

Business Interruption – Challenges and Solutions

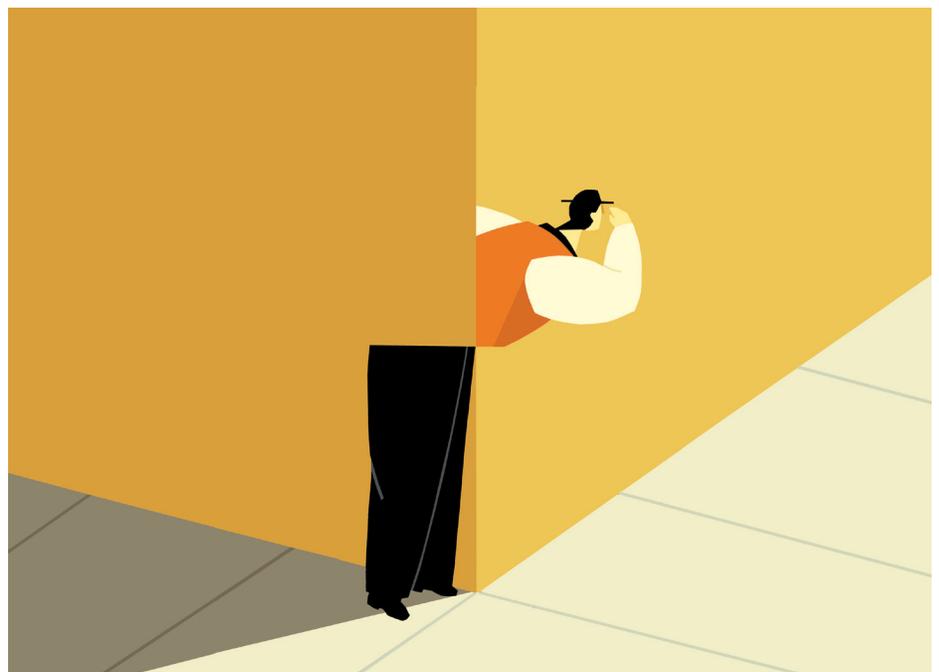
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Introduction

Business interruption insurance coverage and claims are considered one of the most complex challenges for risk managers with large, multifaceted and/or global programs as well as smaller organizations. Large natural disasters in North America over the last decade include 9/11, four large hurricanes in 2004, Hurricanes Katrina and Rita in 2005 and Hurricane Ike in 2008, and their impact on businesses worldwide presented the insurance industry with an unprecedented volume of claims under various coverage endorsements that had previously seldom been contemplated or tested. While things have been quiet in the past year on the domestic front in terms of broad-scale natural catastrophes, disaster can strike at any time and corporate America needs to be ready with appropriate insurance coverage

to protect its assets and bottom line, as well as a comprehensive plan for recovery and management of the claims process. Further, as the recent deteriorating economic conditions have forced companies to downsize or restructure, risk management must re-evaluate limits and coverage to match the company's current, adjusted risk profile.

Although business interruption ("BI") is a specialized insurance product intended to provide protection for the earnings of a business in the event of a loss, many policies aren't thoughtful or well defined enough to address all of the issues that arise out of large scale loss, leading to inconsistent interpretation of policy terms. In addition, there is limited guidance in many policies for calculating the proper amount of business interruption loss. This has led to recurring issues which have largely re-



mained unaddressed in litigated cases and policy refinements, leaving policyholders, insurers, and claims professionals clamoring for legal precedents, clarification of policy intent, and guidance on how to properly address such issues when they arise.

The following text outlines some practical guidance to help the risk manager establish a solid business interruption insurance program, including policy design, determining exposed and ratable values, and pre-loss business continuity and leadership planning.

In addition, we explore the post-event claims adjustment and settlement process, along with loss determination and measurement issues commonly confronted by risk management. Ultimately, appropriate accounting and claim presentation determines whether or not losses are measured accurately. Accordingly, we offer some slightly technical, but practical advice to help the risk manager proactively address these challenges as the claim unfolds.

Before the Loss

A number of topics address the measures that should be employed by the risk manager to prepare his or her organization's BI program in advance of a loss event. Some of these are as follows:

Review BI Policy

The purpose for business interruption coverage is to protect the earnings stream of a company after a loss. In other words, the income statement should, effectively, be returned to a state where it reflects the same results that would have been reported had no loss occurred.

