," and therefore it was not entitled to recover proceeds for profits it *would* have earned from an influx of temporary relief workers after Hurricane Hugo); *But see, Levitz Furniture Corp. v. Houston Cas. Co.*, CIV. A. 96-1790, 1997 WL 218256 (E.D. La. Apr. 28, 1997) (court adopted insured's argument that it was entitled to recover insurance proceeds based on the favorable market conditions for furniture following flood).

Another recent change to an ISO policy form attempts to address this ironic twist by including provisions that keep an insured from receiving insurance proceeds based on the increase in business in the surrounding area:

> The amount of Business Income loss will be determined based on . . . [t]he likely Net Income of the business if no physical loss or damage had occurred, but not including any Net Income that would likely have been earned as a result of an increase in the volume of business due to favorable business conditions caused by the impact of the Covered Cause of Loss on customers or on other businesses.

ISO CP 00 30 06 07 (1995).

Another issue yet to be addressed by New York courts but will surely be a subject of future Sandy litigation is whether an insurer can subtract "make-up" profits from the insurance proceeds. Many courts outside of New York have held that when a business has increased sales substantially post-loss, the claim must be reduced accordingly.

For example, in *Fireman's Fund Ins. Co. v. Holland Am. Line-Westours, Inc.*, 25 F. App'x 602, 603 (9th Cir. 2002), a major storm struck Seattle, causing the power supply to a cruise line's reservation center to shutdown. Once the power was restored, the cruise line's reservations actually increased. The Ninth Circuit ruled that the cruise line was not entitled to a "windfall," and therefore it was only entitled to recover its actual loss after the "make-up" reservations. *See also, Prudential LMI Commercial v. Colleton Enterprises, Inc.*, 976 F.2d 727 (4th Cir. 1992) ("Generally, business interruption insurance 'is designed to do for the insured in the event of business interruption caused by [an insured peril], just

what the business itself would have done if no interruption had occurred - no more'").

There are limited exceptions to this rule, as in *Orrill, Cordell, & Beary, L.L.C. v. CNA Ins. Co.*, CIV.A. 07-8234, 2009 WL 701714 (E.D. La. Mar. 16, 2009), where a plaintiff's law firm lost contingency fees after Hurricane Katrina damaged its office. Although the firm subsequently raised its *hourly* rates, the court ruled that the insurance carrier could not subtract the increased revenue from the firm's total business income under the policy.

2. Necessary Suspension of Operations

While business interruption policies generally require the "necessary suspension of operations," few (if any) provide any guidance as to what the term "suspension" means. Such an inquiry is typically fact-sensitive. But appears to require the total cessation of business operations.

For example, in *Broad St., LLC v. Gulf Ins. Co.*, 37 A.D.3d 126, 832 N.Y.S.2d 1 (1st Dept. 2006), a claim arising out of September, 11, the owner of a building three blocks from the World Trade Center, sought business interruption coverage for the suspension of its business. The insured claimed that it had difficulty renting out more apartments and spaces for approximately one year following the attacks of September 11th. The Appellate Division, First Department held that a "necessary suspension of operations" means that there

must be a "total interruption or cessation" of business operations. As such, the court held that business interruption coverage did not continue beyond when the tenants were permitted to return to the building.

3. The Period of Restoration

Another topic of frequent litigation is determining when the "period of restoration" has ended, which is generally a question of fact. Under business interruption coverage, the period of restoration is the period of time in which an insured business may recover proceeds for its loss. That period of time is typically defined by the policy. An example of a typical definition for a "period of restoration" is:

> Period of restoration is the time that "[b]egins 72 hours after the time of direct physical loss or damage for Business Income Coverage . . . caused by or resulting from any Covered Cause of Loss at the described premises . . . and [e]nds on the earlier of: (1) The date when the property at the described premises should be repaired, rebuilt or replaced with reasonable speed and similar quality; or (2) The date when business is resumed at a new permanent location."

