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ALERT

Show Me the Losses: Recent Federal Decisions Demonstrate the Importance of Properly Documenting Business Interruption Claims

By Allen R. Wolff and Eric R. Reed

Decisions made by a company in the days and weeks following an unforeseen event — think flood, fire or equipment breakdown — bear directly on the success of a claim for business interruption losses. Business interruption insurance, also known as business income insurance, is usually included as part of a first party (i.e., non-liability) commercial property insurance policy. It's essential for any hospitality business, for which business income is directly related to the functioning and appearance of the business's structures.

The typical insuring clause states something similar to the following:

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.

Business interruption coverage is designed to replace income that would otherwise have been earned by the business had no loss occurred. Over the last year, at least three federal court decisions reminded policyholders that the success of a BI claim is contingent on promptly identifying and documenting the losses related to an interruption.

In *Pyramid Technologies, Inc. v. Hartford Casualty Insurance Company* 752 F.3d 807 (9th Cir. 2014), a flood prompted Pyramid to notify Hartford of potential damage to electronic components a customer had recently committed to purchase. Hartford found no evidence of water-related damage and denied coverage under Pyramid's BI policy. Pyramid sued for declaratory relief as to coverage, but Hartford prevailed on summary judgment. The Ninth Circuit affirmed because Pyramid failed to show that it actually lost business as a result of the flood. The court noted the "commitment" to purchase the components was still subject to the approval of the customer's quality control department. It pointed to evidence that the customer may have rejected Pyramid as a supplier anyway because the facility lacked a humidity control system. The Court of Appeals refused to allow the business interruption claim to go to trial

ANDERSON KILL
1251 Avenue of the Americas
New York, NY 10020
(212) 278-1000 Fax: (212) 278-1733

ANDERSON KILL
864 East Santa Clara Street
Ventura, CA 93001
(805) 288-1300 Fax: (805) 288-1301

ANDERSON KILL
1600 Market Street, Suite 2500
Philadelphia, PA 19103
(267) 216-2700 Fax: (215) 568-4573

ANDERSON KILL
1055 Washington Boulevard, Suite 510
Stamford, CT 06901
(203) 388-7950 Fax: (203) 388-0750

ANDERSON KILL
1717 Pennsylvania Avenue, Suite 200
Washington, DC 20006
(202) 416-6500 Fax: (202) 416-6555

ANDERSON KILL
One Gateway Center, Suite 1510
Newark, NJ 07102
(973) 642-5858 Fax: (973) 621-6361

ANDERSON KILL
JP Morgan International Plaza III
14241 Dallas Parkway, Suite 650
Dallas, TX 75254
(972) 728-8753 Fax: (805) 288-1301

www.andersonkill.com





who's who

Allen R. Wolff is a shareholder in the New York office of Anderson Kill. Mr.

Wolff's practice concentrates in construction litigation, insurance recovery, and the nexus between the two, as well as in complex commercial litigation. Mr. Wolff is a member of the firm's hospitality industry practice group.

awolff@andersonkill.com
(212) 278-1379



Eric R. Reed is an attorney in the Ventura, California, office of Anderson Kill. Mr. Reed's practice concentrates in corporate and

commercial litigation and insurance recovery, exclusively on behalf of policyholders.

ereed@andersonkill.com
(805) 288-1300

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when doing so would require the jury to "speculate" about whether the customer would honor its commitment to buy from Pyramid.

Just two months before the appellate court's decision in favor of Hartford in the *Pyramid Technologies* case, Hartford had prevailed on summary judgment in another business interruption claim within the Ninth Circuit. In *Nonpareil Corp. v. Hartford Cas. Ins. Co.* (No. 4:10-cv-00500-EJL; March 17, 2014; 2014 U.S. Dist. LEXIS 35461), Nonpareil suffered a seven-week boiler failure that prevented it from processing existing stocks of potatoes. The company was forced to discard the rotten product and sell the balance at distressed prices to mitigate its losses. Hartford paid expenses related to boiler repairs and order fulfillment, but refused to pay a significant part of the rot-related losses claimed by the policyholder. Nonpareil filed a federal coverage action seeking the value of 70,000 pounds of discarded potatoes. The district court ruled that Nonpareil failed to adequately document more than 30,000 pounds of the claimed loss:

The Court finds Nonpareil was well aware of the date of the boiler breakdown and that it would be filing an insurance claim for the expenses incurred as a result . . . [T]he burden was on Nonpareil to keep adequate business records of the potatoes that could not be processed during the boiler shutdown and rotted . . . Since such does not exist, the Court will only consider the [documented] weights in calculating the loss due to rotten potatoes.

