
Extra Expense Losses and Claim Handling Issues

A Lawyer's and a General Adjuster's Perspective

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I. Origins of Extra Expense Coverage

With commercial claims, a great deal of focus is often given to damages resulting from the interruption of a business' operations. With many claims, after all of the property damage has been paid, this coverage, Business Income Coverage (Formerly Business Interruption) will take the backseat to its sometime companion -- Extra Expense. The presence of Extra Expense coverage along with proactive adjustment can significantly minimize or even *prevent* more costly income losses.

Extra Expense coverage is an expansion of the concept of Expense to Reduce Loss – a concept as old as Use & Occupancy insurance itself. Writing for the Rough Notes Company in 1916, Mr. I.A. Moore, General Adjuster, New York Underwriting Agency observed that: “Use and occupancy forms generally provide that assured shall, in the event of loss, exercise due diligence and dispatch in placing his plant in condition to resume operations.... “

Mr. Moore further noted:

While it is incumbent upon the assured to use every reasonable means to hasten resumption of operations, he frequently expends more than would be necessary in the normal way in order that as little time as possible may be lost, for such items, for example, as temporary repairs, cost of express on machinery, etc. over freight, extra expense of and overtime of labor, and various other items, according to the necessities of his business.

Perhaps, strictly speaking, use and occupancy insurance would be liable for none of the expense so incurred, but if the assured does incur such expense and make extraordinary efforts to resume operations, it would seem reasonable for use and occupancy insurance to recognize such outlay if the use and occupancy loss would thereby be reduced below what it would otherwise have been if assured simply proceeded in a normal way.

The concept of expense to reduce the loss found favor among adjusters, as this understanding fulfilled classic policy interpretation. As explained by K.W. Withers, Executive General Adjuster, General Adjustment Bureau in his classic work, Business Interruption Insurance Coverage and Adjustment (1957):

Under this coverage, extra expense to prevent reduction of normal income during the period of suspension is the subject of insurance. Although no reference is made to expense incurred to reduce the period of suspension, such incurred cost is a salvaging operation presumed under any insurance coverage without specific mention. In Property Insurance, recovery of salvaging costs, unless incurred by or with the specific approval of the company or their adjuster, would be limited to the property saved. So, under this coverage expense to reduce the period of suspension would be limited to the amount of extra expense saved by reducing the period of suspension.

The early Extra Expense Forms, developed in the late 1930's were stand-alone forms that did not cover the loss of income (and still do not), but rather covered the additional expenses necessary to maintain income. For example, a laundry that lost its facilities to fire and utilized reciprocal arrangements with other laundries during the period of restoration. The additional costs of utilizing the temporary facilities, over and above the normal operating costs, would be covered by the Extra Expense coverage.



Modern day Extra Expense coverage is designed to protect the businesses that, if shut down, will not only lose continuity of operations, but more importantly, will likely lose long-time customers to competitors. For many businesses, it is imperative to continue operations during the restoration or replacement of surroundings and furnishings. Numerous studies have indicated that as many as 60% to 90% of businesses that have a major loss eventually go out of business.

As an example, fire damages a photography shop and graphic layout computers belonging to one of two major city magazines. If the magazine suffers a lengthy shutdown, the members of its readership will likely switch to the competitor. It is imperative; therefore, that the magazine's layout operations stay in business and remain in operation, regardless of cost or saved net income. In order to do so, the magazine may well incur significant extra costs.

It may be that the magazine may have to pay higher printing costs, use alternate or rented computer facilities, outsource its printing, or pay its employees overtime to train or operate the alternate facilities. These expenditures, necessary to continue the magazine during the time it takes to repair or replace, are the focus of Extra Expense coverage. Now, should the magazine incur express delivery charges for the replacement equipment, this is generally still expediting expenses, considered to the extent it reduces the amount of loss otherwise payable.

One commentator has observed that Extra Expense coverage is the opposite of Business Interruption coverage.^[1] Under Business Interruption, the policy reimburses for lost ordinary income when a business is shut down for a period of time. Extra Expense, on the other hand, is designed to assist the business to earn the income that would have been earned had there been no loss.

