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How to Recover Business Interruption Losses

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When people think of commercial property insurance policies (assuming that they ever think of them at all), they typically think of coverage for damage to buildings and their contents. For example, if a factory burns down, the property insurance policy will pay the amount needed to replace the damaged property—or at least the value of the property that was destroyed.

But most commercial property insurance policies provide additional coverage that not only insures the cost to repair or replace what has been physically damaged but also compensates the policyholder for profits lost during the period of time needed to recover from the physical damage. Thus, for example, if it takes a year to rebuild the damaged factory, and the policyholder suffers $3,000,000 in lost sales, after considering saved expenses during the rebuilding process, most property insurance policies will cover these "business interruption" (BI) losses.

The specific scope and terms of "business interruption" coverage vary from one policy form to the next, but most have similar sets of moving parts. First, there is the coverage grant. The standard Insurance Services Office Inc. (ISO) policy form promises to pay as follows:

> 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.

Basically, this coverage is designed to do for the policyholder what its business would have done had no loss occurred.

The amount of time for which lost profits are covered depends on the "period of restoration" or "period of recovery" specified in the policy. Under the ISO form, for example, the period begins a certain number of hours after the physical loss occurs and 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. Because it can take many years to make the physical repairs following certain losses, the wording of the period of recovery provision can be very important to policyholders.
Other insurance policies provide a period of recovery as follows:

> Starting from the time of physical loss or damage of the type insured against; and ending when, with due diligence and dispatch the building and equipment could be repaired or replaced and made ready for operations under the same or equivalent physical and operating conditions that existed prior to the damage.[1]

Of course, for many businesses, the lost profits do not cease completely as soon as the doors reopen following a loss. Indeed, for most businesses, there is a period of time needed to "ramp up" operations following a loss before business levels return to normal. The continued lost profits during this time period are covered under many property policies' "extended business interruption" coverage. Under the ISO form, coverage is extendedfor the actual loss of Business Income you incur during the period that: (a) Begins on the date property is actually repaired, rebuilt or replaced and "operations" are resumed; and (b) Ends on the earlier of: (i) The date you could restore your "operations", with reasonable speed, to the level which would generate the business income amount that would have existed if no direct physical loss or damage had occurred; or (ii) 60 consecutive days after the date determined in (1)(a) above.

For many policyholders, this "extended business interruption" can be very valuable, but its ultimate value often is truncated by the 60-day or other cap on the length of the coverage—a cap that is common in many policies.

Many times, a policyholder suffers a serious loss in business income because of an event or damage that occurs away from the policyholder's insured premises. Such losses commonly are covered under the "contingent business interruption" (CBI)provision included in many property insurance policies. CBI coverage typically is measured like a business interruption loss and covers the policyholder's lost profits, but it is triggered by a covered loss event at the premises of a customer or supplier—possibly even twice removed from the policyholder.[2]

Calculating Losses

The calculation of a business interruption loss is guided by the terms in the insurance policy, which can vary from policy to policy. The ISO form uses the following language to explain how BI losses are to be measured:

> The amount of Business Income loss will be determined based on:
> (1) The Net Income of the business before the direct physical loss or damage occurred;
> (2) The 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;

> (3) The operating expenses, including payroll expenses, necessary to resume "operations" with the same quality of service that existed just before the direct physical loss or damage. . . .

Applying such provisions when measuring business interruption losses is part art and part science. Claims adjusters and forensic accountants are wise to follow the terms in the policy and the applicable legal standards when calculating a loss. In general, whether a party is seeking damages for property loss, business interruption, or other loss, it must prove those damages to a "reasonable certainty."[3]

In some instances, proving damages is relatively straightforward. For a party seeking the cost of repairing damaged property, for example, proving the cost of those repairs to a reasonable certainty generally entails providing the insurance company or court with documents substantiating the amount spent to perform repairs. In some instances, where repairs have not yet been completed, a party may rely on estimates showing how much it is reasonably likely to cost to perform those repairs. In these instances, having an expert testify as to the reasonable cost of repairs may be sufficient to satisfy the policyholder's burden of proof.