Volumes can be written about the intricacies of business interruption coverage, but the essential elements which should be in place are as follows:

- » Obtain proper coverage – This includes using the right type of form (manufacturing, mercantile, etc), and

assuring the underlying property form contains the essential coverage, such as flood, earthquake, BI and extra expense applicable to the risk.

- » Establish adequate limits – Assure the limit (blanket preferable) is adequate for exposure (more below).
- » Obtain special endorsements – Extended period of interruption coverage, contingent business interruption, service interruption and claim preparation expense coverage are extensions of coverage that may not otherwise exist in the core policy.
- » Deductibles – Understand how the deductible works for all of the above coverage provisions and modify to match company needs (more below).
- » Understand Exclusions – Some standard exclusions should be tailored to the insured risk and understood prior to any loss.

Ultimately, the policy should match the type of risk and levels of exposure represented by the company, in order to ensure the best chances of a full claim recovery.

Determine Exposed/Reported Values

In designing the BI program, the risk manager must assess the amount of value at risk and how best to report it to underwriters. Most policyholders are asked to submit their business interruption values as part of the initial underwriting or program renewal, via completing a brief worksheet, usually supplied by the underwriter. Generally there is limited guidance provided to support completion of these worksheets and the implications of the values included in that worksheet are often misunderstood, creating issues if/when the values are relied upon, as explained below.

"Business interruption values" is a catch-all term given to a variety of measures related to the business interruption amount at risk for the policyholder. The perceived meaning ranges from annual business income to

“MFL” (Maximum Foreseeable Loss). These values can reflect overall, consolidated measures or measures by location or business unit. Values are utilized in a number of ways, such as:

- » Basis for annual premiums
- » Basis for percentage-of-value deductibles and average daily value (“ADV”) deductibles
- » Basis for establishing policy limits (aggregate and by location)
- » Basis for determination of MFLs and PMLs
- » Basis for allocation of premium to business units

- » Basis for allocating program risk across market capacity

Conflicts can arise when the methods of determining values are inconsistent with their intent. For example, if a company evaluates its exposure and determines its MFL to be less than one year’s earnings and reports this amount on the business interruption (BI) worksheet, this amount may be appropriate for establishing policy limits, but it may not be the proper basis for determination of percent-of-value deductibles or ADV deductibles. This example is better illustrated in Exhibit 1, which shows numerous “BI value” formulations and how they could be applied to a % of value deductible.

Exhibit 1: Effect of Reported Values on Deductibles			
	Trailing Actual 12 Month Amount	Maximum 7 Months (MFL)	Projected Future 12 Month Amount
Gross Sales	\$109,500,000	\$63,875,000	\$125,925,000
Selling Expenses	(\$10,950,000)	(\$6,387,500)	(\$12,592,500)
Net Sales	\$98,550,000	\$57,487,500	\$113,332,500
Materials	(\$32,850,000)	(\$19,162,500)	(\$37,777,500)
Supplies	(\$5,475,000)	(\$3,193,750)	(\$6,296,250)
Outsourced Product	(\$6,570,000)	(\$3,832,500)	(\$7,555,500)
Fixed Utilities	(\$2,500,000)	(\$1,458,333)	(\$2,500,000)
Gross earnings	\$51,155,000	\$29,840,417	\$59,203,250
Noncontinuing Expenses	(\$24,637,500)	(\$8,623,125)	(\$28,333,125)
Business Interruption Value	\$26,517,500	\$21,217,292	\$30,870,125
Monthly BI value	\$2,209,792	\$3,031,042	\$2,572,510
Percent of Value Deductible (Based on Net BI Value):			
3% of Latest 12 Months	\$795,525		
3% of Projected 12 Months			\$926,104
3% of MFL		\$636,519	
Percent of Value Deductible (Based on Gross Earnings Value):			
3% of Latest 12 Months	\$1,534,650		
3% of Projected 12 Months			\$1,776,098
3% of MFL		\$895,213	



There are a wide variety of scenarios that show how the earnings results can be used. In Exhibit 1, the 3% deductible could range from \$636,000 to \$1.8 million, depending on which interpretation of values or deductible (discussed in more detail later in this article) is applied. It is important that the policyholder understand how the values being reported will be used by the underwriter, both in the placement of the insurance program in the marketplace with an appropriate limit and premium and in the design of the policy and application of value-based deductibles.

Questions to ask include the following.

