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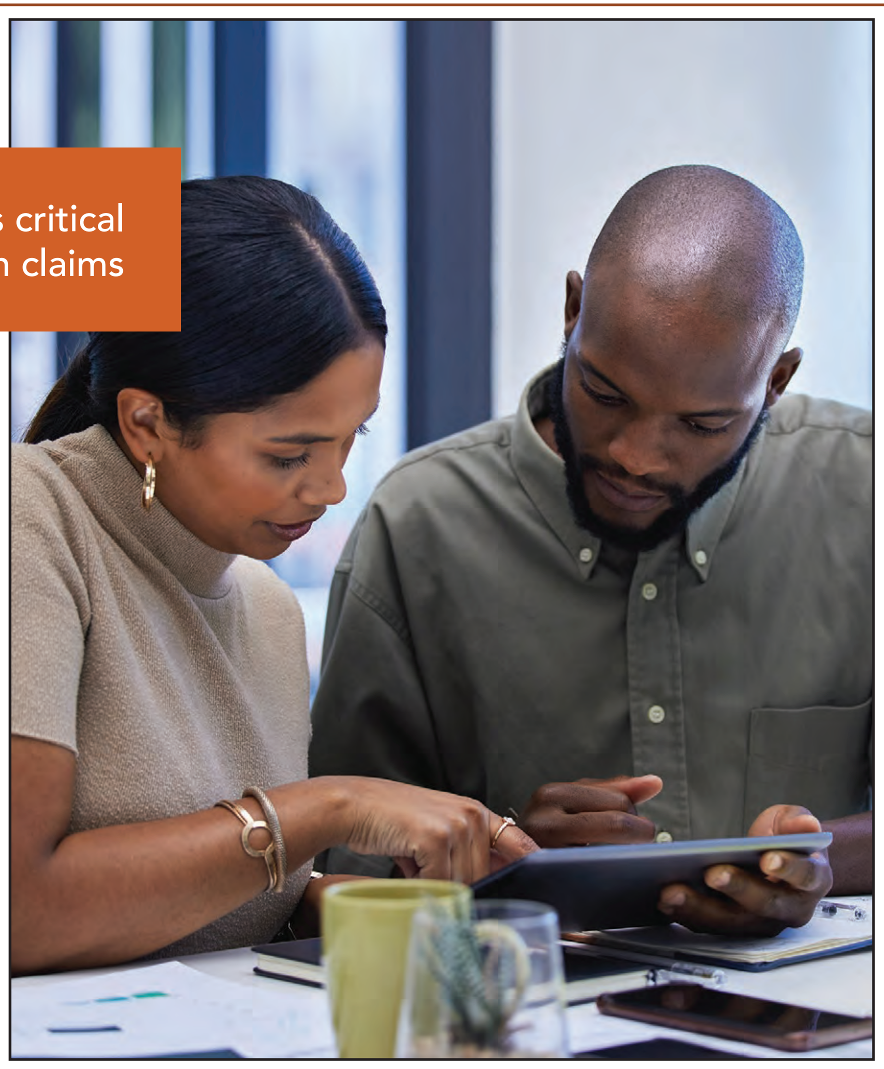

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Why policy language is critical in business interruption claims

When a business seeks to recover damages under a business interruption policy, the language of the policy is critical. Even if a policyholder presents a well-reasoned claim backed by solid evidence, it may be denied if the business has failed to meet the policy's conditions for recovery.

Series of unfortunate events

This was the central issue in *TransWorld Food Service, LLC v. Nationwide Mutual Insurance Company*, a recent case decided by the U.S. District Court for the Northern District of Georgia. From 2015 to 2018, the business suffered one disastrous loss after another. Although management had the foresight to buy "businessowner" insurance policies, the insurer (Nationwide) denied all or part of claims filed for the following events:

Refrigeration mishap. In December 2015, a contractor charged TransWorld's refrigeration system with an incorrect coolant, affecting the ability of some of the system's coolers to reach optimal temperatures. TransWorld claimed that the error forced it to lower prices to remain competitive. Nationwide denied this entire claim.