In one particular loss handled by Jerry Provencher, the insured's business was completely shut down by a snow collapse that literally brought down the roof. The initial inspection was constantly interrupted as the owner was besieged by staff handing him cell phones, peppering him with questions and pushing forms in front of him to sign. I recall at one point our discussion was interrupted by his executive assistant, who needed a decision on what toppings to put on the pizza's being ordered for the emergency crews. At the time, the insured was struggling to demonstrate damage on a fairly minor piece of equipment.

I finally asked him how much the piece of equipment was worth, and how costly would it be to him if we threw the item away. Quite surprised, he indicated it was worth \$300. I then asked how costly it would be if he lost his business because he was too busy deciding on pizza toppings to do the high level management required to stay in business. After the initial shock, you could see the light bulb go on!

Rather than avoiding the newspaper, he immediately issued a news release and told his customers what had happened, what was to be done and kept them apprised nearly daily of his progress. He designed an advertising campaign that thoroughly involved his customers in the emotional recovery of the business. Customers became like family members. Repairs were expedited through extraordinary effort and a party was held to celebrate the reopening, which occurred in only 19 days! His concerted efforts at positive publicity and emotionally engaging his client base was so successful, he reopened with more clients than he had when the loss occurred.



What follows is a review of the pertinent policy language relative to Extra Expense coverage, and the factors necessary to adjust Extra Expense claims. We will also discuss some common and recent controversies surrounding this coverage, and outline some recent cases with hypothetical examples for further discussion.

II. *Extra Expense Policy Language*

Many commercial policies follow or adopt the ISO form for Business Income and Extra Expense Coverage. In this article, we will follow the policy language found in ISO form CP 00 30 (10/00). There can be significant differences from policy to policy. A word to the wise: never adjust from memory, always check the form!

That said, the pertinent language from the basic ISO form is as follows:

BUSINESS INCOME (AND EXTRA EXPENSE) COVERAGE FORM

3. Additional Coverages

a. Extra Expense

Extra Expense means necessary expenses you incur during the “period of restoration” that you would not have incurred if there had been no direct physical loss or damage to property caused by or resulting from a Covered Cause of Loss.

(1) We will pay any Extra Expense to avoid or minimize the “suspension” of business and to continue “operations”:

(a) At the described premises; or

(b) At replacement premises or at temporary locations, including:

(i) Relocation expenses; and

(ii) Costs to equip and operate the replacement or temporary locations.

(2) We will pay any Extra Expense to minimize the “suspension” of business if you cannot continue “operations”.

(3) We will pay any Extra Expense to:

(a) Repair or replace any property; or

(b) Research, replace or restore the lost information on damaged valuable papers and records;

to the extent it reduces the amount of loss that otherwise would have been payable under Coverage Form.

4. Loss Determination

b. The amount of Extra Expense will be determined based on:

(1) All expenses that exceed the normal operating expenses that would have been incurred by “operations” during the “period of restoration” if no direct physical loss or damage had occurred. We will deduct from the total of such expenses:

(a) The salvage value that remains of any property bought for temporary use during the “period of restoration”, once “operations” are resumed; and

(b) Any Extra Expense that is paid for by other insurance, except for insurance that is written subject to the same plan, terms, conditions and provisions as this insurance; and

(2) All necessary expenses that reduce the Business Income loss that otherwise would have been incurred.

c. Resumption Of Operations

We will reduce the amount of your:

- (1) Business Income loss, other than Extra Expense, to the extent you can resume your “operations”, in whole or in part, by using damaged or undamaged property (including merchandise or stock) at the described premises or elsewhere.
- (2) Extra Expense loss to the extent you can return “operations” to normal and discontinue such Extra Expense.

- d.** If you do not resume “operations”, or do not resume “operations” as quickly as possible, we will pay based on the length of time it would have been taken to resume “operations” as quickly as possible.

G. Definitions

2. “Operations” means”

- a.** Your business activities occurring at the described premises; and
- b.** The tenantability of the described premises, if coverage for Business Income including “Rental Value” or “Rental Value” applies.