ISO CP 00 30 06 95 (1994)

New York courts have addressed the issue of how long the period of restoration will extend following another catastrophic event; the attacks of September 11th.

In *Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co.*, 411 F.3d 384, 386 (2d Cir. 2005), Duane Reade operated a store in the World Trade Center ("WTC"), which St. Paul Fire & Marine Ins. Co. insured for business interruption. Duane Reade sought a declaration that its business interruption coverage continued until the entire WTC complex was rebuilt. By contrast, St. Paul argued that the coverage terminated 21 months after 9/11, because that was the amount of time that was reasonably necessary for Duane Reade to relocate its store. The Second Circuit agreed with St. Paul's position, finding that the period of restoration only extends until the "hypothetical time" it would reasonably take an insured to "repair, rebuild, or replace" its WTC store to a suitable location. *Duane Reade, Inc.*, 411 F.3d at 398.[13]

Likewise, in *Retail Brand Alliance, Inc. v. Factory Mut. Ins. Co.*, 489 F. Supp. 2d 326 (S.D.N.Y. 2007), the insured operated three women's clothing stores in the WTC, and was insured under a policy with business interruption coverage. The district court held that based on the insured's hundreds of stores across the country, its business was not dependent on the WTC. Nonetheless, the business interruption coverage did not end until the insured could open a

[13] Some courts have found that *Duane Reade, Inc.* does not apply where the insured business could not simply relocate because it has a special relationship with the affected area. For example, in *Zurich Am. Ins. Co. v. ABM Indus., Inc.*, 01 CIV. 11200 (JSR), 2006 WL 1293360 (S.D.N.Y. May 11, 2006), the insured provided janitorial services to the common areas of the WTC and to virtually all of the tenants in the WTC. The court held that the insured "cannot simply relocate to another building and carry on its business. [The appropriate POR was] "the hypothetical length of time required to rebuild the WTC." But *ABM Indus., Inc.* is a bit of an outlier because it contained very unique policy language, and applied to a very unique situation where the business had a special relationship with the affected area.

"reasonably equivalent store in a reasonably equivalent location." *Retail Brand Alliance, Inc.*, 489 F.Supp. 2d at 334, *quoting Duane Reade, Inc.*, 411 F.3d at 398.

4. Direct Physical Loss to Covered Property

Business income coverage is not intended to afford insurance for purely economic losses. To that end, there is no coverage where the insured simply cannot use the premises. There must be *physical* damage to the Covered Premises, which are typically scheduled in the list of "insured locations."

So, for example, in *Philadelphia Parking Auth. v. Fed. Ins. Co.*, 385 F. Supp. 2d 280, 289 (S.D.N.Y. 2005), the Philadelphia Parking Authority sought business income coverage for lost business after the FAA grounded air traffic after the attacks of September 11th. The court rejected the Philadelphia Parking Authority's argument that the damage provision is ambiguous, finding that the provision requires that "claimed loss or damage must be physical in nature."

In addition, the event that triggered the business income coverage must bear some relationship to the actual loss of income. No such causal relationship was found in another case arising out of the September 11th attacks. In *United Airlines, Inc. v. Ins. Co. of State of Pa.*, 385 F. Supp. 2d 343, 350 (S.D.N.Y. 2005) *aff'd sub nom. United Air Lines, Inc. v. Ins. Co. of State of PA*, 439 F.3d 128 (2d Cir. 2006), United Airlines claimed that it suffered "physical damage" to its ticket

office, which was located in the WTC and destroyed on September 11th. United Airlines claimed that the it was therefore entitled to business interruption coverage for its system-wide business losses in the amount of approximately $1.2 billion. The district court rejected United Airlines' argument, finding that it was "untenable because the amount of recovery sought bears no relation to the actual damage suffered at the WTC Insured Location."

