

Advanced BI Subjects

Manufacturers' Wages Paid under Both Material Damage and BI Claims

Introduction

If wages are insured by a Business Interruption policy but also paid in a Material Damage claim (for staff cleaning up debris, handling a salvage sale, repairing plant) there is a potential double-recovery. If we assume that this should be avoided, what is the correct mechanism for doing so?

Recently a colleague was being "put to the sword" by an insured's broker for making an adjustment in a Business Interruption ("BI") claim for wages paid under the Material Damage claim and I was asked to give my opinion on its correctness. For years I have been routinely making that same adjustment, which, of course, is not a guarantee that it is correct.

The facts of the claim were that settlement under the Material Damage policy had included a sum for the insured's wage costs, possibly including directly wage-related overheads, of staff involved in clean-up, salvage or sorting of damaged stock and customers' goods and conducting a salvage sale. The loss adjuster of the BI claim had established that it was not additional wages that were being reimbursed and then deducted the sum from the claim under the Gross Profit Item. (Wages were 100% insured under that Item.)

Although I was very clear in my mind that I would have done precisely the same as the adjuster, the need to justify it in a written opinion forced me to re-examine its credibility. First I considered the BI policy, which is the ultimate authority. I also referred to a selection of textbooks to see whether my treatment was generally in accordance with these authors.

I quote from these recognised authorities:

1 Gordon Southern

Consequential Loss Risk and Insurance Concepts and Applications by Gordon Southern, published by Gordon Southern Ltd, NSW, Australia, 1989

"If the \$10 actual payroll incurred during the initial period (*or the Indemnity Period*) included payroll that had been claimed under the material damage claim (say, normal labour rates for cleaning up) an adjustment would have to be made to the savings." (page 92/93)

The above is written in the context of savings in wages under a Dual Wages Item. The principles and practice are identical for savings under a Gross Profit Item if wages are

insured under such an item. I have therefore added the phrase in brackets and italics because it is the total Indemnity Period that is relevant to a Gross Profit Item.

2 The Insurance Institute Tutorial Notes

Australia and New Zealand Institute of Insurance and Finance, Study Materials, Business Interruption Loss Adjustment

"Similarly, if payroll is covered under the gross profit item and normal labour charges are indemnified under the material damage claim, then the normal labour element of the material damage settlement would need to be deducted as a saving." (page 4.9)

3 Riley

Consequential Loss and Business Interruption Insurance and Claims, Fifth Edition by Dennis Riley, published by Sweet & Maxwell, London, 1981.

"So when the insured's own employees have been engaged on such work (*cleaning up, protecting & salvaging undamaged or repairable plant & equipment*) it is the general practice to reimburse the insured for their wages as part of the claim under the material damage insurance. To this extent there is an overlap between the cover under the material damage policy and under a c.l. (*consequential loss*) policy.

"and the established method of dealing with such a situation is to deduct from the claim under the c.l. policy the amount paid for wages under the material damage insurance, as follows:

" (a)

" (b) where the wages concerned are insured for 100% in the item on gross profit (as 100% Payroll or otherwise): as a saving in a charge or expense of the business under the savings clause, for the benefit of the insurers." (paragraph 460)

I have added the words in brackets and italics.

For the last 34 years my practice has been consistently to deduct the value of normal wages paid under the material damage claim, as savings, to reduce the sum to be paid under the Business Interruption claim.

The above three quotes from textbooks support my view.

However, I also have a textbook that expresses an entirely opposite opinion. Because this dissenting opinion appears to encapsulate the counter arguments that have been put to me on the occasions in which my treatment has been challenged, I quote it as follows:

4 Walmsley

Business Interruption Insurance Law and Practice, First Edition, by R.M.Walmsley, published by Witherby & Co Ltd, London, 1999.

"A practice has grown up of taking credit in the indemnity calculation under the business interruption policy for these wages paid under the material damage policy.

"It is sometimes argued that there has been a saving in wages, but the fact of the matter is that the wage bill will have remained the same.....

