



# Averting Disaster: Techniques for Analyzing Business Interruption Claims

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**M**ajor disasters, such as the September 11 terrorist attacks and Hurricane Katrina, grab the headlines, but more common events, such as fires, power outages or burst pipes, can also cause businesses significant problems – work stoppages, lost income and even termination of operations. Whatever the cause, business interruption insurance is essential, and businesses that conduct their own forensic accounting analysis immediately after the event can expedite the recovery process, maximize reimbursement from the insurance carrier and generally improve their chances for survival.

## **The Goal: Resumption of Operations as Soon as Possible**

Prolonged business interruptions can have devastating long-term impacts: employees may look for work elsewhere; customers may lose confidence in the company; credit might dry up. In fact, approximately 40% of companies that experience a disaster will be out of business within five years, according to research conducted by The Gartner Group.

Obviously, businesses that resume normal operations as quickly as possible after an unplanned interruption are less likely to suffer this fate. A business continuity plan is an essential tool for resurrecting a company's operations, and business interruption insurance is an important component of that plan. This insurance replaces income lost as a result of a disaster and helps defray the expense of restoring normal operations. Business interruption insurance policies, because of the way they are written, often leave a certain amount of room for interpretation. Forensic accounting techniques can help an insured maximize its recovery by developing evidence to support its claim.

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### Assembling a Multidisciplinary Team

Immediately after a loss, it is critical to assemble a multidisciplinary team of competent, independent professionals to launch the recovery plan. With an attorney coordinating the effort, the team may include public adjusters, independent appraisers and forensic accountants with insurance experience.

Too often, businesses fall into the trap of relying too heavily on the insurance carrier's forensic accountants or its own internal accounting staff to calculate the business interruption loss. The insurance company's accountants, however, work for the carrier. Even if they endeavor to provide an accurate estimate of the loss, they have no incentive to pursue creative, but legitimate, interpretations of policy language that would enhance the insured's recovery.

On the other hand, an insured that performs its own analysis – measuring its losses and documenting its claims – can help define the scope of coverage under the policy. Such analysis provides the insured's team with the ammunition needed to clearly communicate the facts to claims adjusters and other insurance company representatives, and thereby to present a cogent basis for the claim.

It is important to move quickly. Soon after a business notifies the carrier of its claim, the carrier, with the advice of its adjuster, will establish a reserve. Once that figure is set, it can be very difficult to convince the carrier to settle for a larger amount. The business will benefit greatly if its financial experts have an opportunity to meet with the adjuster and provide their input into the development of a preliminary loss estimate. By providing the carrier's representatives with the relevant facts and educating them about the nature of the policyholder's business and its

financial condition, a forensic accounting analysis can help ensure that the insurance company does not underestimate the loss.

### Case Study: Recovery from Katrina

A large residential property owner had sustained a business interruption loss as a direct result of Hurricane Katrina. The property lost rental income for a period of 16 months on more than 1,000 rental units. The owner was satisfied with the loss estimate made by the insurance carrier's forensic accountants, but his attorney recommended performing his own, separate analysis to verify the calculations made by the carrier's expert.

This company's financial statements were maintained on a hybrid basis, meaning rental income was recorded when received and expenses were recorded when incurred. The company maintained records of rents billed and collected, as well as receivables, but chose to record income on a cash basis for purposes of its internal financial reporting. The insurance policy stated that the company was insured for the net income that the business would have "earned."

The carrier's calculations, which projected rental income on a cash basis, were consistent with the company's financial statements. But by adjusting the carrier's calculation to reflect projected rental income on an accrual basis – which was consistent with both the insurance policy language and generally accepted accounting principles – the insured's own expert enabled the company to support a claim that was \$1.4 million higher than the carrier's initial determination.

As this example illustrates, a forensic accounting analysis, combined with the advice of the attorneys and adjusters in interpreting the policy language, can have a significant impact on the end result in a business interruption claim. In addition, providing this analysis to the insurer increases the

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likelihood that the claim will be resolved quickly, which improves the insured's chances of making a full recovery.

### Measuring the Loss

The amount of a loss depends on how the policy defines "business income." The two most common definitions are

1. net income the business would have earned but for the loss, plus continuing operating expenses; or
2. lost gross earnings less non-continuing expenses.