3. “Period of Restoration” means the period of time that:

- a.** Begins:
 - (1) 72 hours after the time of direct physical loss or damage for business Income coverage; or
 - (2) Immediately after the time of direct physical loss or damage for Extra Expense coverage;
- b.** Ends 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.

“Period of restoration” does not include any increased period required due to the enforcement of any ordinance or law that:

- (1) Regulates the construction, use or repair, or requires the tearing down of any property; or
- (2) Requires any insured or others to test for, monitor, clean up, remove, contain, treat, detoxify or neutralize, or in any way respond to, or assess the effects of “pollutants”.

The expiration date of this policy will not cut short the “period of restoration”.

6. “Suspension” means:

- a. The slowdown or cessation of your business activities; or
- b. That a part or all of the described premises is rendered untenable, if coverage for Business Income including “Rental Value” or “Rental Value” applies.

In summary, although there are some variations between policies from one company to the next, the basic, standard Extra Expense policy covers incurred costs:

1. That result from damage to or destruction of real or personal property on the insured premises, during the policy term, caused by one of the perils insured against in the building/personal property coverage form.
2. That are necessary expenses in excess of normal operating expenses.
3. That are incurred during the defined “period of restoration.”
4. That would not have been incurred had it not been for the loss.
5. To avoid or minimize the “suspension” (slowdown or cessation) of business.
6. To allow a business to continue operations either at the insured location or an alternate facility.

Note: Expenses incurred to reduce the business income loss that otherwise would have been incurred are always covered to the extent that they reduce the loss (dollar for dollar).

III. Interpretations of Extra Expense Policies

Now that we know the basics of an extra expense policy, the next question is, what does it mean, and what are some of the variations to be aware of? Again, each policy is different and each set of facts applied to the policy is different. What follows is a discussion of how some courts have interpreted sections of this policy, and how they apply practically in analyzing Extra Expense claims.

A. What Happened to Cause the Expense?

As with any other commercial property coverage, coverage for Extra Expense depends upon a covered cause of loss to property at the described premises during the policy period.

1. Was There An Actual Loss? Actual damage to Real or Personal Property?

Where there is no damage to property, there is no coverage under an Extra Expense policy. In *Port Murray Dairy Co. v. Providence Washington Ins. Co.*,^[2] the New Jersey Superior Court rejected an insured's claim for Extra Expenses when it was forced to secure and process milk at another location. While such expenses would normally be covered, in this case, the cause of the relocation was rioters who blockaded the insured plant, but caused no direct destruction or damage to the insured's buildings or contents.

In another example, the insured's inability to get to his place of business was not sufficient to establish a suspension of business due to physical damage or destruction. In *Harry's Cadillac-Pontiac v. Motors Ins. Co.*,^[3] a snowstorm struck an auto dealership, preventing access to the property for a week. The insured filed a claim for business interruption, which was denied. The court held that the insured did not prove that any lost income resulted from damage to the property, only that the loss was proximately caused by the inability to access the dealership.

In both of the above examples, the question was whether an actual physical loss occurred. In other cases, where there is a physical loss, the question is, is that loss covered under the policy? Even if there is a physical loss from which Extra Expenses arise, the proximate cause of loss must be covered, and not excluded.

2. If There Was Physical Damage – Is It Due To a Covered Cause of Loss?

A recent example of this question is the dispute found in *NMS Services, Inc. v. Hartford*.^[4] There, the insured, a software development company, discovered that its computer systems were damaged as the result of an employee "hacking" into the company's network, and intentionally causing damage. The company filed a claim for damages, part of which was under Extra Expense coverage. The insurer argued that there was no coverage for the entire claim because of an exclusion barring coverage when damage is caused by an employee's dishonesty.

However, the policy had an exception to that exclusion, allowing coverage for acts of “destruction” by an employee. The Court found that the computer damage claimed resulted from an act of “destruction.” Therefore, because the company suffered damage to its property, and the loss was covered, the company was entitled to recover under the Extra Expense portion of the policy.

3. Was the Damage or Destruction to Property at The Described Premises?

Yet a third question here is whether the damage or destruction was to property at the described premises. In the ISO form, above, the Extra Expense coverage applies only when there is loss to the “premises described in the Declarations.” In some policies, this is not as clear, and again, careful reading and interpretation of the policy, possibly in conjunction with legal counsel, should be undertaken.