(*Id.* at pp. 41-42.)

More recently, in *Metro Hospitality Partners, Ltd. v. Lexington Ins. Co.*, 2015 U.S. Dist. LEXIS 10171 (S.D. Texas January 25, 2015) the trial court granted an insurance company summary judgment for similar reasons in a hospitality context. The loss occurred when a Texas hotel's air conditioning unit failed during the summer. Lexington accepted the loss under the equipment-breakdown coverage in the hotel's commercial property policy and requested repair or replacement quotes, invoices, and contracts. The hotel forwarded the insurance company an initial estimate but did not provide additional information or documents for another nine months — at which point the hotel demanded over \$600,000 for repair costs and unquantified "reputation" damages. The hotel sued for coverage under the business interruption part of the policy, but Lexington prevailed on summary judgment. The court agreed that a spreadsheet produced during the corporate designee's deposition did not satisfy the requirement that losses be supported by "financial records and accounting procedures, bills, invoices and other vouchers, and deeds, liens or contracts." The court took issue with the designee's lack of knowledge about the data underlying losses related to meal vouchers, canceled reservations, and room discounts purportedly caused by the outage.

Pyramid Technologies, *Nonpareil Corp.*, and *Metro Hospitality* illustrate that a policyholder must assemble historical documentation evidencing past income and expected income to support its interruption claim. Business income loss can be calculated from historical figures contained in the following:



- Tax returns for the loss year and three years prior.
- Income statements, balance sheets, and cash flow statement for the loss year and three years prior.
- Inventories and records of sales volume.
- Budget projections.
- Marketing plans.

Establishing an income history is contingent on the policyholder maintaining a cache of financial records in advance of a loss event. The insurance company (and later, the court) will view post-loss attempts to reconstruct financial figures with suspicion, or even disregard them altogether.

The policyholder must document the economic impact of the interruption. Vendors must be directed to describe interruption-related services thoroughly in invoices. The policyholder should look beyond lost sales or other typical balance-sheet indicators of profit and loss by asking questions such as:

- How long will the policyholder need to continue paying salaried employees until the business is restored?
- Can those employees assist with restoration of the premises and business operation?
- Are long-term contracts with suppliers at risk?
- Will the policyholder be able to supply customers from inventory during the interruption?
- If inventory is drawn down to meet orders, how long will it take to replenish them to pre-loss levels?

The policyholder must also document its efforts to resume operations quickly. Many BI policies limit interruption losses to those incurred during the “period of restoration,” which is typically defined as the period bounded by the shorter of (a) the *hypothetical* time in which the destroyed property could be repaired, rebuilt or replaced or (b) the *actual* time it takes to repair, rebuild or replace the property. The policyholder must make sure delays are explained in writing and supported by construction contracts, schedules, invoices, and change orders.

Many BI policies include “loss preparation fees,” which may also be referred to as “claim preparation expenses” or “loss adjustment expenses.” This benefit provides a predetermined sum (typically between \$10,000 and \$20,000) to hire an independent, skilled financial professional, typically a CPA, to help prepare the policyholder’s business income claim. The insurance company likewise benefits from a clearer and better organized claim presentation.

Fastidious recordkeeping does not likely rank as a high priority when faced with a flooded warehouse, tons of rotting produce, or a broken air conditioner in mid-summer. But surviving such an event and resuming operations quickly may hinge on the policyholder’s ability to document its losses and its efforts to mitigate those losses. ▲

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For additional information about the firm's national Hospitality Industry Practice Group, please visit our web site at www.andersonkill.com or contact the group's chairs:

David P. Bender Jr.
(805) 288-1300 or dbender@andersonkill.com

Diana Shafter Gliedman
(212) 278-1036 or dgliedman@andersonkill.com