These definitions are simply two different routes to the same destination: restoring the income the business would have earned had no loss occurred (subject to policy limits, of course). Maximizing a company's recovery involves

1. analyzing the company's performance prior to the loss;
2. estimating what the company would have earned during the recovery period had no loss occurred, based on historical trends, reasonable pre-loss business plans and projections, and current industry and market conditions; and
3. analyzing the company's fixed and variable costs to identify continuing and non-continuing expenses.

In estimating business interruption losses, insurance carriers typically focus on the insured's historical operating experience. But in many cases it is possible to demonstrate that the insured would have generated more income during the recovery period than it did in the past.

Consider the case of *General Insurance Co. of America v. Pathfinder Petroleum Co.*<sup>1</sup> The insured, which had been in business only eight months, had little or no profit before a fire destroyed its gasoline manufacturing plant. It sought to recover lost profits under a 90-day "use and occupancy" policy. One issue in the case was whether the insured's recovery should include net profits that would have been earned by a polymerization plant the insured had contracted to build on the destroyed premises during the recovery period.

The insurance carrier argued that the insured should not recover these profits because the plant didn't exist at the

time of the loss. The court disagreed, noting that the insurance policy covered net profits from the business of manufacturing gasoline and the contracted polymerization plant was part of that business. The loss of use of its facility prevented the insured from building the plant and earning the profits it would have generated.

This demonstrates that a thorough analysis of a company's pre-loss business plans and projections, as well as post-loss market conditions, can help it develop a picture of the expected financial performance but for the covered loss.

### Profiting From Disaster?

It is clear that a loss calculation can consider post-loss market conditions to support a recovery of higher net profits than the insured enjoyed in the past. But what if the disaster that caused the loss also has an impact on those conditions? Can an insured calculate its lost profits based on increased demand for its products or services caused by the disaster itself? The answer to these questions depends on the specific policy language and its interpretation by the courts.

In *Prudential-LMI Commercial Insurance Co. v. Colleton Enterprises, Inc.*,<sup>2</sup> for example, the insured operated a Florida hotel that had been losing money for more than two and one-half years before Hurricane Hugo struck. After the hurricane damaged its property, the insured sought to recover lost profits under its business interruption policy. It claimed that had it not lost the use of its property, it would have profited from the influx of construction workers and other temporary residents into the area after the hurricane. Not surprisingly, the insurance company argued that the insured should not receive a "windfall" by virtue of the very disaster that caused its loss in the first place.

The answer turned on the meaning of the word "loss." In determining the insured's recovery, the insurance policy allowed consideration of its "probable earnings . . . had no loss occurred." If "loss" meant damage to the covered property, then the insured should be able to recover the profits it would have earned in the post-hurricane economy. But the court interpreted the term to mean the covered peril – that is, the hurricane. In other words, the

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insured was only allowed to recover the profits it would have earned if Hurricane Hugo had not happened.

A similar conclusion was reached in *American Automobile Insurance Co. v. Fisherman's Paradise Boats, Inc.*,<sup>3</sup> which concerned an insured's boat and marine accessory store damaged by Hurricane Andrew. The court rejected the insured's argument that it should be permitted to recover the profits it would have earned based on increased demand for its products in the hurricane's aftermath.

Critics of this conclusion, including the dissenting judge in *Prudential-LMI v. Colleton*, point out that "loss" most likely refers to the insured's loss, not the overall loss in the area struck by the disaster. And at least one federal court has agreed. In *Stamen v. CIGNA Property & Casualty Co.*,<sup>4</sup> several of the insured's grocery stores were damaged by Hurricane Andrew. The insured claimed business interruption losses based on the profits it would have earned had the stores stayed open after the hurricane. Rejecting the insurer's "windfall" argument, the court made a distinction between "loss" and "occurrence." In this case, the "occurrence" was the hurricane, while the "loss" was the property damage to the insured's stores. The court observed that if the insurer intended to calculate the insured's lost profits based on what it would have earned if the hurricane had never occurred then the policy could have used that language.

The insured also prevailed in a case involving different policy language. In *Levitz Furniture Corp. v. Houston Casualty Co.*,<sup>5</sup> a flood damaged the insured's furniture store and destroyed its showroom inventory. The court allowed the insured to recover lost profits based on increased demand for its products caused by the flood. Unlike the policy in *Prudential-LMI v. Colleton*, which allowed the insured to recover its probable earnings had *no loss occurred*, the policy in this case provided for recovery of earnings "had no interruption of production or suspension of business operations or services occurred."<sup>6</sup> The court distinguished *Colleton* and *American Automobile Insurance Co. v. Fisherman's Paradise*, explaining that in this case the policy unambiguously provided for coverage of income the insured would have earned "had no interruption occurred"

and did not "exclude profit opportunities due to increased consumer demand created by the flood."<sup>7</sup>

Many newer business interruption policies contain language intended to prevent policyholders from recovering a perceived windfall. The Insurance Services Office (ISO), for example, has amended its forms to exclude "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."