- » Will the amounts reported in the BI worksheet be used to establish policy limits? Annual premium?
- » Should the amounts included in the BI worksheet represent the MFL or PML?
- » Should the amounts included in the BI worksheet represent the annual earnings insured under business interruption?
- » How should one consider non-continuing or saved expenses when reporting business interruption values?
- » How will the amounts reported in the BI worksheet affect the determination of coverage for a specific loss event?
- » How will the amounts reported in the BI worksheet be used in the formulation of value-based deductibles?

Once the questions above are answered and the intended uses of reported values are understood, a policyholder should be proactive in properly preparing the values to be reported. In doing so, consideration should be given to the coverage afforded in the policy, consistency in the accounting across business units or locations, mitigation capabilities, and likely loss scenarios (MFL or PMLs). Also, current business trends should be considered, particularly in the current economic environment. Claims

consultants who are also familiar with assisting policyholders with business interruption values can be helpful in completing this project. As noted above, it is also imperative that the policyholder gain an understanding of the purpose and intended use of the reported values and how they relate to the insurance policy before the loss event occurs. Ultimately, the submission of accurate and properly understood business interruption values at the outset of the insurance program will help ensure a smooth transaction in the event of a claim. Thus, a discussion with the underwriter to establish the ground rules is advised.

Establish a Business Continuity Plan (“BCP”)

BCP is essential for reacting to the events of a loss. As organizations become more global, reduce inventories, and rely more heavily on sophisticated supply chains, it is imperative that a comprehensive plan be in place should one link in the chain fail. Companies that have a BCP in place are able to recover more quickly from the loss event and minimize the operational impact and business interruption claim. Since standard BI policies require the policyholder to make all efforts to mitigate their loss, some level of formal, advanced business continuity planning will help expedite insurer approval and facilitate the claim process. BCP is also an effective tool when marketing a property insurance program.

Claim Decision Team

Business interruption and property claims are generally long, burdensome and time-consuming efforts which demand the attention of high-level management. At the same time, these same individuals must continue to manage the business and return operations to normal. To ensure both interests are met, the risk manager should establish who will be assigned to address the needs of the organization and the insurer in

the event of a claim to ensure a successful outcome. This would include individuals in the following roles:

- » Risk Management – Central point of contact for the organization’s claim.
- » Finance/Accounting – To provide the necessary records and information upon which the claim is based.
- » Sales/Operations – To determine the impact to operations and ensuing production and sales losses.
- » Broker – To advise on policy concerns and interface with the insurer.
- » Claims Accountant – Accountants with specialized experience to prepare and submit the claim measurement.
- » Named Adjuster – There are several benefits of naming an independent adjuster in the policy prior to the loss.

After/During the Loss – Claim Challenges

Adjustment Process

Often times, risk managers are surprised at the level of activity, personnel and documentation required to process their business interruption claim. Following a loss event, the adjuster will normally engage a host of experts who will be involved. Many of these will focus on the underlying property damage, such as construction, engineering and equipment consultants. But often overlooked are the ramifications these individuals may have on the BI claim, such as establishing causation and the length of interruption. Virtually every BI claim will involve the adjuster engaging an accountant representing the insurer to audit the claim. This process will include the need to provide a well designed claim package along with supporting documentation. The adjuster typically relies on the opinion of the accounting consultant as a basis for

adjusting the BI claim. Therefore, the risk manager should make sure the interests of the policyholder are being addressed, and expectations properly aligned. A proactive claim compilation will aid in this effort.

During the adjustment process, the policyholder should make every attempt to include the adjuster in recovery decisions and obtain advance approval to the extent it is practical. This includes providing requested information in a complete and timely manner. One adjuster states:

“The biggest element in having a smooth claims process is cooperation by the policyholder/insured. Sharing information on a timely and ongoing basis is critical. To that end, the most challenging issue on claims is when, as adjusters, we have to guess what path an insured will take. Nobody likes surprises in these matters, so it’s best to maintain an open communication.”

Nevertheless, the policyholder should not let indecision on the part of the adjuster or his/her experts hamper the recovery efforts and a complete return to normal operations.