Proving damages when there is a business interruption loss, however, may not always be so straightforward. One reason is that business income loss claims must be calculated based on an alternate universe in which the loss to the business did not happen.[4] To calculate the loss, therefore, the policyholder typically has to project income, estimate earnings, and also estimate or justify soft costs such as payroll for employees who may have no place to work.[5] Calculating business income loss can be further complicated in situations where an event, such as a hurricane or other natural disaster, has caused a widespread loss that affects the surrounding economy.[6]

When there is a widespread catastrophic event, there is not only a question of how the policyholder's business would have performed had there been no loss to its business, but there is also a question as to what the surrounding economy would have been had there not been a natural disaster or other loss where there is a widespread impact. A related question may also be whether it is appropriate to measure the policyholder's business income loss by taking into consideration how much time it may take for the surrounding area and economy to recover. These issues were addressed on numerous occasions in the coverage disputes that arose following the terrorist attacks on September 11, 2001.[7]

Given the complexities in calculating business income loss, policyholders and practitioners often use forensic accountants to assist in the measurement of such losses. Insurance companies also typically engage forensic accountants to estimate the loss and reserves, and to check the policyholder's methodology. Whether the accountant is working on behalf of the policyholder or insurance company, there is rarely agreement on the "right" way to estimate a loss and predict the business's behavior and performance had there been no loss. To some degree, both the policyholder's and insurance company's accountants are providing their best estimates.

As noted, the majority of courts weighing in on the question of whether a policyholder has sufficiently proven its business income loss have concluded that a policyholder must prove its damages with "reasonable certainty."[8] For example, courts have found that providing "summaries" of calculations to substantiate business income loss satisfies the "reasonable certainty" requirement.[9] Indeed, courts have relied on all sorts of evidence in ruling on business income loss claims.[10]

This "reasonable certainty" standard is different from *Daubert* and for good reason. When predicting what a business would do in a hypothetical environment, that prediction—whether performed by the insurance company's or policyholder's expert—can never be said to be verifiable "with scientific certainty."[11] Calculating business income losses can be complicated enough when dealing with a business that is a going concern and has a long record of performance. But consider the scenario where the loss is to a start-up operation. Consider, for example, the situation in which there is an explosion days before a factory was to open. How should a practitioner approach the calculation of the business income loss for a business with no operating history and potentially no peers?

Projecting Profits

One of the most common areas of dispute in business interruption claims is projecting the profits a business would have had "but for" the loss.
There are several ways one could select to project a business's profitability (in terms of revenues and expenses). The following are among them:

- budgets
- adjusted budgets
- forecasts
- run rates or pre-loss averages, including for the prior year
- percentage of market share
- other independent variables
- financial data for comparable businesses not affected by the loss

In addition, there are several internal and external factors to consider when projecting profitability. Internal considerations include capacity, labor force availability, maximum production volumes, labor cost, material cost, sales force, and working capital. External considerations include the industry, competition, and the economy, among others.

Given the numerous variables involved in projecting profitability, differences of opinion on the method or the amount being projected (or both) do occur. But generally, with the appropriate data and proper analysis, these differences can be eliminated or at least narrowed greatly.

However, there are a few situations where projecting the profitability of a business could be significantly affected by the event itself. Here are a few examples:

· A major hurricane, such as Katrina, dramatically changes the conditions of the market locally and regionally for an extended period of time.
· A loss at a single facility disrupts the entire supply of a product, causing price increases for the product through the entire industry.
· A loss occurs at a start-up operation for which there is no operating history and no history of revenues, costs, or profits.

An illustration of the first example is that many restaurant, hospitality, and retail businesses have a sales increase after a widespread natural disaster. Local residents who lost their homes move to hotels for lodging and dine at restaurants for meals. In addition, there is an influx of construction workers and insurance personnel (adjusters, accountants, engineers, etc.) into the area, which causes increased demand and sales for hotels and restaurants. To complicate things further, hotels are frequently damaged or destroyed in the event, making them uninhabitable, which prevents the hotel from participating in the current market conditions, while also reducing the supply of rooms. Generally, retail businesses enjoy increased sales as residents who lost their personal property in the event flock to stores to replace belongings. Home improvement retail stores have huge increases in sales as people and businesses in the area begin the rebuilding process.

