Because an increased incidence of natural disasters seems to be on the horizon, claims adjustment is a business recovery issue that merits urgent attention on the part of agents and brokers.

Risk Managers' Forum

By Scott E. Bushnell, CPA

BUSINESS INTERRUPTION AND NATURAL DISASTERS

Case study sheds light on claims adjustment process

A recent report, The Allianz Risk Barometer for 2018, lists business interruption as the number one risk facing companies. Number three on the list, and up a notch from the prior year, is natural disasters. The link between natural disasters and business interruption is inextricable. Many small and mid-sized businesses do not have full-time risk managers and rely fully on insurance to cover business interruption costs and losses after a catastrophic event. In these cases, the agent or broker's coverage knowledge and awareness of the related risk management concerns can be of great value to the client.

Déjà vu all over again?

In late August 2017, Hurricane Harvey moved at a devastatingly slow pace over the course of five days. Because of an area of high pressure to its north, the hurricane beat against the Texas coast, crawled inland, and then headed east, eventually stalling over the Houston area and dropping record amounts of rain on the city and surrounding locales.

In the wake of Harvey, numerous meteorological studies indicate that a change in wind patterns makes this lingering hurricane scenario more likely, at least in the near future. What post-disaster problems should businesses, agents/brokers, and risk managers be thinking about as they consider their geographic location and potential risks?

One important likelihood is operational—business interruption—and along with it business recovery. Business interruption is a big concern after a natural disaster strikes, and the claims adjustment process can affect the progress of business recovery.

To understand what can go wrong with a claim and the business implications, let's look at a case study of a client whose facilities sustained damage during Hurricane Harvey. A more detailed case study can be found on my website.

Background

The insured operated from a single location that was directly in the path of Hurricane Harvey. The property and related risks were covered by a businessowners policy that included business income and extra expense coverage. Damage caused by a hurricane was a covered cause of loss.

Shortly after the hurricane, the insurer's adjuster conducted an initial site inspection with the insured. Damage to the facilities and inventory was identified as being a result of the hurricane. Business interruption losses were discussed in a general way, and the adjuster agreed that the insured would incur some financial loss as a result of damage caused by the hurricane.

The insured solicited three repair estimates from local contractors and sent this information to the adjuster. The estimate accepted by the insured specified approximately three weeks for completion. The insurer rejected the estimate on the grounds that it provided insufficient detail for the scope of work, and the adjuster obtained another estimate.

Over the next few months, the adjuster's team conducted on-site inspections to check the progress of repair to the facilities and to monitor the resumption of operations.

With little input from the adjuster, the insured prepared a business interruption loss report to the best of its ability and submitted a $150,000 claim for business interruption. The insurer's forensic accountant reviewed the submission and requested additional details. Six months later the adjuster offered the insured $20,000, at which point the insured's broker requested a review of the claim.

One of the biggest takeaways in this case is the fact that the loss adjustment took place with little communication among the adjuster, the insurer's forensic accountant, the insured, and the insured's broker.

Such lack of communication can be a significant problem in the adjustment of claims, and it can lead to key pieces of information being overlooked.

Indemnity period

One of the most important aspects of a business interruption claim is the period of time the insured is unable to operate as it normally would. This period usually ends when the physical assets are restored and the business is back up and running.

In this case, although the facility sustained serious damage, the insured was able to resume partial operations within a matter of weeks.

The insurer's forensic accountant timed the period of indemnity from the date of loss to the resumption of partial operations and ended it just 11 days after the resumption of operations. The accountant stated that the reason the period was ended so soon after partial operations resumed was that sales in a single week exceeded pre-loss sales. Although sales can be used as a barometer, this approach was inconsistent with the policy wording and didn't fit the reality of the post-loss situation.

Our rebuttal focused on several key points. Although the actual repair period was 15 days, crews needed to be assembled and materials ordered and delivered to the site, and this happened during a chaotic time when resources were still scarce because of the hurricane's devastation of the area's infrastructure. The actual period of restoration was determined to be 57 days or approximately eight weeks. The policy provided coverage for 60 days of extended business income. During this entire 117-day period, the insured continued to sustain a financial loss because of the hurricane damage.

Business interruption coverage is written on an actual loss sustained basis, which means the loss is based on net income plus normal ongoing operating expenses. In most business interruption calculations, the losses incurred are determined by applying a business interruption rate to total lost sales. This rate is net income plus continuing expenses expressed as a percentage of sales.

The loss of income analysis usually looks at the 12 months that preceded the loss period. With this claim a common miscalculation occurred: The forensic accountant analyzed sales on a weekly basis and adjusted the previous year's weekly sales to "correct" the expected loss in the month after the loss. The accountant ended the indemnity period early because one week's sales in the period were greater than those in the pre-loss period.

Our rebuttal was based on an analysis that considered historical sales trends on a monthly basis and the likely market conditions had no loss occurred. Ultimately the adjuster accepted our analysis as providing a more realistic picture of expected post-loss net income and continuing expenses.

When insureds sustain a catastrophic loss, they look to their agent or broker for guidance. This case study shows the role that experts like forensic accountants can play in claims situations. It also illustrates the need for agents/brokers and risk managers to prepare clients for the claims adjustment process and work with them until the claim is resolved. Because an increased incidence of natural disasters seems to be on the horizon, claims adjustment is a business recovery area that merits urgent attention on the part of agents and brokers.

To see a more detailed case study, go to businessinterruptionconsulting.com. ■

The author

Scott E. Bushnell, CPA, is a forensic accountant with over 20 years of experience assisting global clients in preparing complex business interruption claims. He provides continuing education for accountants and insurance professionals. Scott can be contacted at scott.bushnell@businessinterruptionconsulting.com or (713) 751-9553. The National Alliance's Certified Risk Manager (CRM) program includes the Control of Risk course, in which crisis and disaster planning, as well as business interruption, are discussed.