For example, in one policy, the omission of the terms “premises described in the Declarations” allowed one Federal Court to extend Extra Expense coverage from property damage suffered by an insured’s exclusive supplier, because the supplier became unable to provide the insured necessary raw materials.

In *ADM v. Phoenix Ins. Co.*,^[5] ADM made a claim in excess of \$44,000,000 for increased costs of raw materials and transportation incurred as the result of the Mississippi River floods in 1993. The policy language providing Extra Expense coverage was not limited to damage at the insured premises. In fact the policy required only that, 1) expenses were incurred as the result of direct physical damage and 2) that the damage was caused by a peril insured against. While other portions of the policy were limited to damage occurring only on the insured premises, this clause was not. Therefore, it was taken that the Extra Expense coverage grant extended outside the scheduled location.

There are some other notable variations on this theme. Other policies provide for “Contingent Extra Expense.” These provide coverage for loss resulting from damage to suppliers and other contingent locations upon which the insured relies for parts and supplies. Thus, a fire at a key supplier’s factory may involve Extra Expense on the part of the insured to make up for the affected supply chain.

Taking the magazine example above, “Contingent Extra Expense” would apply if the publisher, on a normal basis, outsourced its photography and layout operations to another company. If that other company had suffered a loss, it would cause the magazine much the same losses as if its own graphics room had shut down. While a standard Extra Expense policy would not normally cover this type of loss, a “Contingent Extra Expense” policy would if the graphics company was identified on the policy.

B. What is an “Expense,” and Is It “Necessary?”

In general, policies do not define the term, “necessary.” Therefore, under general rules of contract construction, courts will apply the plain, ordinary meaning of the word.

One court in Minnesota, as do many courts, turned to the dictionary for the meaning. In *Butwin Sportswear Co. v. St. Paul Fire & Marine Ins. Co.*^[6], the court found that the term, “necessary” meant:

[a]bsolutely essential . . . [n]eeded to achieve a certain result or effect; requisite. Citing, American Heritage Dictionary, 1207 (1992). A necessary expense, therefore, is one that is essential. The district court erred in finding this term ambiguous.

Necessary expenses may include: expedited repair expense if those expenses will reduce the amount of business interruption; overtime expenses or premium substitute payroll labor; operational expenses in excess of normal; expenses incurred at a temporary location; temporary material costs; moving expenses; installation of rental or temporary equipment; rental of temporary equipment.^[7]

Remember that the “Extra Expense” must be in excess of a business’ ordinary operating expenses. In a Connecticut case, *Irving v. St. Paul Fire & Marine Ins. Co.*,^[8] the insureds’ property was damaged by water. Claim was made for Extra Expenses to cover temporary rental of office space, and then the relocation back to their own office space. The court considered that the normal office space rental was approximately \$55,000, and the temporary office space rental costs were approximately \$34,000. Because the temporary rental costs did not exceed what would have been paid had there been no flood, there were no damages to be covered under Extra Expense coverage.

While this case remains good law, and has not been appealed, we question the result without further facts. The court did not indicate whether the insureds would have had to continue payment on their previous lease even in the event of a casualty. If that was the case, then the \$34,000 should have been paid as Extra Expense, above and beyond the \$55,000 they were already obligated to pay under the lease.

Adjustment Tip! Remember, “We will deduct from the total of such expenses: The salvage value that remains of any property bought for temporary use during the “period of restoration”, once “operations” are resumed.” Good negotiating tool.

C. What “Expenses” Do Not Fall Under Extra Expense Coverage?

Certainly, in the rush and bustle of a loss situation, it is common to find an insured may have included items in its claim which are not appropriate for Extra Expense coverage. It is important for the adjuster to carefully comb through each line item of expense presented in a claim. Inappropriate items are generally those unrelated to restarting the insured’s business. These may include: legal fees,^[9] public adjuster fees,^[10] advertising expenses,^[11] expenses used to facilitate going out of business^[12] and expenses already included in the Building or Personal Property claim.^[13]

Some policies contain “Claim Preparation Expense” coverage, where expenses for services of auditors, accountants, appraisers, engineers, lawyers, or others involved in the claim preparation process are covered. These clauses, however, typically exclude fees for public adjusters.^[14] Careful consideration of the policy and a full understanding of the expense is required before a decision should be made to exclude an expense. Never be drawn into a commitment on coverage before reading the policy.

