

Inventory Shrinkage, 'Unexplained Loss' Exclusions & Insurance Coverage For Organized Retail Crime

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PRACTICES Insurance Recovery, Retail

Organized crime is a growing problem for the retail industry. According to the National Retail Federation, retailers lost \$94.5 billion in “inventory shrink” in 2021, with the majority of this loss driven by theft, including organized retail crime (ORC), which saw a 26.5% increase in 2021.¹ Last week, discount retailer Target Corporation reported that inventory shrinkage had already reduced gross margins by \$400 million, compared to 2021, with a total reduction in gross margin projected to be \$600 million by the end of the year.² Target is not alone. In October, the U.S. Immigration and Customs Enforcement Agency launched “Operation Boiling Point” to target domestic and transnational criminal organizations engaged in high-dollar thefts from a variety of retail businesses.³ Earlier this month, authorities apprehended thieves stealing from CVS, Walgreens and Publix, among other stores.⁴

While private industry and public authorities are increasing security and enforcement efforts, companies suffering these losses may also find relief in commercial insurance coverage. Most corporate property insurance policies protect against “physical loss and damage” to business personal property, including inventories. These same policies also typically include exclusions for inventory shrinkage with some variation on the following terms denying coverage for “mysterious disappearance, loss or shortage disclosed on taking inventory, or any unexplained loss.”

However, these types of exclusions are intended to “curb abuses by employers insured against employee dishonesty where covered losses were claimed on the basis of mere estimates, but where the losses might actually be the result of bookkeeping errors, waste or negligence.” *Coleman Cable, Inc. v. Travelers Indemnity Co.*, 790 F. Supp. 2d 742, 757 (N.D. Ill. 2011). Such exclusions are not intended to avoid coverage for the actual loss of inventory resulting from organized retail crime. Moreover, once the insured has established the existence of “physical loss or damage,” the burden of proof falls to the insurer to demonstrate that the loss or damage in question is subject to an exclusion, including one addressing inventory shrinkage. See, e.g., *Betty v. Liverpool & London Globe Ins. Co.*, 310 F.2d 308, 311 (4th Cir. 1962) (“[W]e do not think that the exclusion can be held to shift the burden from the insurer to the insured to prove that the loss falls within the exclusion. Once a loss is shown it would be incumbent on the insurer to show that such a loss or disappearance was inexplicable or mysterious.”).

Not surprisingly, state and federal courts have had numerous opportunities over decades to interpret and apply these kinds of “unexplained loss” exclusions. In many cases, including the following non-exclusive examples, courts have refused coverage where the insured only provided evidence of the “loss” in the form of competing records of inventory volumes:

- *Betco Scaffolds Co. v. Houston United Casualty Insurance Company*, 29 S.W.3d 341, 346 (Tex. App.—Houston [14th Dist.] 2000, no pet.) (“Although Betco seeks to attribute the September shortage to the two burglaries, it presented no evidence to support any such inference. On the contrary, Betco’s loss prevention manager admitted that he did not have

even the capability to determine whether any of the items discovered missing in the September inventory could have been taken in the burglaries.”)