"There can be no sensible argument that there has been a saving in wages. If the business interruption insurers are to take credit it can only be in relation to some concept of *indemnification aliunde* that is the insurer is entitled to take in to account money obtained by the insured from any other source in relation to the loss sustained. This is subtly different from the notion of subrogation. This possible justification fails however in that the wages paid by the material damage insurers are for repairs etc, and are paid as part of *the value of the material damage loss* i.e. the value of the machine etc. at the time of the loss. The wages paid are not being paid as a 'loss of wages' as is the case for any money paid under the indemnity formula of the business interruption policy." (page 380/381)

In my opinion Walmsley's argument has no merit whatsoever.

He is wrong to state that there has been no saving in wages. Perhaps he is deluded by too narrow a focus on the payroll. I might agree that the payroll will not have been reduced (i.e. the sums transferred from the insured's bank account into the bank accounts of the employees and the IRD) but "wages" as insured under the Gross Profit Item of a Business Interruption policy are the wages that are an expense of the business.

Even if the payroll is not reduced, the expense to the business, as will be reflected in the "Statement of Financial Performance" (current jargon for the Profit and Loss Account) will be reduced if correct accounting treatment is followed.

That is, if wages are reimbursed, that reimbursement should be credited to the expense item, "Wages", which will reduce it. This is clearly a saving as envisaged by the Gross Profit item's requirement:

"less any sum saved during the Indemnity Period in respect of such of the charges and expenses of the Business payable out of Gross Profit as may cease or be reduced in consequence of the Damage."

Such an accounting treatment would be correct for the wages of staff involved in clean-up, debris removal, sorting damaged stock, running a salvage sale, etc. I doubt that this is done in practice but whether the wages account is credited or not, the fact is that the cost of wages that must be born by the business has been reduced because part of it has been reimbursed to the insured. Therefore that sum does not have to be recovered from turnover in the normal course of trading or from the claim in respect of reduction in turnover resulting from the insured interruption.

Similarly, if wages are paid to staff who are involved in reinstating damaged assets (repairing machinery, rebuilding moulds) they should be capitalised rather than "expensed". That is, they are debited to an asset account not to the expense account, "Wages".

I suspect that Walmsley has taken a legalistic stance but failed to recognise the correct accounting treatment of expenses, recoveries and capital costs. He therefore fails to reflect the practicality of business expenses and their correct treatment should they be reimbursed from another source and as a result his opinion supports the over-indemnification of the insured's loss.

I would also take issue with his reference to "loss of wages":

"The wages paid are not being paid as a 'loss of wages' as is the case for any money paid under the indemnity formula of the business interruption policy."

BI claims do not pay for "loss of wages". They reimburse the insured for the loss (of profit) that arises because, as a result of a reduction in turnover, the insured is unable to recover its normal wages expense. In this case study the insured did not have to recover its normal wages from turnover because part of the expense had been recovered from the Material Damage claim.

An opinion such as mine is without merit if it cannot be supported by the words of the policy. I quote again from the specification of the Gross Profit Item:

"less any sum saved during the Indemnity Period in respect of such of the charges and expenses of the Business payable out of Gross Profit as may cease or be reduced in consequence of the Damage."

To the extent of their reimbursement under a Material Damage policy or their being debited to a capital account (as cost of creating an asset instead of producing turnover) the wages are not payable out of Gross Profit. As a charge or expense of the business they have been saved. If they are not deducted the combination of Material Damage and BI claims will over-indemnify the insured for its loss.

I do not wish to expand this opinion into a dissertation on the vexed question of whether BI policies are contracts of indemnity but at the least I suggest that the principle on which they are based is that of indemnity. Therefore if it is possible to interpret the specification of what is payable in a manner that indemnifies the insured for its loss, I will always prefer that interpretation to one that under or over indemnifies it.

Conclusion

If normal wages that are 100% insured under the Gross Profit Item have been reimbursed as part of the Material Damage claim that sum should be deducted from the Business Interruption claim as a saving in insured expenses.

In my opinion this is authorised by the specification of the policy, it is in accordance with correct accounting treatment (credit the recovery of wages against the same account to which they were first debited as an expense and debit wages to a capital account if staff are creating a new or replacement asset) and it produces a settlement of Material Damage and BI claims that correctly indemnifies the insured for its loss in respect of wages.

Brett Fawcett
February 2008