Should these market increases be factored into the sales projections of restaurants, hotels, and retail businesses that were damaged and could not operate during this period? If they had not been damaged, they too would have enjoyed an increase in sales during the post-event period. This issue has been disputed and litigated many times over. As usual, it depends on the specific insurance policy in force at the time of the loss and the facts of the matter. There have been some changes in policy language to address this issue, but unfortunately, those changes do not reflect a balanced approach. Several policies, including the ISO form, now have language that excludes the effect of any “favorable business conditions caused by the impact.” Of course, if an insurance company can draft and use language that does not allow favorable conditions to be factored into the BI calculation, it surely could use language clearly stating that unfavorable post-loss conditions must be discounted as well—but such provisions are uncommon (if they exist at all). Thus, insurance company efforts to reduce BI loss calculations due to unfavorable post-loss conditions generally are inconsistent with the policy wording. Absent clear policy language to the contrary, the approach adopted by courts is to prohibit an insurance company from reducing the amount of the BI calculation based on unfavorable business conditions caused by the wider effects of a catastrophe.[12]

For start-up businesses, there are several methods that can be used to estimate the income that the business would have generated in the first weeks and months after a loss. One way is to use materials that were submitted to banks or other lending institutions to support an application for a business loan. That information regularly contains projections for business income and can be valuable to substantiate business income loss estimates.[13] For example, policyholders starting businesses frequently prepare projections of how rapidly loans will be paid. Other documents, including 10-K filings, may provide additional information about the projected time line of operations, revenue, and business income that the business is expected to generate. These documents, prepared before a loss, may enjoy an imprimatur of reliability that can be powerful both in negotiating a business income loss payment and in persuading a court or arbitrator of the validity of the business income loss calculation.

Another potentially compelling source of information that can be used to substantiate business income loss claims and calculations is the set of business income loss calculations and estimates that were part of the policyholder's insurance policy application. Policyholders who are purchasing business interruption coverage are routinely required to provide estimates of their business income to substantiate the limits that are requested. Policyholders are wise to turn to those estimates and consider using the same methods for calculating business interruption losses.
The counterfactual basis of business interruption coverage provides fertile ground for coverage disputes. The more precisely policyholders can document their loss calculations, the more likely they are to expedite and maximize recovery.

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[1] *Retail Brand All., Inc. v. Factory Mut. Ins. Co.*, 489 F. Supp. 2d 326, 329 (S.D.N.Y. 2007).
[2] As the Seventh Circuit noted in *Archer Daniels Midland Co. v. Hartford Fire Insurance Co.*, 243 F.3d 369, 371 (7th Cir. 2001), CBI coverage can be "just the ticket" for policyholders whose businesses are affected by remote events.
[3] *See, e.g.*, *Albany Ins. Co. v. Bengal Marine, Inc.*, 857 F.2d 250, 253 (5th Cir. 1988) ("It suffices if a state of facts is shown from which a court or jury can find with reasonable certainty that the damages claimed were actually or may be reasonably inferred to have been incurred[.]" (quoting *Mitsui O.S.K. Lines, K.K. v. Horton & Horton, Inc.*, 480 F.2d 1104, 1106 (5th Cir. 1973))); *Int'l Commc'n Materials v. Emp'r's Ins. of Wausau*, No. 94-1789, 1996 U.S. Dist. LEXIS 21825, at *28 (W.D. Pa. May 29, 1996) ("[A]s in any breach of contract action, the insured had the burden of proving damages with reasonable certainty."); *see also* Fed. R. Evid. 702.