Common Measurement Issues

As mentioned above, the calculation of business interruption losses are essentially rooted in the application of accounting concepts, analyses and insurance policy valuation clauses, which is not based on an exact science, but rather subjective opinions. Below, we explore common measurement issues confronted in the measurement of business interruption losses and the presentation of BI claims:

Deductibles

One element of change in BI policies is the use of increasingly higher and more complex deductibles. Determining appropriate deductibles is an important decision the risk manager can make in policy design. Below are the most common types of de-

deductibles available in the marketplace for business interruption insurance:

- » Fixed/Stated Policy Amount
- » Percentage of Value
- » Average Daily Value
- » Waiting Period

It is not uncommon for deductibles to be disputed or unclear to the adjuster on a claim, due to uncertainty about loss causation (wind vs. flood) or ambiguity in the policy. This gives the risk manager pause when reporting to management or investors about the potential recovery of a business interruption claim. Service interruption, earthquake, wind, flood, and software endorsements (among others) may contain more restrictive limits as well as deductibles larger than the deductible in the main policy form. In many cases, it is necessary to review multiple sections of the policy, followed by certain calculations, in order to determine the deductible (with the exception of a flat dollar amount). Some policies contain terms within the deductible clause that are defined in another section of the policy.

A property policy can contain various methods of calculating the deductible based on the type of peril. Consider the following loss scenario:

XYZ Manufacturing Company suffers damage during a named windstorm that completely shuts down operations at its only location for 3 months, resulting in a BI loss of \$25MM and property damage of \$75MM. XYZ reported annual BI values at \$100MM and property values of \$200MM 14 months prior during its latest renewal of its 2 year insurance policy. The policy has a deductible of \$1MM, except for windstorm, which is based on 3% of values (undefined). For the 12 months preceding the loss, XYZ had generated \$125MM in BI value.

Percentage of a Defined Value

Generally, this type deductible applies to windstorm and flood losses. The stated percentage is applied to the basis value in the event of a loss to determine the applicable deductible. Some considerations are:

- » **Applicability to locations** – Some percentage deductibles only apply in certain windstorm or earthquake zones, or may vary depending on zone or distance from coastal areas. If XYZ's policy only applied to "Tier 1" locations, then only those locations would be subject to the 3% deductible.
- » **Unit applicability** – The basis value may only include certain lines of insurance (BI, Property or TIV), or may apply separately to each physical location "unit", such that locations or line losses falling below their deductible can be excluded from the claim. This is very useful policy language and allows the policyholder the greatest flexibility.
- » **Value definition** – The basis value may be based on a defined timeframe (12 months pre/post-loss) or defined calculation (gross earnings, etc). It also may refer to reported values, as opposed to actual values.

In our example, if the policy stated that the 3% applied to all locations and the basis value was to be the BI values anticipated for the 12 months preceding the loss, then the BI deductible would be \$125MM x 3%, or \$3,750,000. Change the policy to state the deductible to be based on reported values, and it becomes \$100MM x 3%, or \$3,000,000. The other considerations mentioned above create a multitude of scenarios which would alter the deductible.

Average Daily Value ("ADV")

This deductible simply uses a number of days times an average daily rate, which

should be defined by the policy. As with the percentage deductible, there are several variables that should be considered when determining the average daily rate:

- » Basis period for determining the daily rate: Pre-loss, post-event projected, other
- » Basis assumption – Formulate based on amounts projected or amounts lost

In our example, if the loss were not wind-storm, and the policy stated the average daily value deductible applied, based on 5 days times the ADV for the 12 months preceding the loss, the deductible would be $\$125\text{MM}/365 \text{ days} \times 5 = \$1,712,329$. If we change the facts, and XYZ was only partially shut down, losing $\$12.5\text{MM}$ over 3 months and the deductible is based on the amounts lost during the indemnity period, the deductible would be $\$12.5\text{MM}/90 \text{ days} \times 5 = \$694,444$.

Waiting Period Deductibles

Many large commercial policyholders retain part of their business interruption risk through the use of a waiting period for certain types of covered perils, such as service interruption or software coverage (among others). A waiting period is a deductible that starts at the time of loss and continues through the period of time as set out in the policy. During this period of loss the insured assumes all business interruption loss, as compared to a stated dollar or percentage deductible that is deducted from the total business interruption amount of loss.

Some policies first require a stated waiting period before a payable loss begins, and after the waiting period is passed, a dollar value deductible may be applied (type depending on the policy). In these cases, a waiting period is generally listed separately from the deductible in the declarations section of the policy. Some policies have a waiting period

following which all losses from day one are insured. Other policies have a stated period of time during which no coverage exists, and coverage then starts after the stated period of time. In a loss event, consideration must be given to losses incurred during the waiting period, and whether those losses should be excluded, paid, or allocated across the entire period of indemnity.

Other Deductible Scenarios

Sub-limits and Deductibles – Policyholders sometimes face losses with certain components exceeding sub-limits (i.e. debris removal). If the policy allows the loss amounts exceeding sub-limits to count towards the deductible, this increases the amount payable to the policyholder.

