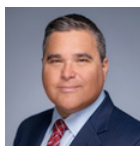


ANDERSON KILL

## Construction Industry Advisor

# Don't Let Your Builder's Risk Insurance Company Depreciate Your Business Interruption or Rental Income Losses



By **Dennis J. Artese**

### *Key points:*

**In claims under builder's risk insurance policies, insurance companies often attempt to reduce business interruption and rental income recoveries by deducting depreciation as a "non-continuing expense."**

**A majority of courts have ruled that depreciation is not a non-continuing expense that should be deducted.**

**Business interruption and rental income coverages are designed to protect cash flow, and because depreciation is an accounting device unrelated to cash flow, it should not be deducted.**

Two significant coverages under builder's risk and commercial property insurance policies are business interruption and rental income coverages. In the builder's risk context, these coverages are intended to protect the policyholder's lost profits and continuing expenses, typically for the time in which completion of the project is delayed as a result of a covered event under the policy. Policyholders cannot recover non-continuing expenses, i.e., those expenses that do not continue when operations are suspended. Insurance companies routinely attempt to slash business interruption and rental income recoveries by arguing that saved depreciation — for tax purposes — on a damaged or destroyed building is a non-continuing expense and thus must be deducted from the obligation to pay most business interruption and rental income losses. Don't let them do it.

Courts have long recognized the fundamental difference between accounting methods and valuation for property insurance. Indeed, the strong majority of courts to consider the issue recognize that depreciation is an accounting device unrelated to the cash flow that business interruption and rental income



coverages are designed to protect, and, therefore, it would be improper to discontinue depreciation during the time in which the covered property is damaged or the project's completion is delayed because of that damage.

In *155 N. High Ltd. v. Cincinnati Insurance Co.*, 599 N.E.2d 352 (Ohio Ct. App. 1991), the policyholder sought business interruption coverage after the office building where it was located was destroyed. The accountant and the insurance company concluded depreciation was a non-continuing expense, thereby significantly reducing the policyholder's loss. (*Id.* at 354.) The policy at issue provided that the insurance company would "be liable for 'the actual loss sustained by the insured resulting directly from necessary inter-

ruption of business, but not exceeding the reduction in earnings less charges and expenses which do not necessarily continue during the interruption of business...,” and provided that the insurance company would be liable for “the ACTUAL LOSS SUSTAINED by the Insured resulting directly from necessary untenability, ...but not exceeding the reduction in Rental Value less charges and expenses which do not necessarily continue during the period of untenability.” (*Id.* at 356-57.) The trial court held depreciation was not a non-continuing expense and was therefore improperly deducted from the policyholder’s claim. (*Id.* at 354.)

On appeal, the court affirmed, concluding that depreciation was not a “charge or expense” that was non-continuing:

In the final analysis, depreciation is not an out-of-pocket charge or expense; rather, it is an accounting device that permits a taxpayer to recover his or her investment in property over the property’s useful life. Since depreciation is an accounting device not pertinent to determining cash flow, which RVI coverage protects, depreciation is not properly deducted as a noncontinuing expense in calculating actual loss under plaintiff’s RVI endorsement. (*Id.* at 357-58, internal citations omitted.)

The court in *Vermont Mutual Insurance Co. v. Petit*, 613 F. Supp. 2d 154 (D. Mass. 2009), articulated a number of reasons why it would be improper not to treat depreciation as a continuing expense, including the fact that the insurance company already had deducted depreciation from the policyholders’ property damage recovery:

Courts in other jurisdictions that have considered whether de-

preciation constitutes a discontinuing expense have answered in the negative, and this court agrees. The Policy is intended to reimburse the [policyholders] for the gross income that they would have earned by leasing the units in the Property, or “cash flow.” Cash flow is “[c]ash receipts minus cash disbursements for a given period.” [The insurance company’s] own expert agreed that depreciation “would not impact [the policyholders’] cash flow on a month-to-month basis.” Moreover, because depreciation is an accounting factor for tax purposes, including it as a discontinuing expense would lead to “inconsistent results ... depending solely on whether the insured took depreciation on his tax return.” Finally, depreciation has effectively been “accelerated” in this case because [the insurance company] and the [policyholders] deducted it from the [policyholders’] stipulated-to property damages recovery. Deducting depreciation from the [policyholders’] lost rental income recovery would amount to double-counting. (*Id.* at 160.)

The court in *Grevas v. United States Fidelity & Guaranty Co.*, 604 N.E.2d 942, 943 (Ill. 1992), also addressed the issue of depreciation as a continuing expense for business interruption purposes. The trial court concluded that it was ambiguous as to whether depreciation should be considered a continuing expense, because: (1) the policy did not specifically list depreciation as a non-continuing expense; and (2) treating depreciation as a non-continuing expense would lead to inconsistent results depending on whether (a) the policyholder took

***The Illinois Supreme Court found it important that the policy did not mention depreciation as a non-continuing expense, and that “there is no indication here that depreciation is anything other than an accounting device for tax purposes.”***

depreciation on his tax return and (b) the building was damaged (and depreciation was still taken) or it was destroyed (and it was not taken). *Id.*

The appellate court reversed, but on appeal, the Supreme Court of Illinois cited *155 N. High Ltd. v. Cincinnati Insurance Co.*, 599 N.E.2d 352 (Ohio Ct. App. 1991), concluding as follows: “Noncontinuing charges and expenses under different policy provisions may differ. While we do not address whether depreciation is a charge or expense under a loss of earnings provision, under the loss of rents provision it is not, for depreciation has no effect on cash flow.” Grevas, 604 N.E.2d at 947. Further, the court found it important that the policy did not mention depreciation as a non-continuing expense, and that “there is no indication here that depreciation is anything other than an accounting device for tax purposes.” *Id.*; see also *Boardwalk Apartments, L.C. v. State Auto Prop. & Cas. Ins. Co.*, 11 F. Supp. 3d 1062, 1094 (D. Kan. 2014), *rev’d on other grounds*, 816 F.3d 1284 (10th Cir. 2016) (“The Court is persuaded that the Grevas line of cases controls this question. In the rental value context, depreciation should not be treated as a non-continuing expense that should be deducted from [the policyholder’s] business income benefit. [The policyholder’s] business income claim is for rental value, and under the cases construing policies that apply to such rental income, only out-of-pocket expenses that affect cash flow should be deducted; depreciation is instead an accounting figure for tax purposes.”).

This is the correct result for all business interruption and lost rents claims. While some case law exists standing for the opposite proposition, these decisions almost universally conflate depreciation, the accounting principle, with continuing necessary expenses, the business interruption principle. Those cases also may be distinguishable on their facts, as they typically do not deal with properties that generate cash flow through rental payments, unlike many claims under builder’s risk policies.

Business interruption and rental income coverages are designed to protect cash flow, and because depreciation is an accounting device unrelated to cash flow, it should not be deducted from business interruption or rental income recoveries as a non-continuing expense. Policyholders should strongly resist any attempt to do so by their insurance companies, and should consider engaging experienced coverage counsel to support that effort. ▲

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