B. Contingent Business Interruption Coverage

A more recent development in insurance law was the creation of a specific variety of business interruption coverage known as "Contingent Business Interruption" ("CBI") coverage, which indemnifies the insured when its business is suspended due to damage to a "dependent property." Typical CBI provisions provide that "[t]he 'suspension' must be caused by direct physical loss of *or damage to property at premises which are described in the Declarations* and for which a Business Income Limit of Insurance is shown in the Declarations" [emphasis added]. Some policies will provide blanket coverage for suspensions of business arising out of damage to "direct suppliers" or "direct customers" not scheduled.

The Court of Appeals for the Second Circuit aptly explained that CBI coverage "reimburses [the insured] for BI losses that are caused by damages to property that is not owned by [the insured] but upon which its business depends."

Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co., 411 F.3d 384, 394 (2d Cir.2005). Yet, because CBI coverage is such a recent development in insurance law, courts have not fully fleshed out the scope of the coverage.

In a separate decision in *Zurich Am. Ins. Co. v. ABM Indus., Inc.*, 397 F.3d 158, 168 (2d Cir. 2005), the Second Circuit provided some guidance with regard to how courts here interpret CBI clauses. The insured in *Zurich Am. Ins. Co.*, provided janitorial services to the common areas of the WTC and to virtually all tenants in the WTC. Zurich provided CBI coverage to the insured, ABM, that applied to properties "*not* operated by" ABM (emphasis added). The primary issue was whether ABM "operated" the common areas and tenants in the WTC. The Second Circuit ruled that ABM "operated" the business tenants to the extent that ABM was responsible for running the physical plant and performing maintenance of the infrastructure for the business tenants. As such, the CBI coverage did *not* apply.

One potential limitation on CBI coverage is that the supplier or customer must be "direct," or otherwise the dependent business must be listed in the policy's schedule.

For example, in *Archer-Daniels-Midland Co. v. Phoenix Assur. Co. of New York*, 936 F. Supp. 534 (S.D. Ill. 1996), an Illinois district court provided a broad interpretation of what business/entity can constitute a "direct supplier." An insured farm-product processor brought a declaratory judgment action against its

insurers, claiming that it was entitled to CBI coverage. The CBI coverage provision provided coverage for loss arising out of damage to "any supplier of goods or services which results in the inability of such supplier to supply an insured locations [sic]." After a significant amount of flooding along the Mississippi River, the insured alleged that transportation of raw material costs skyrocketed because barge travel along the river was significantly limited. The insured contended that the United States Coast Guard and the Army Corps of Engineers were "suppliers" under the policy, as they oversaw the navigation of the river. The court agreed, and held that the Coast Guard and Army Corps of Engineers provided services to the insured, and therefore the insured was entitled to coverage under the CBI coverage part.

In interpreting a CBI coverage clause that explicitly extended to power outages, the Court of Appeals for the Eight Circuit ruled that there was no coverage losses due to power outages of suppliers. *Pentair, Inc. v. Am. Guarantee & Liab. Ins. Co.*, 400 F.3d 613 (8th Cir. 2005). In 1999, a large earthquake struck Taiwan, disabling a substation that provided electric power to Taiwanese factories that manufactured products for the insured. As a result of the power failure, the factories could not manufacture any of the products for two weeks. The insured was forced to expedite its shipping, at an additional cost, in order to meet demand for the Christmas season. Under the insured's CBI policy, the insured could recover for "losses incurred by [the insured] as the result of 'damage' to 'property

of a supplier of goods and/or services to the Insured' that is caused by a covered peril, here, an earthquake." The Eight Circuit declared that the "power station was not a 'supplier of goods and/or services'" to the insured. According to the court, although "the substation supplied power to the Taiwanese factories, the Taiwanese power company did not supply a product or service ultimately used by" the insured, and thus the power company was not a supplier under the policy. The loss was too remote.

Another potential limitation to CBI coverage is that the supplier/customer must have sustained physical loss or damage.