Waterline failure. In January 2016, a waterline in TransWorld's building failed, resulting in flooding and property damage. Nationwide hired financial experts to assess the property damage and lost income. Although TransWorld received roughly $711,000 for property damage and $342,000 for lost business income, the company claimed it was entitled to higher amounts.

Roofing contractor error. In July 2017, a roofing contractor hired by the building owner cut TransWorld's freon supply line, resulting in property damage and lost inventory. TransWorld obtained a partial recovery from the contractor's liability insurer and sought additional compensation from Nationwide for property damage and lost business income. Nationwide made a small payment for equipment damage. But its financial expert concluded that there was no suspension of business that would trigger a lost income claim.

Leaky neighbor. In July 2018, a water leak in a neighboring unit allegedly caused TransWorld to suffer roughly $162,000 in property damage and $180,000 in lost business income. TransWorld filed a claim with the building owner's insurer, but it was denied.

Motion for summary judgment

TransWorld brought a lawsuit to recoup additional damages related to these claims. And Nationwide subsequently filed motions for summary judgment. The court granted summary judgment for the pre-2018 claims on procedural grounds, finding that they were barred by the statute of limitations or by TransWorld's failure to satisfy the policy's notification provisions.

Hire an expert to support your claim

When a company files a claim under a business interruption insurance policy, involving a forensic accountant or other financial expert early in the process can enhance the chances of success. Relying too heavily on the insurance company's experts — who ultimately are advocates for the insurer — can be risky.

Examples of ways that a financial expert can assist the insured include:

- Interpreting the policy language — in particular the definition of "lost business income,"
- Determining the scope of coverage,
- Establishing the loss period,
- Calculating and documenting lost income and other damages,
- Supporting requests for advances from the insurer, and
- Advising on loss mitigation strategies.

Perhaps most important, an expert can communicate with claims adjusters and other insurance company representatives in language they understand and present a well-reasoned analysis of the facts. This can significantly expedite the claims process.

But the court did look at the substance of the 2018 claim. Nationwide argued that TransWorld wasn't entitled to recover for lost business income, because TransWorld lacked a record of profitability and failed to show the requisite suspension of its business. The policy stated that Nationwide "will pay for the actual loss of 'business income' you sustain due to the necessary suspension of your 'operations' during the 'period of restoration.'" TransWorld countered that its profits were quantifiable, and that the policy didn't require a complete cessation of business activity.

The court didn't address the profitability issue. Instead, it determined that TransWorld wasn't entitled to recover its lost business income because a mere reduction in business activity didn't constitute a "suspension of operations" under the policy. According to the court, the term "suspension" unambiguously meant "a temporary, but complete, cessation of activity."

The court also held that Nationwide didn't waive its right to exclude coverage by paying Transworld's lost income related to its 2016 claim. "The doctrines of implied waiver and estoppel," the court explained, "are not available to bring within the coverage of a policy risks not covered by its terms, or risks expressly excluded therefrom." (Internal citation and quotation omitted.)

Lessons learned

This case demonstrates the importance of understanding a business interruption insurance policy's language when pursuing a claim for damages. The court's holding suggests that if TransWorld had shut down its operations completely in the wake of the flooding — even for a short time — the outcome may have differed. For help understanding policy language and providing a well-supported estimate of damages, contact a financial professional with experience in preparing business interruption claims. ■

Human capital: What's it worth?

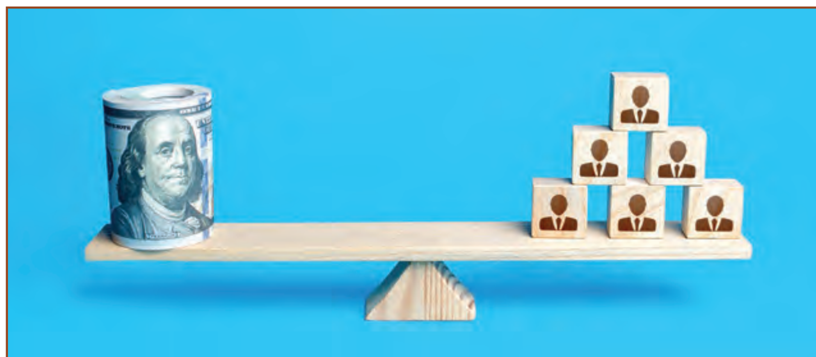
In today's tight labor market, human capital is critical to the success of a business. The term "human capital" refers to a trained and assembled group of workers who know how to operate equipment, follow the company's policies and procedures, innovate to build new products and services, and work together as a team to achieve the company's strategic goals. Although it's not usually reported on the balance sheet, human capital can be a valuable asset.