In one loss we were involved in, the insured submitted a budget for approximately \$1,900,000 for proposed advertising expenses to “resume operations”. Considering the business was hemorrhaging money prior to the loss, such a windfall for advertising would have been most welcome. However, this proposal was designed to increase market share, not resume operations to the same level as existed prior to the fire. This represented an entirely new expense, totally unrelated to the loss and was properly denied.

Adjustment Tip! It is always a good idea for the adjuster to advise the insured, in writing, at the beginning of the adjustment that all planned extra expenses should be pre-approved by the adjuster *before they are incurred*. It is in both the insured’s best interest and that of the company that any disagreements over coverage for an expense item are discussed before that expense is incurred.

D. What is a “Suspension” of Operations and What is the “Period of Restoration?”

Another of the requirements for consideration as Extra Expense is that the insured business incurs its expenses during the “period of restoration” which is usually a defined term under the policy. There have been numerous interpretations of these clauses:

In *American Medical Imaging Corp. v. St. Paul Fire and Marine Ins. Co.*,^[16] a medical ultrasound center suffered a fire, making the use of the building and equipment impossible. The business immediately rented space at a new site, and relocated there the next day with rented ultrasounds. This relocation lasted six weeks. At the temporary location there were not enough telephone lines – vital to their business.

The business filed a claim for additional telephone lines and worker overtime. The main issue was whether the business suffered, in the words of the policy, a “necessary or potential suspension of business.”^[17] The insurance company denied the claim, arguing that, because the business conducted the same kind of operations at its new location and was able to function, the business did not suffer a “suspension” of business as required under the policy.

The Appellate court disagreed. The business did actually experience a “suspension,” and was not able to use its telephone system to the fullest extent. The court recognized that there was “potential” for further suspension.

It was also important that the business took immediate steps to reduce its damages – as there was a duty on the part of the insured in the policy to do so. Under the insurance company’s argument, whether the business started up in a new location or not, it would

have forfeited some right under the policy – whether violating a condition by failing to mitigate its damages, or giving up Extra Expense coverage by starting up operations too soon. That result, according to the Court, made no sense.^[18]

In another example, in *Winters v. State Farm Fire and Cas. Co.*,^[19] the court concluded that the plain language of the policy precluded recovery for Extra Expense where there was absolutely no corresponding suspension of business operations, and no period of restoration. In this interesting loss, the policyholder attorney purchased five saws for demonstrative use at a trial. Before the trial, the saws were stolen and were never recovered. The company adjusted the loss of the saws with the insured under the personal property policy, but denied as to the loss of income and extra expense claim.

The attorney, while conceding that his law practice went uninterrupted after the theft of the saws, nonetheless argued that he had to replace the stolen saws in order to continue his trial, and argued that his purchase of new saws was an expense designed to “avoid or minimize” the suspension of business. Because there was no period of restoration, and no suspension of the business, the insured did not have a right to recover under the Extra Expense portion of the policy. A classic case of “*The Double Dip?*”

From these examples, it can be seen that a “suspension of operations”, defined as a “Slowdown or cessation of your business activities” in the ISO form, must be evaluated on a claim-by-claim basis. Generally, it is not required that the business be entirely shut down. A covered loss which negatively impacts the normal business activities (and affects the income stream) will generally qualify for Extra Expense coverage. Where the policy requires the insured to take steps to reduce their loss, the insured cannot and should not be penalized for doing so.

The “Period of Restoration” is usually a defined term in these policies, and it is important for the adjuster to determine the appropriate beginning date, and ending date. Many losses will require the adjuster to put the insured on written notice, as early as can be practically determined, when the “Period of Restoration” ends. Failure to take this step can lead to substantial disagreements and loss of control of business income and extra expense claims. Remember, it is easy to extend the stated Period of Restoration should circumstances warrant; it is very difficult to enforce a Period of Restoration at the end of the adjustment period.

