

General BI Subjects

Redundancy Pay under Gross Profit & Dual Wages Items

Introduction

The insurance of redundancy pay liabilities under a separate Business Interruption policy item is usually unnecessary and therefore a waste of money. This article considers the cover for redundancy pay that is automatically provided by Gross Profit or Dual Wages items.

Redundancy Pay

Most Business Interruption ("BI") policies now make a Redundancy Pay item available and because it has provision for its own sum insured to be listed on the Schedule my inference is that there is additional premium involved. I have adjusted many BI claims that do not have this item and cannot remember one in which the redundancy pay was not fully covered with wages insured under a Gross Profit or Dual Wages item.

Is it ever necessary to insure redundancy pay if wages are already insured?

I will consider the need when wages are 100% insured by a Gross Profit item and when they are insured by a Dual Wages item. In both scenarios I will assume that the interruption is severe and long term (or redundancies would not be appropriate). To simplify the illustrations I will assume that no turnover is possible for the entire Indemnity Period and therefore all of the Direct Wages staff are eventually "let go".

Because there is no turnover all the wages incurred before the staff are "let go" must be recovered from the BI claim.

Redundancy under a Gross Profit Item

If the rate of insured Gross Profit is, say, 70% and half of it is wages then the rate of insured wages within the Gross Profit is 35%. The basic data for my illustration is:

But for the Damage the insured would have achieved turnover of \$12 million during the 12 month Indemnity Period at a Direct Wages cost of \$4.2 million (i.e. 35%).

A simplified view of the wages component within the Gross Profit claim is:

Reduction in Turnover	\$12,000,000
Rate of Wages	<u>35%</u>
	\$4,200,000

In a total loss (of turnover) the claim must cover total actual wages, which it does. (Half of the claim in respect of reduction in turnover under clause (a) of the Gross Profit item relates to wages.)

However it is far more likely that there will be substantial savings in wages. Let us assume that after 6 weeks for assessment and negotiation with staff during which wages of \$484,000 were paid, all Direct Wages staff were then made redundant with a final pay of \$2,100,000. The total pay was therefore \$2,584,000, which leaves savings in wages of \$1,616,000 (\$4,200,000 – \$2,584,000).

The claim is, again, equivalent to actual wages paid, which provides a complete indemnity for the insured's loss. i.e. The insured is unable to pay the wages (net of savings) from turnover and so the BI claim pays for them as an element of the Gross Profit claim.

Reduction in Turnover	\$12,000,000
Rate of Wages	35%
	<u>\$4,200,000</u>
Less Savings in Wages	<u>\$1,616,000</u>
	<u><u>\$2,584,000</u></u>

The effect of the redundancy component is simply to reduce the savings in wages. The claim still covers the total actual wages of \$2,584,000, net of savings.

The requirement to insure redundancy wages as an additional policy item only arises if the redundancy pay is so large that it more than wipes out the savings.

The next table shows wages plus redundancy pay of \$4,800,000, which is more than the standard wages that would have been paid but for the damage (\$4,200,000). There are no savings; rather there is an increase in wages.

Reduction in Turnover		\$12,000,000
Rate of Wages		35%
		<u>\$4,200,000</u>
Standard/Normal Wages	\$4,200,000	
Actual Wages plus Redundancy Pay	<u>\$4,800,000</u>	
Increased Wages		<u>\$600,000</u>
Net Claim		<u><u>\$4,800,000</u></u>

But the most that a Gross Profit item can pay for the wages component of insured Gross Profit is:

Reduction in Turnover	\$12,000,000
Rate of Wages	<u>35%</u>
	\$4,200,000

... which is the standard/normal wages that would have been paid but for the damage, with no savings (\$4,200,000). This falls short of the total cost of wages inclusive of redundancy pay (\$4,800,000).

I know of one industry in NZ for which this scenario is theoretically possible but despite dealing with several major BI claims in this industry I have not seen it occur.

So how do you assess the risk and advise your clients?

Allow a reasonable period after major damage for a feasibility assessment of the future of the business and calculate the total wage bill for that period.

Add the total cost of wages for a notice period.

Add the total redundancy pay liability.

If these three cost components total more than the standard/normal wages that would have been paid during the maximum Indemnity Period, but for the damage, the surplus has to be insured under an additional Redundancy Pay item.

Using the data from the above tables, the Gross Profit item would reimburse normal wages of \$4,200,000 and only the surplus of \$600,000 would remain to be claimed under a specific Redundancy Pay item.

I have to include a caution because my calculations assume that the cost of redundancy pay is added to actual wages and it therefore reduces the savings that are deducted from the claim. But if an adjuster or insurer advocated that redundancy pay is not wages and cannot be included in the claim under a Gross Profit item it would only reimburse the wages during the period of feasibility assessment plus the wages in lieu of notice.

I do not believe that this view is correct but if it were, the client would have to have the full redundancy pay insured separately. Redundancy only arises in circumstances that include major savings in ordinary wages and so why should it have to be insured additionally to the wages.

Any doubt about this situation could easily be avoided by including the following memorandum:

Memo #: Wages in Lieu of Notice and Redundancy Pay

For the purpose of calculating a claim under Section 2 – Business Interruption of this Policy, wages, salaries or payroll paid during the Indemnity Period shall include wages, salaries or payroll in lieu of notice and redundancy pay.”

Redundancy Pay under a Dual Wages Item

I have illustrated that an additional item insuring redundancy pay is rarely necessary if wages are insured in full within a Gross Profit item. The need only arises if the redundancy pay obligations are greater than the savings in normal wages that will follow the redundancies thus producing a total payroll including redundancy pay that is greater than standard or normal wages. Under a Gross Profit item these factors are assessed over the maximum Indemnity Period.

The principle is identical for a Dual Wages item but the calculations of loss are more complicated because they are separated into an initial period of total wages cover plus a remainder period of limited cover, and any savings in wages during the initial period can be carried over to increase the limit in the remainder period. A Dual Wages item provides less than total cover and would normally only be used when significant savings in wages will occur in major business interruptions.

But redundancy pay reduces those savings and so if your client would be faced with substantial redundancy pay obligations probably a Dual Wages cover is inappropriate. How can you advise your client?

I suggest that the critical element in any Dual Wages specification is the length of the Option to Consolidate period, which should be the total number of weeks to cover:

The number of weeks required for the feasibility assessment, plus

The number of week wages in lieu of notice, plus

The number of weeks wages for the redundancy pay liability

Then the initial period and the percentage limit for the remainder period when not using the Option to Consolidate can be selected with the proviso that they must combine to produce the necessary initial period of the Option to Consolidate.

Remember that the economies of a Dual Wages item reflect its limited cover and the insured must achieve savings in wages when the interruption lasts beyond the Option to Consolidate period. Redundancy pay reduces such savings.

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