A need for valuation

Investors, lenders and other stakeholders have been asking for more detailed information about human capital in recent years. Enhanced financial statement disclosures may call for valuations of various human-capital-related intangible assets. The fair value of human capital also comes into play when reporting business combinations and testing for impairment under U.S. Generally Accepted Accounting Principles.

The value of these assets may be relevant in other situations, too, including:

- Mergers and acquisitions,
- Ad valorem property tax assessments, and
- Divorce cases in jurisdictions that differentiate business goodwill from personal goodwill when splitting up marital estates.



In addition, litigation involving alleged violations of contractual obligations — such as the terms of employment contracts, noncompetes or celebrity endorsement agreements — may warrant damage calculations based on the value of human capital.

Beyond employees

Human capital comes in many forms. The most obvious example is employees on the company's payroll. It also may include relationships with independent contractors, consultants and celebrities, as well as employment contracts, noncompetes and confidentiality agreements.

Professional licenses may be considered another type of human capital, because they allow professional services firms to conduct business and, therefore, add value. But these licenses can't be transferred to third parties and, therefore, are typically the property of individual practitioners, not the company.

Reproduction vs. replacement

A logical starting point for valuing human capital is to estimate the cost to reproduce or replace the company's workers. This estimate should include the costs to recruit, hire and train each level of the workforce.

Examples include headhunter fees, salaries and benefits of recruitment and training staff, relocation fees, moving costs, and signing bonuses. Valuators also may factor in the costs of background checks, drug tests and screening exams, as well as any lost productivity of new and existing staff during the recruitment and training processes.

When valuing human capital, an important distinction should be made between reproduction cost and replacement cost. Reproduction cost is the current cost of an identical property — in other words, the same

number of employees with the same skills, education levels, experience and salary requirements.

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Replacement cost is the current cost of employing a similar workforce that has the nearest equivalent utility to the existing workforce. Replacements might be younger employees who are willing to perform the work for less money — or fewer employees who are more highly qualified and efficient — than the existing workforce.

Additional techniques

The income or market approaches are sometimes used to gauge whether the results of the replacement or reproduction cost analyses make sense. For example, the cost to reproduce or replace the company's workers could be divided by the number of employees to calculate the average value per employee. This amount could then be compared to the average net realizable billable hours per employee to impute the firm's return on human capital.

Assembled workforces aren't normally sold as separate assets, so the market approach is rarely used to value human capital. But a valuator might ask: How much would a buyer be willing to pay to acquire such assets? And would a seller be willing to give up these assets for this amount?

Specialized approach

Valuing human capital presents many challenges compared to standard business valuations. It's important to hire an expert with an in-depth understanding of today's human resource guidelines, employment trends and market compensation rates. Human capital should be valued using objective market data and independent analysis of the case at hand. ■

Focus on fraud in M&A transactions

Due diligence is a critical part of the merger and acquisition (M&A) process — and an area of particular concern is fraud risk. Financial statement manipulation can sometimes make the target appear more valuable than it really is. Likewise, weak fraud policies, internal controls and cybersecurity practices can be ticking time bombs for an unwary buyer.

A forensic accountant can help a buyer evaluate a target's fraud risk and look for signs of earnings manipulation and other accounting irregularities. Here are some examples of areas to examine before closing a deal.

Uncovering accounting fraud

It's important to look for red flags that indicate that the target's financial statements may not provide a true picture of its value. For example, revenue might be overstated if it has increased over time without a corresponding increase in cash flow or receivables. Another red flag of revenue overstatement is unusually strong revenue growth in comparison to the company's competitors.

Earnings growth coupled with recurring negative cash flows may be a sign that expenses have been understated or that assets have been overvalued.