[4] *See, e.g.*, *Polytech, Inc. v. Affiliated FM Ins. Co.*, 21 F.3d 271 (8th Cir. 1994); *Blis Day Spa, LLC v. Hartford Ins. Group*, 427 F. Supp. 2d 621 (W.D.N.C. 2006); *Howard Stores Corp. v. Foremost Ins. Co.*, 82 A.D.2d 398 (N.Y. App. Div. 1981).
[5] *See, e.g.*, *La Louisiane Bakery Co. v. Lafayette Ins. Co.*, 61 So. 3d 17, 31 (La. Ct. App. 2011).
[6] *See, e.g.*, *Maloney Cinque, L.L.C. v. Pac. Ins. Co.*, 89 So. 3d 12 (La. Ct. App. 2012).
[7] *See, e.g.*, *Duane Reade, Inc. v. St. Paul Fire & Marine Ins. Co.*, 411 F.3d 384 (2d Cir. 2005); *Retail Brand All., Inc. v. Factory Mut. Ins. Co.*, 489 F. Supp. 2d 326 (S.D.N.Y. 2007); *Streamline Capital, L.L.C. v. Hartford Cas. Ins. Co.*, No. 02 Civ. 8123, 2003 U.S. Dist. LEXIS 14677 (S.D.N.Y. Aug. 25, 2003).
[8] *See, e.g.*, *La Louisiane Bakery*, 61 So. 3d 17 ("[A]s a general rule damages for loss of profits may not be based on speculation and conjecture; however, such damages need be proven only within reasonable certainty. . . . Broad latitude is given in proving lost profits because this element of damages is often difficult to prove and mathematical certainty or precision is not required." (citations omitted)).
[9] *See, e.g.*, *Diamond Shamrock Corp. v. Lumbermens Mut. Cas. Co*., 466 F.2d 722, 728 (7th Cir. 1972).
[10] *See Maher v. Cont'l Cas. Co.*, 76 F.3d 535, 541 (4th Cir. 1996) ("[E]vidence such as economic and financial data, market surveys and analyses, business records of similar enterprises, and—of course—expert testimony" all can be used to establish lost profits); *Am. Med. Imaging Corp. v. St. Paul Fire & Marine Ins. Co.*, 949 F.2d 690, 694 (3d Cir. 1991) (projections formulated in regular course of business prior to loss sufficient to defeat summary judgment); *Presbyterian Manors, Inc. v. SimplexGrinnell, L.P.*, No. 09-2656, 2011 U.S. Dist. LEXIS 83134, at *39 (D. Kan. July 29, 2011) ("spreadsheets setting forth information regarding damages, but not a calculation of lost profits" sufficient to overcome summary judgment); *Net 2 Press, Inc. v. Emp'rs Fire Ins. Co.*, No. 03-124-P-H, 2004 U.S. Dist. LEXIS 18929, at *27–29 (D. Me. Sept. 22, 2004) (unsubstantiated estimates of lost income sufficient to defeat summary judgment motion); *Rubbermaid, Inc. v. Hartford Steam Boilers Inspection Co.*, 645 N.E.2d 116, 118–19 (Ohio Ct. App. 1994) (despite no evidence "concerning actual lost sales to specific customers" policyholder presented sufficient evidence of lost profit by submitting other evidence including the sales record of the product from its beginning, which showed that the product's sales declined during the business interruption period; forecasted sales; and how the product was sold).
[11] *See, e.g.*, *Precision Pine & Timber, Inc. v. United States*, 72 Fed. Cl. 460, 490 (2006) (stating that lost profits can be shown by the estimate of "what might have been" (quoting *Glendale Fed. Bank, F.S.B. v. United States*, 239 Fed. Cl. 1374, 1380 (Fed. Cir. 2001))).
[12] *See Prudential LMI Commercial Ins. Co. v. Colleton Enters., Inc.*, No. 91-1757, 1992 U.S. App. LEXIS 25719 (4th Cir. Oct. 5, 1992); *Georgia-Pacific Corp. v. Allianz Ins. Co.*, 977 F.2d 459, 462 (8th Cir. 1992); *Gen. Ins. Co. of Am. v. Pathfinder Petroleum Co.*, 145 F.2d 368, 370 (9th Cir. 1944); *Catlin Syndicate Ltd. v. Imperial Palace of Miss., Inc.*, No. 08CV97, 2008 U.S. Dist. LEXIS 103831, at

*20 (S.D. Miss. Dec. 15, 2008); *Am. Auto Ins. v. Fisherman's Paradise*, Nos. 93-2349-CIV, 94-0014-CIV, 1994 U.S. Dist. LEXIS 21068, at *9–11 (S.D. Fla. Oct. 3, 1994); *Cappel House Furnishing Co. v. United States*, 140 F. Supp. 92, 95 (S.D. Ohio 1956); *cf.*, *Levitz Furniture Corp. v. Houston Cas. Co.*, No. Civ. A. 96-1790, 1997 U.S. Dist. LEXIS 5883 (E.D. La. Apr. 28, 1977) (allowing the policyholder the *benefit* of *favorable* post-loss business conditions in calculating its BI loss).
[13] *See, e.g.*, *Kilpatrick v. Wiley*, 37 P.3d 1130 (Utah 2001).