In cases where a disaster affects post-loss market conditions, it's particularly critical to conduct an analysis of economic and market factors. If the policy language prevents the insured from taking advantage of post-loss opportunities – or if the courts in the relevant jurisdiction follow the *Colleton-Fisherman's Paradise* line of thinking – this analysis can help maximize the insured's recovery by distinguishing market conditions created by the disaster from those caused by other factors.

### Determining the Period of Restoration

The period of restoration (POR) has an enormous impact on a company's potential recovery under a business interruption policy. Traditionally, policies have permitted an insured to recover lost income during the time it would take, with due diligence, to repair or replace the damaged property and resume operations under the same or equivalent conditions that existed before the disaster. Some policies also provide extended coverage to compensate the insured for the lingering impact of the disaster on sales even after operations are restored.

It is important for attorneys and financial experts to work together to ensure that an appropriate POR is used to calculate the loss. For example, the POR usually includes delays in repairing or rebuilding the property caused by the insurer, construction problems or other factors beyond the insured's control.

In some cases, it may be appropriate to extend the POR to allow the insured to make improvements to the property. In *Compagnie Des Bauxites de Guineea v. Insurance Co. of*

*North America*,<sup>8</sup> for example, the court found that the POR should allow the insured time to improve its facility in order to prevent the same type of damage from recurring. And in *Anchor Toy Corp. v. American Eagle Fire Insurance Co.*,<sup>9</sup> the court rejected the insurance company's argument that the POR should be based on the time needed to build an identical structure. "It is beyond the bounds of reasonable contemplation," the court explained, "to expect that a replacement structure would ignore all progress in the art and slavishly retain any proven disadvantage. It must be the intent of the policy that the new building to be erected would be modern as well."<sup>10</sup>

### Location as Factor in Recovery

The destruction of the World Trade Center (WTC) as a result of the September 11 terrorist attacks led to some interesting litigation over the appropriate POR. Traditionally, courts interpreted business interruption policies in a way that recognized the value of the insured's location. Even if an insured permanently relocated to a different location, the POR was based on the *theoretical* time it would take, with due diligence, to rebuild at the original location. This approach allowed the insured to recover for the lost value of its location – mitigated, of course, by any profits earned at the new location during the POR.

Some modern policies, however, have redefined the POR as the time it takes to repair or replace the damaged property or, if less, the time it takes to resume operations at a new, permanent location. Some courts have taken a similar approach, even in cases involving policies containing the traditional definition described above.

For example, *Duane Reade, Inc. v. St. Paul Fire & Marine Insurance Co.*<sup>11</sup> concerned the drugstore chain, which had operated a retail outlet in the WTC concourse. The district

court found that the POR was the time needed for the insured to resume "functionally equivalent operations" at the location where its WTC store had been. The appellate court disagreed, however, defining the POR as the time required to "build a reasonably equivalent store *in a reasonably equivalent location*."<sup>12</sup>

The court's conclusions in *Duane Reade* were based in part on a very narrow interpretation of the damaged property that triggered business interruption coverage, limiting it to the insured's *personal* property at the WTC store. The court also found that because the policy was a blanket policy covering all of the insured's stores, it was inappropriate to tie the POR to a specific site.

Other cases have reached a different conclusion. *Zurich American Insurance Co. v. ABM Industries*<sup>13</sup> involved a company that maintained facilities at the WTC and provided janitorial and engineering services to WTC tenants, and common areas. Its business interruption policy covered damage to property "owned, controlled, used, leased or intended for use by" the insured. Instrumental to ABM's recovery was the appellate court's finding that it "used" the WTC in its business.<sup>14</sup>

On remand from the circuit court of appeals, the district court distinguished this case from cases like *Duane Reade*: "ABM cannot simply relocate to another building and carry on its business. To the contrary, ABM's business was . . . fundamentally connected to its use of the common spaces at the World Trade Center."<sup>15</sup> The court concluded that the appropriate POR was "the hypothetical length of time required to rebuild the WTC."<sup>16</sup>

### Scope of Coverage

Historically, business interruption coverage was triggered by direct damage to the insured property, but modern policies often provide broader protection. For example, many policies offer "ingress/egress" coverage, which compensates the insured when damage to a third party's property prevents access to the insured's business.

