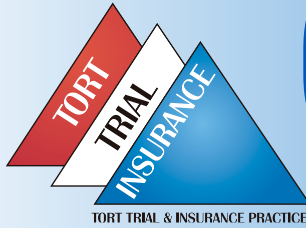

Committee News

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How Speculative Is Speculative? Testing the Limits Of Business Interruption Coverage

By John V. Garaffa[1]

In *Safeguard Storage Properties, L.L.C. v. Donahue Favret Contractors*, Parish of Orleans, Civil District Court Div. H, No. 2007-9359, what began as a relatively modest claim for property damage due to Hurricane Katrina became a case that tests the very limits of business interruption coverage. Initially, the claim involved storm damage to a small number of self storage facilities in Louisianna. The facilities that suffered damage were owned by various individual companies controlled by Safeguard Storage Properties LLC. (Safeguard). A majority interest in Safeguard had been purchased three months before Hurricane Katrina by Prime Property Fund, a real estate investment trust managed by Morgan Stanley Real Estate Advisor, Inc. At the time of Hurricane Katrina, Morgan Stanley had secured a blanket policy providing coverage for other real and personal property that it either owned or managed.

Repairs were made to the seven damaged self storage facilities and they were all reopened for business by December of 2005. Following Hurricane Katrina, Safeguard's management decided to move its call center to one of its facilities in Chicago and, in late 2006, moved both the call center and its corporate offices in New Orleans to space managed by Morgan Stanley in Atlanta.

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Safeguard's business model had a separate limited liability company for each self storage facility it owned or controlled. In September of 2007, Safeguard filed suit, alleging breach of the insurance contract and bad faith. While only seven facilities had been damaged, each of Safeguard's fifty seven LLC's and the parent LLC were named as plaintiffs. Despite the fact that the coverage provided by some excess carriers did not attach below 200 or even 400 million dollars, all the

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excess insurers who provided coverage under the blanket policies issued by Morgan Stanley were also named as defendants. On January 31, 2008, the plaintiffs filed their Supplemental and Amended Petition, seeking recovery for, inter alia, "loss of development properties and opportunities." In an April 16, 2008 report by an accountant, Safeguard asserted that its business interruption loss was $170,787,502.00.

The accountant asserted that Safeguard was in the business of producing self storage facilities and Hurricane Katrina had interrupted its production, resulting in a permanent loss of 39 "units." The accountant advised that he reviewed Safeguard's long range business development plans and financial models prepared for internal use and those prepared by Morgan Stanley, Bank of America and J.P. Morgan in conjunction with Morgan Stanley's 2005 decision to purchase Safeguard. He asserted that these business development plans and financial models included projections that Safeguard would construct new facilities similar to the ones owned by each of the Safeguard subsidiaries on the date of loss. The report subtracted the number of projected facilities (55) from the number of facilities actually built by Safeguard after the date of loss (19), concluding that Safeguard "missed" 36 new developments.

Plaintiffs' accountant hypothesized that each unbuilt self storage facility equaled a "loss" of $4,262,894, representing the present value of all the income each unformed future LLC would have realized over the projected 39 year existence of each lost facility had it been built and opened. According to the accountant's initial report, the total "lost development" claim was $170,787,502, representing a "loss" of $4,262,894 multiplied by thirty six "missed opportunities," plus a claim for judicial interest on the present value of the income that would not be generated by the facilities that were never built. In a later report in February 9, 2009, the accountant penned a new report, this time estimating the present value of the loss of income from the unbuilt facilities to be between $205,974,215 and $379,489,741.