Construing whether CBI coverage was triggered for an interruption in business due to the loss of the natural gas supply to a insured's titanium dioxide production facilities, one court held that there need not be a direct contract between the parties for the supplier to have directly contributed to the insured's operation. *See*, *Millennium Inorganic Chemicals Ltd. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, CIV.A. ELH-09-1893, 2012 WL 4480708 (D. Md. Sept. 28, 2012). An explosion occurred at a natural gas supplier, the Apache Corporation, which resulted in the complete shutdown of the insured's facility because it had no natural gas to operate. The question raised in *Millennium Inorganic Chemicals Ltd.*, was whether Apache's natural gas production facility was a "direct contributing property" to the insured's facilities, despite the fact that the insured purchased natural gas from an intermediary that, in turn, purchased gas from

Apache and others. Notwithstanding that there was no direct contractual relationship between Apache and the insured, the court declared that Apache was a "direct contributing property" to the insured's operations, so as to come within the CBI coverage. The court based its decision on the fact that Apache provided a direct supply of natural gas to the insured.

In another instructive case arising out of the attacks of September 11th, a New Jersey court declared that CBI coverage does not cover generalized losses from a catastrophic event. *See*, *Arthur Andersen LLP v. Fed. Ins. Co.*, 416 N.J. Super. 334, 3 A.3d 1279 (App. Div. 2010). An accounting firm sought CBI coverage for loss of revenue resulting from the terrorist attacks. The court found that the accounting firm "neither identified any interruption of its business nor any customer who was unable to receive services as a result of property damage to the WTC or Pentagon." 3 A.3d at 1288.

Disputes over CBI coverage is certain to be a source of litigation in New York, because businesses across the country rely on the strong economic engine that is the New York economy. No doubt, countless businesses will claim that they were negatively affected by the sudden cessation of business in New York in the immediate aftermath of Sandy.

IV. RISK MANAGEMENT ISSUES FOR ART INSURERS IN CATASTROPHIC WEATHER LOSSES

A. WAREHOUSE ISSUES

The ongoing volatility in the financial markets since the Financial Crisis of 2008 has led to a steady flight of investment capital into "tangible assets" and as a result the value of fine art continues to skyrocket. Art held for investment typically does not adorn collectors' walls but instead is stored in warehouses located throughout the world. It is speculated that there are trillions of dollars' worth of art stored at the Freeport in Geneva and at other major storage facilities, many of which specialize exclusively in fine art storage.

Fine art insurers therefore have a significant interest in managing their risk for art that is stored in such warehouses. We set forth below, with an emphasis on New York law, some of the key issues.

1. Bailment Relationship

Most property held in trust, including art, is governed by the law of bailments. A bailment exists when one party ("the bailor") contracts with another party ("the bailee") to transfer possession of an item of personal property. The bailor who owns the property transfers control and possession, but not ownership, for a specified period of time after which the bailee must return the property in

substantially the same condition as when originally received. *Marvin E. Herman, Inc. v.* White, 1994 WL 363980 (S.D.N.Y 1994)

The common law rule is that the bailee is not an insurer of the goods and is only liable for damage resulting from the bailee's negligence. But the parties may change that liability pursuant to the terms of a contract. While a bailee can enlarge its potential liability, the more typical contract limits the liability of a bailee, and courts generally hold that terms of an express contractual limitation are enforceable. *See First National Bank v. Frederics–Helton Travel Service, Inc*., 209 N.Y.S.2d 704, 709 (Sup.Ct.N.Y.County 1961); *Sagendorph v. First National Bank of Philmont*, 218 N.Y.S. 191, 192 (3rd Dept.1926).

2. Warehouse Liability under the UCC

The Uniform Commercial Code governs commercial transactions and has been adopted in slightly different forms by the majority of states. The UCC has a specific statute to address the conduct of a "Warehouseman," defined as "a person engaged in the business of storing goods for hire." UCC § 7–102(1)(h).

Pursuant to UCC § 7–204(1), a "Warehouseman is liable for damages for loss of or injury to the goods caused by his failure to exercise such care in regard to them as a reasonably careful man would exercise under like circumstances…" A Warehouseman may limit its liability for damages for loss of or damage to the

goods, and may set "forth a specific liability per article or item, or value per unit of weight, beyond which the warehouseman shall not be liable." UCC § 7-204(2).