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“Contingent business interruption” insurance protects a business against losses resulting from property damage suffered by a supplier or customer. Coverage can vary dramatically, however, from policy to policy. Some policies, for example, provide coverage up to overall policy limits, while others impose smaller limits on contingent business interruption claims. Also, some policies limit this type of coverage to specifically named customers or suppliers, while others are less restrictive. Interestingly, in *Zurich American Insurance Co. v. ABM Industries*, the insured had purchased contingent business interruption coverage, but it was subject to a \$10 million limit. By establishing that it had an insurable interest in the WTC itself, the company was able to take advantage of its business interruption policy’s overall limit of \$127 million.

Major disasters can raise challenging issues regarding the scope of coverage. Most policies contain a “civil authority clause,” which compensates a business for losses incurred when an order of a civil or military authority impedes access to the insured property. Would this allow a resort hotel in Hawaii, for example, to recover losses caused by the Federal Aviation Administration’s ban on air travel after the September 11 terrorist attacks? Or was coverage limited to policyholders who sustained physical damage to their insured property?

The answer to these and other questions depends on the language of the policy and, in many cases, on the interpretation of that language by the courts.

### Mitigating Losses

In the early stages of the claims process, it is critically important for a business that has suffered a disaster to identify actions it can take to mitigate losses. For example, a manufacturer or distributor that suffers a business interruption might be able to preserve its income stream by shifting production or sales to another facility, or to an outside contractor. In most cases, the insurer will be willing to pay the extra expense resulting from such a shift because it should reduce the company’s overall losses. In addition, offering to take these steps demonstrates to the insurer that the insured is acting in everyone’s best interests.

### Conclusion

Some policyholders take the approach of throwing every possible loss against the wall and seeing what sticks, but this is rarely a good strategy. Not only does it delay recovery while the insurer attempts to separate fact from fiction, but it is also a sure way to lose credibility with claims adjusters and other key insurance company decision-makers. Policyholders know more than anyone else about their business, their industry, and their financial condition. Conducting their own forensic accounting analysis gives them an opportunity to communicate relevant information to their insurers in language the latter can understand, enabling adjusters and others involved in the process to conduct an efficient, well-reasoned analysis of the claim.

Taking this step in the early stages of the claim not only maximizes an insured’s ultimate recovery, but can also accelerate the reimbursement process and support requests for advance payments from the insurer – which can be essential to the company’s cash flow as it restores its operations. The actions taken by a business immediately following a disaster therefore are critical, and can have an enormous impact not only on its insurance recovery, but on the survival of the business itself. Forensic accounting techniques can play an invaluable role in this process. ■

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<sup>1</sup> 145 F.2d 368 (9th Cir. 1944).

<sup>2</sup> 976 F.2d 727 (4th Cir. 1992).

<sup>3</sup> No. 93-2349, 1994 WL 1720238 (S.D. Fla. Oct. 3, 1994).

<sup>4</sup> No. 93-1005, Slip Op. (S.D. Fla. June 13, 1994).

<sup>5</sup> No. Civ. 96-1790, 1997 WL 218256 (E.D. La. Apr. 28, 1997).

<sup>6</sup> *Id.* at \*8.

<sup>7</sup> *Id.*

<sup>8</sup> 794 F.2d 871 (3d Cir. 1986).

<sup>9</sup> 4 Misc. 2d 364, 155 N.Y.S.2d 600 (Sup. Ct., N.Y. Co. 1956).

<sup>10</sup> *Id.* at 367.

<sup>11</sup> 411 F.3d 384 (2d Cir. 2005).

<sup>12</sup> *Id.* at 393 (emphasis added).

<sup>13</sup> 265 F. Supp. 2d 302 (S.D.N.Y. 2003), *aff’d* in part, *vacated* in part, *rev’d* in part by 397 F.3d 158 (2d Cir. 2005), on remand to No. 01 Civ. 11200, 2006 WL 1293360 (S.D.N.Y. May 11, 2006).

<sup>14</sup> *Zurich*, 397 F.3d at 165–67.

<sup>15</sup> *Zurich*, 2006 WL 1293360, at \*2.

<sup>16</sup> *Id.* at \*3.