Conclusion: Business Income and Extra Expense claims can be of the most interesting claims an adjuster will ever handle. A sharp and analytical eye is required to accurately adjust these claims, and there is wide latitude for the adjuster to impact the loss. Our best advice is to develop a team of qualified consultants and counsel and learn the business the old fashioned way – *Under Fire!*

We wish you success.

Notes

[1] Stephen A. Cozen, *Insuring real property*, Volume I, Sec. 3.04 “Extra Expense Coverage.”

[2] 145 A.2d. 504 (N.J. Super. 1958).

[3] 486 S.E.2d 249 (N.C. Ct. App. 1997).

[4] No. 01-2491, (US Ct. App. 3rd Cir, April 21, 2003).

[5] 936 F. Supp. 534 (S. D. Ill. 1996).

[6] 534 N.W.2d 565 (Minn. 1995).

[7] For example, *see, Travelers Indemnity v. Pollard*, below, at note 10. In that case, the court allowed extra expenses such as clean up costs, extra security, employee overtime, and obtaining property for temporary use, as these expenses allowed and enabled the insured to resume its business, and the expenses were not those normally contemplated in the insured’s normal operations.

[8] 1995 Conn. Super. LEXIS 1742 (1995)(unreported case).

[9] *See, Travelers Indemnity v. Pollard*, below at note 10. (Holding that expenses for outside professional consultants, legal expenses or CPA expenses in conjunction with the claim presentation were not recoverable under an Extra Expense coverage because those expenses were not “necessary emergency expenses,” as defined in the policy, of the limited type required to get the business running again.)

[10] *Butwin Sportswear, supra*, 534 N.W.2d 565 (Minn, 1995)(holding that a public adjuster’s help in presenting a fire loss claim was not a covered expense because it was not essential. However, to the extent that the public adjuster mitigated the insured’s business interruption and property damages by salvaging the business’ goods, his fees were covered.)

[11] *Travelers Indemnity Co. v. Pollard Friendly Ford Co.*, 512 S.W.2d 375 (Tx. App. 1974)(holding that, while expenses such as watch protection, debris clean up, preserving the operation, extra compensation to employees, and preparing to re-open a

dealership after a tornado loss were covered, expenses dealing with advertising which amounted to no more cost than normal advertising, were not covered).

[12] *Thriftmart, Inc. v. State Farm Fire & Cas. Co.*, 558 N.W.2d 531 (Nebraska, 1997)(holding that Extra Expense coverage was not available where a liquidation of product was used to facilitate a company's going out of business rather than expediting the resumption of business.)

[13] *F. P. Woll & Co. v. Valiant Ins. Co.*, 226 F. Supp. 668 (E.D. Pa. 2002)(holding that payment under a property policy for construction of new office space after a hold-back once the office space was completed was sufficient compensation and there was no further recovery under an Extra Expense policy for the same damages).

[14] See, for example, policy language quoted in *Fountain Powerboat Indus, Inc. v. Reliance Ins. Co.*, 119 F.Supp. 552 (N.C. Dist. 2000):

o. Claim Preparation Expenses

Expenses Incurred by the Insured or by the Insured's representative including auditors, accountants, appraisers, lawyers, consultants, architects, or other such professionals in order to arrive at the loss payable under this policy in the event of a claim. This provision does not cover expenses incurred for the services of any public adjuster.

[15] 573 N.E.2d 851 (Ill.App.Ct. 1991).

[16] 949 F.2d 690 (3rd Cir. 1991).

[17] The policy discussed in this case is slightly different than the standard ISO form, allowing for coverage not only for actual, but for "potential" suspension of operations.

[18] This sentiment has been echoed in other cases. For example, in *Metalmasters of Minneapolis v. Liberty Mutual Ins. Co.*, 461 N.W.2d 496 (Minn. 1990) the court said, "Liberty cannot have it both ways. If, as they strenuously urge, the insured has a contractual as well as a common law duty to mitigate damages, then the expenses of that mitigation must be covered."

[19] 73 F.3d. 224 (9th Cir. 1995).