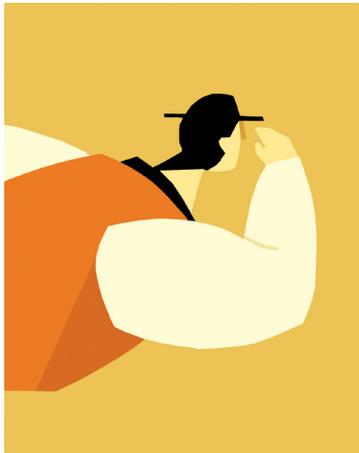
“Occurrence” Versus “Per Loss” or “Per Location” – Most policies apply one deductible for a single occurrence, but some apply a deductible on a per location per occurrence basis. In such an instance, the same hurricane damaging multiple locations could result in a separate deductible for each location.

Contingent Exposures – Recent catastrophic events have involved a large number of contingent claims, without clear guidance as to which deductible should apply.

As indicated above, the policyholder should carefully consider their risk exposures when determining deductibles. Certain endorsements may alter the deductible language, so the policy should be reviewed prior to a loss event.

Projections

One of the most common areas of dispute in business interruption claims is projecting the profitability a business would have had “but for” a loss occurring. There are several ways one could select to project a business’



profitability (in terms of revenues and expenses), including, but not limited to:

- » Budgets
- » Adjusted Budgets
- » Forecasts
- » Run Rates or Pre-Loss Averages, including prior year
- » Percent of market share
- » Independent variables
- » Comparable businesses not impacted by the loss

In addition, there are several internal factors as well as 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 and/or amount being projected 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 impacted by the event itself. Here are a couple examples:

- » A major hurricane, such as Katrina occurs, dramatically changing the conditions of the market locally and regionally, for an extended period of time.
- » A loss at a single facility that impacts the entire supply of a product(s) causing price increases for the product through entire industry.

An illustration of the first example is that many restaurant, hospitality and retail businesses have a sales increase after a wide-

spread natural disaster. Local residents that 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, many times hotels are damaged or destroyed in the event, making them uninhabitable, which prevents the hotel from participating in the current market conditions, as well as reduces 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.

So 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? Had they not been damaged, they too would have also enjoyed an increase in sales during the post-event period. This has been an issue that 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 it has not been a balanced approach. Several policies now have language that excludes the effect of any "favorable business conditions caused by the impact..." Excluding the effect of any favorable business condition without excluding the effects of any unfavorable business conditions is flawed. An equitable solution to this issue would be to have language that would both exclude the unfavorable as well as favorable business conditions. Here is some language proposed by one attorney to consider:

"In no event will this policy pay for any increase or decrease in business interruption loss resulting from the impact of the event upon the economy of the region where it occurred."

Should your company have these types of exposures noted in the examples above, we encourage you to work with your brokers and attorneys to develop language that best fits your company's risk profile.

Continuing vs. Non-Continuing Expenses

Besides the primary drivers of business interruption losses, such as lost production and lost revenue, continuing expenses are a major component of loss calculations. The impact on expenses during a shut-down of operations is often the source of confusion and conflict in the loss adjustment process. Because policies generally fall into two categories – the gross profits (U.K. and non-U.S.) form and the gross earnings form – there are two mirroring approaches to evaluating expenses. Under a gross profits form, the claim must reflect the fixed charges that necessarily continue during the interruption of business. These expenses are added to lost net income to determine the total BI loss. Under a gross earnings form, the claim must reflect the expenses that do not continue during the interruption of business. These expenses are deducted from lost net revenue to determine the total BI loss.

One source of confusion for many policyholders, especially under the Gross Profits form, is the perception that any expense incurred during a loss is wholly covered by the policy. There are two common issues. The first occurs when operations are only partially, not completely, interrupted. In that event, some revenue is still being generated; thus, part of the expenses are being covered by those revenues. It would not be proper to include 100 percent of the continuing expense in the claim, as part of the compensation would be duplicated.

The second issue relates to expenses that are reported, or recognized, during the

period(s) affected by the interruption but do not directly relate to that accounting period. For example, suppose a company had to pay back rent for a location that was previously missed for six months as a result of an accounting error. Should the entire six months of back rent be claimed and covered by business interruption? The same problem can occur with annual bonuses and other expense categories. For these reasons, the Gross Profits form tends to be confusing when dealing with the expense impact.