- *Ernie Von Schledorn Ltd. v. United Fire & Casualty Company*, 635 N.W.2d 27 (Wis. Ct. App. 2001) (“Here, the trial court correctly determined that the policy’s ‘inventory computation’ exclusion applies. The only other information presented by the dealership as evidence of its claimed loss—besides the inventory computations—was a transcript of a purported telephone conversation. This transcript, however, is inadmissible hearsay and cannot be used to support its claim. This, of course, leaves only the inventory computations as proof of the dealership’s loss. Consequently, the claim is explicitly excluded under the clear language of the policy, and we affirm the trial court’s order granting summary judgment to United.” (citation omitted)).
- *W.L. Petrey Wholesale Co. v. Great American Insurance Company*, 2015 U.S. Dist. LEXIS 10943, at *16-17 (M.D. Ala. Jan. 30, 2015) (“Petrey Wholesale argues that, in addition to inventory calculations, it has provided other evidence of the existence of a loss due to employee dishonesty in the form of an affidavit of its chief financial officer, Norman Parks. In his affidavit, Parks states that ‘the proof of the existence of the loss is the missing items themselves,’ but Parks relies on nothing other than inventory calculations as the basis of his knowledge that items were missing. Thus, Parks’s affidavit does not provide any independent corroboration of the existence of a loss apart from inventory calculations.”).
- *Will Repair, Inc. v. Grange Insurance Company*, 15 N.E.2d 386, 392 (Ohio Ct. App. 2014) (“Will Repair has not identified any evidence — much less any physical evidence — to show what happened to its missing property (other than the missing die admittedly stolen by Copen, which all agree was excluded from coverage under the policy). Because Will Repair had no ‘physical evidence to show what happened’ to its missing property, its loss was excluded from coverage under a plain and ordinary reading of the policy language.”).

However, insureds may avoid the application of the “unexplained loss” exclusion by offering circumstantial evidence of the cause of the loss, including “by proving that circumstances surrounding the disappearance of property support an inference that theft probably was the cause of the disappearance. If the insured were required to prove theft by so-called direct evidence production of the thief or of eyewitnesses to the theft ‘(t)his would be tantamount to denial of coverage for theft because theft is generally carried on in a secretive manner.” *Coastal Plains Feeders, Inc. v. Hartford Fire Insurance Co.*, 545 F.2d 448, 452 (5th Cir. 1977). Accordingly, as suggested by the following non-exhaustive examples, a loss initially substantiated by inventory records alone can be justified by other evidence, even indirect evidence, explaining a non-excluded basis for the claim, including theft:

- *Mid-South Sales Co. v. Continental Casualty Insurance Company*, 2007 U.S. Dist. LEXIS 81832, at *16-17 (E.D. La. Nov. 5, 2007) (denying the insurer’s summary judgment motion premised on an “unexplained loss” exclusion because “Plaintiff supports its claim of theft by pointing to the record to show circumstantial evidence of theft. ... In addition to scrutinizing its invoices, sale records, purchase orders, vendor transaction reports, and cancelled checks, Plaintiff submits evidence of widespread looting in the vicinity of plaintiff’s building, which occurred after the storm. For example, support for this claim may be found in an affidavit of a neighbor (Exhibit N), whose home was looted and burglarized after the hurricane.”).
- *Farmland Indus. v. National Union Fire Insurance Company*, 333, F. Supp. 2d 1133, 1142 (D. Kan. 2004) (“The Insurers argue that Farmland ‘can furnish no explanation whatsoever’ for its loss. Farmland, however, has suggested a reason for its loss. Mr. Schuck testified that his record review led him to conclude that Manchester, MEC or Anadarko took Farmland’s 500,000 MMBtu of natural gas. Theft is not a mysterious disappearance. Farmland need not prove who is responsible for the theft to overcome the Policy exclusion; it is the Insurer’s burden to prove that the Policy exclusion is applicable. Farmland has presented facts to

- suggest that something other than a mysterious disappearance accounts for its lost natural gas, and summary judgment on this exclusion is therefore inappropriate.”).
- *HCA, Inc. v. American Protection Insurance Co.*, 174 S.W.3d 184, 214-15 (Tenn. Ct. App. 2004) (“The record before us leads to several inescapable and interdependent legal conclusions. (1) The evidence in the record offered by the non-moving Plaintiff reflects more than a ‘scintilla’ of evidence of loss within the meaning of the policies independent of the September 1998 inventory. (2) Whether the ‘inventory exclusion’ clause can bar recovery by the Plaintiff as a matter of fact must await trial on the merits. (3) The ‘inventory exclusion’ clauses of the policies are not applicable as a matter of law at summary judgment stage in order to bar Plaintiff from proceeding further.”).
 - *National American Insurance Co. v. Columbia Packing Co., Inc.*, 2003 U.S. Dist. LEXIS 5696, at *19-20 (N.D. Tex. Apr. 7, 2003) (“The summary judgment evidence includes a judicial confession and the sworn testimony of William Mahoney admitting that he stole approximately \$ 200,000 worth of meat from CPC between December 1999 and May 2000. Moreover, NAIC has acknowledged that CPC ‘sustained losses in excess of \$ 200,000.00, as evidenced by its inventory procedures and that such losses occurred as a result of theft.’ The mere fact that this loss may have been quantified through routine inventory procedures does not preclude coverage.” (citations omitted)).