3. Limitation of Liability

In interpreting this statute, New York courts have held that a warehouse cannot enforce a contractual provision that exculpates the warehouse from all liability for its own negligence. It would violate public policy to impair the warehouseman's duty of care as set forth under UCC § 7–204(1). *See, Kimberly Clark Corp. v. Lake Erie Warehouse, Division of Lake Erie Rolling Mill, Inc.*, 49 A.D.2d 492 (4th Dept. 1975).

Courts in other states have reached similar decisions. *See Jasphy v. Osinsky*, 364 N.J.Super. 13, 22 (N.J. Super. A.D. 2003) (New Jersey); *Butler Mfg. Co. v. Americold Corp.*, 835 F.Supp. 1274, 1280 (D.Kan. 1993) (Kansas); *Allstate Ins. Co. v. Winnebago County Fair Ass'n, Inc.*, 131 Ill.App.3d 225, 231 (Ill. App. 2 Dist. 1985)(Illinois); *Fireman's Fund Am. Ins. Co. v. Capt. Fowler's Marina, Inc.*, 343 F.Supp. 347, 350 (D. Mass. 1971) (Massachusetts).

But the impact of this general rule is limited, because courts have also held that a warehouse's limitation of liability for its own negligence is permissible, provided that the bailee is given the opportunity to increase the potential liability by paying a higher storage fee. *See, Meyer v. Certified Moving & Storage Co.,*

Inc., 162 A.D.2d 109, 112 (1st Dept. 1990); *ICC Industries, Inc. v. GATX Terminals Corp.*, 690 F.Supp. 1282 (S.D.N.Y. 1988)

Generally, a warehouse agreement incorporates this legal doctrine by offering the art owner an opportunity to insure the art under the warehouse's insurance policy at a specific rate based on a declared value of the art. Otherwise, in rejecting this offer, the art bailor agrees that the warehouse's liability is limited to a certain nominal amount based on the weight of the property (e.g. $0.50 per pound).

4. Piercing the Limitation of Liability

In order to pierce a limitation of liability, a party must establish that the warehouse's actions were more egregious than ordinary negligence, rising to the level of "gross negligence." *See Pacnet Network Ltd. v. KDDI Corp.*, 78 A.D.3d 478, 480 (1st Dept. 2010). This has long been the rule in most jurisdictions outside of New York as well. *See*, *Fidelity Storage Co. v. Kingsbury*, 76 F.2d 978, 980, (1935, the District of Columbia).

In order to establish gross negligence, the offending act must either "smack of intentional wrongdoing" or evince a reckless indifference to the rights of others. Indeed, courts have found that gross negligence differs not only in degree -- but in kind -- from ordinary negligence. *Sommer v. Federal Signal Corp.*, 79 N.Y.2d 540, 554 (1992). Generally, courts are willing, upon a motion

brought by the parties, to dismiss insufficient claims where the conduct alleged does not rise to the level of gross negligence. But where colorable claims of gross negligence have been plead, courts almost always leave the ultimate decision to a jury as opposed to ruling "on paper" that conduct was grossly negligent as a matter of law.

Most litigated matters on this issue arise out of losses involving alarm companies, who have similar limitation of liability clauses in their contracts. One such case is *Sommer v. Federal Signal Corp.*, 79 N.Y.2d 540 (1992), where the defendant fire alarm company confused instructions given to them by the owner of a 42 story skyscraper in Manhattan. The owner had previously requested that the alarm system be temporarily deactivated during maintenance to the building. In such cases, it was the alarm company's policy to automatically restore service a few hours later as a matter of course in order to prevent a catastrophe. Here, the building owner, not realizing that service had already been restored, called the alarm company and asked for service to be activated. The alarm company dispatcher -- allegedly inexperienced and untrained -- could not understand why the owner was requesting activation for a service that had already been restored. So his ill-fated solution was to take the alarm system ***out of service***. Minutes later, with absolutely horrible timing, a fire started -- and this same dispatcher ignored the fire alarm signals, assuming they were related to the building's

request for deactivation. A containable fire thus spread, leading to $7 million of damages and a spate of lawsuits.