For the insurers, the claim presented a number of threshold questions such as why Safeguard believed it would necessarily have built 36 more facilities than it did between September 2005 and June of 2009, how the failure of Safeguard to build them could be related to the damage to seven of its existing facilities in Louisiana in 2005, how the profitability of the unbuilt facilities at unknown and unowned locations could be predicted over a span of 39 years, and how the loss of 39 years of "lost" profit could possibly fall within the period of business interruption provided by the policies at issue. The policy stated:

(1) Period of Recovery: The length of time for which loss may be claimed:

> (a) shall not exceed such length of time as would be required with the exercise of due diligence and dispatch to rebuild, repair, or replace such part of the property as had been destroyed or damaged;
>
> (b) and, such additional length of time to restore the Insured's business to the condition that would have existed had no loss occurred, commencing with the later of the following dates:
>
> > i. the date on which the liability of the Insurer for loss or damage would otherwise terminate; or
> >
> > ii. the date on which repair, replacement, or rebuilding of such part of the property as has been damaged is actually completed;
> >
> > but in no event for more than one year thereafter from said later commencement date;
> >
> > iii. with respect to alterations, additions, and property while in the course of construction, erection, installation, or assembly, shall be determined as provided in (a) above, but such determined length of time shall be applied to the experience of the business after the business has reached its planned level of production or level of business operation;
> >
> > and shall commence with the date of such loss or damage and shall not be limited by the date of expiration of this policy.

Pursuant to this provision it was argued that the time period during which Plaintiffs' business interruption losses were covered by the policies at issue in the case was (1) the time needed, with due diligence and dispatch, to repair $3.6 million in covered property damage that Plaintiffs assert was suffered by their Louisiana facilities plus (2) a separate additional period of no more than one year starting on the later of two dates: either (1) the date those covered repairs were completed or (2) when liability of the Insurer for loss or damage would otherwise terminate. It was argued that in Paragraph B.(1)(a), the insurers' liability for loss or

damage under the initial period of business interruption terminates when the "length of time as would be required with the exercise of due diligence and dispatch to rebuild, repair, or replace such part of the property as had been destroyed or damaged" expires.

Safeguard argued that the period of recovery did not limit their claim for 39 years of lost income because the "business opportunities" that were "lost" were lost in the year they should have been built and thus all their prospective income was actually "lost" in the year the opportunities were "lost." Safeguard defended its period of recovery (2005 through mid-2009) by asserting that all repairs to damaged property had still not been made and (in the alternative) that the second period of recovery actually begins on the date of loss and runs until the termination of the statutory period of limitations on actions against the insured for breach of contract.

While Safeguard attempted to bring the "lost income" within the period for business interruption by asserted that the entire income stream for each lost opportunity was actually lost in the year each "opportunity" was lost, the nature of the claim was more candidly stated by it own expert. He advised that the prediction of future income and the derivation of the present valued of predicted income streams was a acceptable methodology for valuing businesses for sale.

Safeguard asserted that, but for the damage to the insured property caused by Hurricane Katrina, management would have been able to focus its day-today attention on development. According to Safeguard, this loss of management focus prevented management from pursuing development at the rate they had promised their investors. Defendants argued that this represented an indirect or remote loss excluded by the policies issued to Morgan Stanley. The policy provides:

9. Perils Excluded

This policy does not insure:

Against Indirect/remote loss

On December 23, 2009, after more than two years of litigation, the trial court granted the defendant's motions for summary judgment, finding that Safeguards' lost business opportunity claim was too speculative as a matter of law and did not fall within the business interruption provisions of the policy.

> **"claiming damages for 37 non-existing, non-identified storage facilities across the country which were going to continuously operate successfully earning imagined, projected profits for 39 unelapsed, future years constitutes speculation not actual loss sustained."**