While individual policy terms, facts and circumstances vary, reports of criminal investigations and prosecutions⁵ could provide some evidence from which retail policyholders, whose businesses have been afflicted by ORC, may be able to avoid the application of an “unexplained loss” exclusion. Furthermore, subject to the same qualifications, in some cases, multiple thefts occurring over a period of time may be aggregated and made subject to a single deductible/retention enabling the retail policyholder to recover some part of the loss sustained from this epidemic of organized retail crime. See, e.g., *Simplexdiam, Inc. v. Brockbank*, 727 N.Y.S.2d 64, 68 (N.Y. Sup. Ct. 2001) (“The excess insurers’ argument that, in cases of unexplained loss or mysterious disappearance, the burden is on the insured to identify the number of occurrences and the amount of loss per occurrence finds no support in the precedents. Were such an argument accepted, it would render coverage for such risks as unexplained loss, mysterious disappearance or inventory shortage for the most part illusory. Thus, we hold that for purposes of determining the \$ 500,000 threshold, Simplex sustained one loss as a result of the inventory shortages for which it has submitted a \$1,712,779 claim.”).

If you have any questions about coverage for losses from organized retail crime or about insurance recovery in general, please contact one of Haynes Boone’s [Insurance Recovery Practice Group](#) partners listed below.

¹ National Retail Foundation, *2022 Retail Security Survey: The State of National Retail Security and Organized Retail Crime* (2022), available at <https://cdn.nrf.com/sites/default/files/2022-09/National%20Retail%20Security%20Survey%20Organized%20Retail%20Crime%202022.pdf>.

² Brianna Kelly, *Target executives cite theft as key factor impacting retailer’s gross margins*, MINNEAPOLIS/ST. PAUL BUSINESS JOURNAL (Nov. 16, 2022), available at <https://www.bizjournals.com/twincities/news/2022/11/16/target-inventory-shrinkage-theft-q3-2022-earnings.html>.

³ Austin Williams, *Homeland Security cracking down on organized retail theft with Operation Boiling Point*, FOX NEWS (Oct. 18, 2022), available at <https://www.fox29.com/news/homeland-security-cracking-down-on-organized-retail-theft-with-operation-boiling-point>.

⁴ Michelle Boudin, *Major retail theft ring busted in heavily armed takedown*, WCNC CHARLOTTE (Nov. 14, 2022), available at <https://www.wcnc.com/article/news/crime/wheres-the-money-major-retail-theft-ring-busted/275-68c4cc58-ef76-46bc-b717-0eefe82760a7>.

⁵ See, e.g., *United States Department of Justice, Jury Finds Illinois Man Guilty of Operating \$20 Million Retail Crime Scheme* (Mar. 31, 2022), available at <https://www.justice.gov/usao-ndtx/pr/jury-finds-illinois-man-guilty-operating-20-million-retail-crime-scheme>; Kyle Iboshi, *We witnessed shoplifting at Nike, Home Depot and Target, and nobody stopped it*, KGW8 NEWS (Oct. 27, 2022), available at <https://www.kgw.com/article/news/investigations/shoplifters-steal-nike-home-depot-target-nobody-stopped-them/283-d754ed41-ee02-4c8a-a661-9ef3c2e39323>.