The alarm company sought to enforce the limitation of liability contained in their contract with the owner, claiming that a "simple miscommunication" caused the loss. New York's highest court, the Court of Appeals, agreed that this scenario presented a triable issue of fact as to whether the actions of the fire alarm company constituted reckless indifference. With so much at stake, more should have been done to verify what the building owner actually wanted to occur.

By contrast, in *Lubell v. Samson Moving & Storage, Inc.*, 307 A.D.2d 215, 215, 763 N.Y.S.2d 30, 30 (1st Dept. 2003), plaintiff's extensive art collection was stored at the defendant's warehouse subject to a contractual limitation of 30 cents per pound per item. Plaintiff went to the warehouse to remove some of her items from storage, and discovered that certain items were missing while others were "damaged or destroyed as a result of sitting pools of water on the floor." However, in her complaint, plaintiff was unable to articulate any specific conduct by the warehouse that lead to this damage other than general allegations of disorganization and the like. The court thus held that there was no indication that defendant's negligence was "different in kind" from acts of ordinary negligence in warehousing the property.

5. **Conversion**

Although not a typical consequence of a catastrophic storm like Sandy, based on recent controversies like the Salander O'Reilly Gallery scandal, art insurers should also be aware how a claim of conversion impacts a contractual limitation of liability. In *I.C.C. Metals v. Municipal Warehouse Co.*, 50 N.Y.2d 657 (1980), plaintiff, an international metals trader, delivered three separate lots of an industrial metal called indium to the defendant's commercial warehouse for safekeeping. The operative receipts contained a valid limitation of liability up to $50, despite the fact that the value of the property was $100,000. About two years later, plaintiff asked to have one of the metal lots returned, but the warehouse informed plaintiff it couldn't find any of the three lots.

Plaintiff sued the warehouse alleging conversion, which is defined as "an intentional exercise of dominion or control over a chattel which so seriously interferes with the right of another to control it that the actor may justly be required to pay the other the full value of the chattel." (Restatement, Torts 2d, § 222 A; see, generally, Prosser, Torts [4th ed], § 15.) The warehouse countered with the fact that, regardless of the cause of the loss, its contractual liability was limited to $50. In analyzing the case, the Court of Appeals noted that while limitations of liability were generally accepted, limitations cannot be enforced for injuries that result from an affirmative and intentional act of misconduct because to rule otherwise would encourage wrongdoing.

Generally, a *prima facie* case of conversion is made by establishing proof of delivery of the stored property to the warehouse, and a failure to return that property upon a proper demand. The burden is then shifted to the warehouse to come forward with sufficient proof that its failure to return the property is not the result of its conversion of that property to its own use. If the warehouse can persuade the trier of fact of the truth of its "innocent" explanation -- even if it is negligent -- then the limitation of liability can be enforced. In the absence of such an explanation, the owner can recover the full amount of the loss.

6. Waivers of Subrogation

Art insurers ought to also be aware that some warehouses require their prospective customers to request that their personal insurers waive subrogation rights against the warehouses, while other agreements require the customer to unilaterally waive its insurer's subrogation rights. The validity and enforceability of such agreements obviously turn on the wording of the agreement and details of the loss, but the best way for an art insurer to guard against such a waiver is to include a condition in its own policy that nullifies coverage in the event that the insured agrees to waive the insurer's subrogation rights.

B. GALLERY ISSUES

Considerable risks for art insurers arise when art is consigned to a gallery for display, often for the purpose of a potential sale to a third-party. Gallery losses were indeed prevalent after Sandy, particularly for those galleries located in Chelsea on Manhattan's West Side. This neighborhood was not considered to be at a high risk for flooding and therefore most art was displayed on lower floors or even stored in basements. Unlike warehouses, the law is not specifically tailored for galleries and thus the general law of bailments applies.