If the target's practices in any of these areas fall short, the buyer should consider conducting additional due diligence. For example, if the target doesn't conduct employee background checks, the buyer should perform background checks on the target's executives and other key personnel, including the owners.

Also be on the lookout for excessive restrictions on auditors' access to information or personnel, high employee turnover, excessive pressure on management to perform, and an unusually high number of off-balance-sheet or related-party transactions.

Evaluating fraud exposure

During M&A due diligence, the buyer should examine a target's fraud policies and practices to evaluate its exposure to fraud risk. Questions to ask include:

- Does the target's corporate culture reflect a commitment to fraud prevention?
- Has the target adopted anti-fraud measures, such as a code of ethics and a whistleblower hotline?
- Has the target implemented strong internal controls that are regularly reviewed and tested for compliance?
- Does the target conduct background checks of new hires?
- How has the target addressed previous allegations of fraud?
- Are the target's accountants, attorneys and other advisors reputable, and what's the screening process for outside advisors?
- Has the target properly vetted its vendors and third-party service providers, including their anti-fraud policies and internal controls?

Assessing cyber risk

Cyberfraud is an area of growing concern. Data breaches can cause safety issues, negative publicity, lost productivity, and compromised personal and corporate data. The average cost of a data breach has risen to a record high of $4.35 million, according to a 2022 study published by independent research group Ponemon Institute. That's an increase of 2.6% from the 2021 study and 12.7% from the 2020 study.

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There are several ways to manage cyber risk. For example, ask whether the target has conducted a risk assessment, adopted a proven cybersecurity framework and trained employees on best practices. Also consider whether software and devices have been updated with the latest security patches, as well as whether there are effective backup and recovery systems in case an attack occurs.

Let the buyer beware

Comprehensive due diligence is an indispensable part of the M&A process, but it's particularly critical with respect to fraud and cybersecurity. Few risks have greater potential to negatively impact the value of a deal. ■

Sullivan v. Loden

Estate planning attorney sued for undervaluing family business

A recent case illustrates what can happen when a business valuation is prepared by an attorney rather than a qualified valuation professional. In *Sullivan v. Loden*, one of the owner's children sued the attorney for malpractice. The disgruntled heir alleged that she received less than her fair share of the estate because her siblings had previously received gifts of stock that were undervalued. Here are the details.

Background

The decedent was the matriarch of a family business that operated a chain of grocery stores in Hawaii. Two of her four adult children worked for the family business.

In late 2011 and early 2012, the mother transferred her stock in equal shares to the two children who worked for the family business. For gift tax purposes, the mother's estate planning attorney valued the stock, resulting in gifts of roughly $680,000 each.

Post-death drama

The mother died in 2015, leaving an estate worth around $192 million. Her estate plan called for her estate to be divided equally among her four children, except that the children who didn't participate in the business were specifically entitled to cash bequests of $1 million each.

One heir asserted that those bequests were equalizing payments meant to offset the stock gifts to her siblings who worked for the family business. She argued that, had her mother known the true value of the stock, the payments would have been larger.

The disgruntled heir asked the attorney, who was also the estate's personal representative, to obtain a corrected valuation. After he refused, she petitioned the probate court, which appointed a special administrator to evaluate the valuations. The administrator found that they weren't "performed according to applicable standards" and were "therefore unreliable."

Malpractice claim

The disgruntled heir sued her deceased mother's attorney for malpractice in federal court. The attorney moved for summary judgment on two grounds:

1. He owed no duty of care to the heir, who wasn't his client, and
2. The heir was collaterally estopped from bringing her claim because the IRS had "thrice 'accepted' his valuation."

The U.S. District Court for the District of Hawaii denied summary judgment on both grounds. First, the question of whether the attorney owed the heir a duty of care as an intended beneficiary of the valuation at least raised a genuine issue of material fact. Second, collateral estoppel didn't apply because the heir wasn't a party to the IRS proceedings on the valuation.

Critical takeaway

Attorneys may be tempted to perform valuations for their estate planning clients to save time or money. This court's ruling highlights the importance of using a qualified, independent valuation professional to appraise gifts of closely held stock. ■

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