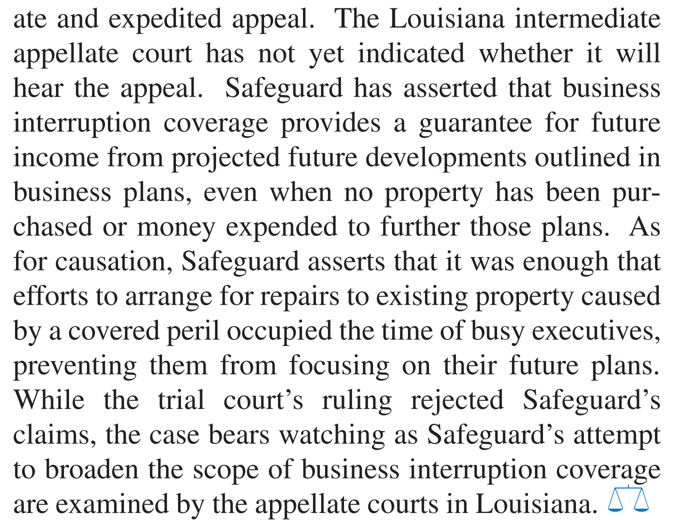
Finding the claim for projected lost income was unduly speculative, the court noted that it "could not find a single case to support, even conceptually, plaintiff's novel claim: that it was going to develop 37 entities that would have operated successfully over 39 years, and therefore, the Court should compress all future income attributable to these entities into the year the business development opportunity was supposedly lost." The court noted that there were a myriad of criteria that had to be met before construction on any of the prospective storage facilities could even begin. The court also noted all the projected sites had not been identified. [2]

In rejecting coverage for the loss under the policies' business interruption provisions, the trial judge found "that claiming damages for 37 non-existing, non-identified storage facilities across the country which were going to continuously operate successfully earning imagined, projected profits for 39 unelapsed, future years constitutes speculation not actual loss sustained." He then advised that the Period of Recovery clause was clear and unambiguous. The trial judge found that "the Initial Period begins at the time of loss and ends when the damaged insured properties could have been repaired, replaced, or rebuilt if done with diligence and dispatch, or when the business reopens. Obviously, the Initial Period is meant to protect the insured from its loss income while it repairs its damaged property. Similarly, the Extended Period begins when the damaged properties are actually repaired (or when the insurers' liability for repairs would otherwise end) and ends when the business returns to pre-loss conditions, but in all events no more than one year in total. Plainly, this Extended Period protects the insured for a limited period of time after it restores its damaged property and needs to bring its business back up to pre-loss conditions."

[2] The court cited to the decisions in *Walsh v. City Mortgage Services Inc*., 102 B.R. 502, 508-09 (M.D. La. 1989) and *Target Market Publishing Co. Inc. v ADVO Inc.* 136 F.3d 1139, 1144-66 (7th Cir. 1998). In *Walsh,* the Middle District of Louisiana rejected projections based on a document submitted for financing before a condominium was built concluding that the projection was clearly "a piece of puff" or best case scenario submitted with the loan application and was intended to convince the prospective lender to make the loan commitment. According to the court in *Walsh*, such a projection "amounts to nothing more than plaintiff's own estimate of lost profits and it thus is clearly inadmissible as evidence to establish the amount of lost profits." In *Target*, the plaintiff's expert based his projections on marketing plans, which, according to the court, were predicated on "certain assumptions that had not yet, and might never, come to pass." The trial judge advised he found Safeguard's arguments to be innovative and creative and noted that "Plaintiffs counsel was passionate about his viewpoint albeit not persuasive."

The trial judge noted that Safeguard's contention was that it was covered by both the Initial Period and the Extended Period simultaneously until it actually repaired or replaced its damaged property and thereafter continued to be covered by the Extended Period until the applicable prescriptive period expires, which Safeguard argued will be ten years after the loss, or August 29, 2015, and further for an additional year thereafter, through August 29, 2016. The trial judge found "Safeguard's view to be a strained interpretation of the policies," inconsistent with the "clear and unambiguous" language of the policies.

Following the court's ruling, Safeguard filed a motion to certify the trial court's judgment for immedi-



ate and expedited appeal. The Louisiana intermediate appellate court has not yet indicated whether it will hear the appeal. Safeguard has asserted that business interruption coverage provides a guarantee for future income from projected future developments outlined in business plans, even when no property has been purchased or money expended to further those plans. As for causation, Safeguard asserts that it was enough that efforts to arrange for repairs to existing property caused by a covered peril occupied the time of busy executives, preventing them from focusing on their future plans. While the trial court's ruling rejected Safeguard's claims, the case bears watching as Safeguard's attempt to broaden the scope of business interruption coverage are examined by the appellate courts in Louisiana.