Under the Gross Earnings form, the proper measure of noncontinuing expenses are calculated by projecting expenses that would have been incurred but for the loss and comparing them to actual expenses incurred during (and related to) the loss period. The evaluation of expenses during an actual loss determines how much was truly saved.

When formulating saved expenses, since actual results should be an undisputed matter of fact, the primary driver is the projection. The exception is in the event of a claim for extra expenses, which is discussed below. Projections can be formulated in a variety of ways, including:

- » Monthly, weekly, or daily historical average amount
- » Percentage of sales
- » Dollar amount per unit of production
- » Dollar amount per unit of sales

Sometimes, the impact of an event results in excess, rather than saved expenses. It is important that the policyholder be prepared to explain and document reasons for extra expenses associated with operating inefficiently and whether the measurement reflects expenses that are, in fact, related to the covered loss. As with many of the contentious elements of a business interruption claim, the answers regarding how expenses are affected and properly claimed lie somewhere in the details. One must examine whether the necessary information exists to properly present the measurement and how

much time and expense would be involved in gathering the information as compared to the potential amount of recovery.

Finished Goods Insured at Selling Price

Most property policies today provide coverage for finished goods (“FG”) based on selling price valuation. This is most common in the retail industry or businesses with substantial investment in inventory stockpiles. This valuation is generally the likely selling price of the lost inventory during the period over which the inventory would have been sold, based on actual sales, market statistics, or other measures, less deductions for “unincurred selling expenses,” such as discounts or spoilage, among others.

The relationship between FG inventory insured at selling price and business interruption is that, in the case of an inventory loss, the FG inventory is effectively sold to the insurer. In theory, the margin earned by selling this inventory to the insurer replaces at least part of the BI loss suffered by not selling to third parties. In fact, some policies specifically provide for the deduction of FG inventory proceeds from the business interruption claim.

Some issues to avoid include duplicating claims for finished goods at selling price with the BI claim and properly matching the valuation between those claims (revenue/selling price vs. margin or net BI value). Another is determining whether, due to the fundamental basis for the BI claim, any duplication even exists. This may be the case where the BI claim is based solely on lost production, depending on the resultant impact to sales. Thus, it is possible to have inventory covered at selling price and still have a valid claim for business interruption, for a variety of reasons.

In summary, a careful evaluation should be made to ensure the proper treatment of fin-

ished goods insured at selling price in the business interruption calculation. This will prevent overstating the potential business interruption recovery in an event where inventory is involved. It will also ensure the proper recovery under both the inventory and business interruption claims.

Loss Mitigation

Most policies require that the policyholder practice due diligence in mitigating or reducing the effects of a loss event. This mitigation can be achieved through several means, including:

- » utilizing extra capacity at the insured location
- » utilizing extra capacity at other owned or operated locations
- » outsourcing partial or entire operations to a third party
- » purchasing same or similar substitute product to fill orders
- » working extra shifts to make up lost production
- » consuming inventory stockpiles to fulfill orders

Policyholders have a vested interest in restoring their business and resuming operations in order to reduce the impact on their business in both the short and long-term. A loss of a large customer or market share could impact their business and profitability well beyond the period that is covered by insurance. Despite their best efforts, policyholders often find themselves challenged by their insurer about whether all efforts were made to mitigate or make up losses. The mitigation question is usually asked early in the interruption, so that the recovery process can be commenced efficiently and effectively. However, often, it does not become clear that mitigation was possible

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until after detailed analysis of statistics and documentation is completed. This occurs sometimes months after any action can be taken. In those instances, sometimes the policyholder finds the post loss recovery efforts challenged or second-guessed by the insurer. Loss mitigation (or failure) can cause ramifications both on the measure of loss magnitude throughout the loss period and on the length of the loss period or period of interruption itself.

Closing

The complexity of business interruption issues in recent years has made resolving insurance claims more challenging. The nature of business interruption and the adjustment process creates challenges in avoiding differences of opinion when determining the amount of claimable loss. The insurance industry is slowly modifying

policy language to address some problematic matters. In the meantime, by properly planning and executing a disaster recovery plan, being proactive in documenting losses as well as business decisions, submitting detailed claims in a timely matter, and including the adjuster in recovery decisions process, the insured can avoid or reduce claim conflicts later. Policyholders can also benefit from engaging claims professionals who are experts in business interruption and who have backgrounds representing both insurers and policyholders in compiling properly formulated and documented claim measurements. This will minimize disagreements with the insurer and expedite the adjustment, settlement, and payment of the claim.

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