1. Law of Bailments

A bailee owes a duty of care to the bailor with regard to the bailed property. The extent of the bailee's duty of care is determined by the type of bailment that exists. If the bailee receives a benefit from the bailment, he owes the bailor a duty of ordinary care. In instances of "gratuitous bailments," where the bailment is solely for the benefit of the bailor, the bailee is obligated to exercise only "slight care" which is violated only when he has committed gross negligence. See *Dalton v. Hamilton Hotel Operating Co.*, 242 N.Y. 481, 487, 152 N.E. 268 (1926) (landlord was a gratuitous bailee when he accepted a prospective tenant's luggage for storage even though he would not have done so if she were not signing a lease); see also *Voorhis v. Consolidated Rail Corp.*, 60 N.Y.2d 878,

458 N.E.2d 823 (1983) (railroad usher was gratuitous bailee when he agreed to watch passenger's bags).

Typically, where a gallery, as bailee, exhibits art -- even if it will not profit from the display in a "commercial sense" – courts throughout the United States consider the bailee a beneficiary of the bailment and impose a duty of ordinary care. See *Hardegg v. Willards*, 12 Misc. 17, 66 N.Y.St.Rep. 524, 33 N.Y.S. 25 (N.Y. Ct. Common Pl. 1895) ("It is idle, then, to argue that the deposit of the picture with the defendant was upon a gratuitous bailment, for the evidence shows a reciprocal benefit to the parties, in a mutual advantage from the exhibition of the picture in the defendant's gallery"); *Gardini v. Museum of City of New York*, 173 Misc. 791, 19 N.Y.S.2d 96 (N.Y.City Ct. 1940) *Colburn v. Washington State Art Asso*., 80 Wash 662, 141 P. 1153 (Wa. 1914); *Prince v. Alabama State Fair*, 106 Ala. 340, 17 So. 449 (Ala. 1895); *Vigo Agricultural Soc. v. Brumfield*, 102 Ind. 146, 1 N.E. 382 (Ind. 1885).

2. Evaluating a Breach of Care

Regardless of whether the duty imposed is of "slight" or "ordinary" care, damage to art while in the possession of a gallery creates a presumption of negligence or gross negligence. Courts have established this burden on the basis that a bailee -- in this case, the gallery -- is in a far better position than the consignor to be able to determine the cause of the loss. It is thus the burden of the

bailee to come forward with evidence to rebut the presumption of negligence. *Commercial Molasses Corp. v. New York Tank Barge Corp.*, 314 U.S. 104, 62 S.Ct. 156, 86 L.Ed. 89 (1943);

The bailee may overcome the presumption of liability by a showing that the loss was caused by "some misfortune or accident not within the control of the bailee." *Stewart v. Stone*, 127 N.Y. 500, 506, 28 N.E. 595 (1891). If the bailee makes such a showing, the burden is placed back upon the bailor to prove that the bailee failed to exercise reasonable or slight care.

In determining whether a bailee was negligent or grossly negligent, the bailee's actions "must be graded by the nature and value of the property and the risks to which it is exposed." The First Nat. Bank v. Ocean Nat. Bank, 60 N.Y. 278, 295 (1875). In the case of negligence, a court will apply a reasonable standard of care. Thus, in the case of art damaged while in the care of a gallery, no doubt expert testimony is helpful to establish how a gallery typically handles or stores fragile and valuable works.

For losses arising out of Sandy, there are certainly a number of factors to be considered, including:

- The location of the gallery (i.e. in a flood zone or its proximity to the water), and whether it was previously prone to flooding;
- The area of the galley where the work was being displayed or stored at the time of loss (i.e. in a crate on the floor of the basement);

- Whether the work was particularly sensitive to the elements;
- The value and rarity of the damaged work;
- The efforts taken to safeguard the property in advance of the pending storm and whether reasonable efforts could have been taken to prevent damage.

Many will surely claim that Sandy was "an act of God" and that the extent of its force so greatly exceeded the strength of previous storms that whether reasonable precautions were taken needs to be measured by historical standards and not by hindsight. But what were also unique about Sandy were the nature and the extent of the advance warnings of the storm. In the days prior to landfall, the media in the tri-state New York City area reported constantly about the expected size and strength of the storm, as well as the fact that the most reliable of computer models predicated a direct hit to the city. Indeed, the government shut down mass transit and evacuated certain neighborhoods and towns on the basis of these warnings. As such, we expect these warnings will be a factor in evaluating whether adequate precautions were taken to protect valuable art damaged in the wake of the storm.

3. Written Consignment Agreements and Basis of Valuation

In the case of valuable works of art, a written consignment agreement will typically be in place between the gallery and the owner of the art in order to best

protect the interests of the parties. Very often the parties will agree on a "Consignment Value" which generally represents the lowest price that the owner will accept if the gallery identifies a buyer. Usually, the gallery will also agree to insure the work under the gallery's policy -- and the gallery's insurer will also use that consignment value as the basis for their exposure under the policy.

While this arrangement seems straightforward, a host of issues arise when a valuable work of art is damaged -- particularly when a subrogated insurer later seeks recovery. Typically, the measure of damage in property cases is the difference between the fair market value immediately prior to and immediately after the loss. But when a consigned value is introduced into the mix, it may be difficult to reconcile the actual damages and the "insurance" values.

For example,

- The consigned value may be lower than the amount that the work is scheduled for under the art owner's policy -- creating a potential disconnect between what is paid by the subrogated insurer and what is recoverable from the gallery.
- The consigned value may be set purposely lower than the market value, perhaps to lower the expectations of the consignor or to reduce the gallery's insurance exposure. But this practice has the potential to invite fraud and abuse, because in the event of a loss the gallery/tortfeasor has likely capped its potential exposure.

- The consigned value may bear no relationship to market value whatsoever; stemming, for example, on a significant passage of time coupled with an erosion of market conditions. Under such circumstances, a loss could create a windfall to a gallery and leave the insurer with no recourse based on policy wording.

On the other hand, the lack of a written consignment agreement can wreak havoc in different ways, particularly if the gallery's policy looks to consignment value as its basis for indemnity without a related requirement that a written agreement exists. In such a case, the value is created solely for purposes of the insurance claim, further inviting the potential for fraud cited above.

V. WHAT DID FINE ART AND PROPERTY INSURERS TAKE AWAY FROM SANDY?

Sandy was truly the perfect storm. It struck at astronomical high tide with a full moon. A wall of water 13 feet above mean tide hit the Battery, and the tidal surge raced up the Hudson, reaching Albany, 135 miles away from the Statue of Liberty.

We leave to meteorologists, global warming theorists and, perhaps, the Farmer's Almanac, the question of when - - yes, the operative word is when - - another such storm will hit the Northeast. Next year, five years, generations

hence? No one knows for sure. But the occurrence of another catastrophic weather event is inevitable.

What did the Art World take away from Sandy?

1. Too many risks were at or below grade.
2. Too few risks had adequate paperwork to allow for proper loss adjustment.
3. Too few resources existed to address the catastrophe (adjusters, conservators and restorers).
4. Too little consideration had been given in risk surveys for the perils posed by a weather event.
5. Too little premium had been charged for flood and power outage coverage.
6. Too much exposure was concentrated in too few facilities.

Obviously, this is a short list. And, no doubt, each of you, in your own way, took away other lessons from Sandy. Our general point is that, because so much valuable art is not in the possession of its owners but instead held in trust by third-parties like storage warehouses and galleries, art insurers that provide worldwide coverage need to be aware that their potential to recover in subrogation may be dramatically impaired by agreements entered into by their own policyholders.

But you all work in a highly competitive rate and wording environment. So, it remains to be seen whether these competitive pressures will allow you to address - - with higher premiums and tighter policy conditions -- the lessons learned from Sandy.