

Advanced BI Subjects

The Overlap between Business Interruption and Retailers' Stock (Salvage) Claims

Introduction

A BI claim can be adjusted to reflect or accommodate different treatments of the proceeds of a "fire sale" in the stock claim. As a result the practice has developed, of deducting the total value of the salvage from the stock claim. This is not a problem for an insured that has a BI policy but it is not an equitable treatment for one that does not insure BI.

A retailer's shop full of smoke-tainted lingerie (retail sales value, say, \$100,000 – to make the maths easy) was sold in a salvage sale for \$60,000, which was approximately equal to its original purchase cost. I overheard a comment that there was no stock claim because the indemnity for retail stock is cost price and in this case it was only the Gross Profit that had been lost.

Usually this view of stock claims, whether right or wrong (quite wrong in my view) doesn't really matter because the loss of Gross Profit is claimed under the Business Interruption ("BI") policy. If the entire proceeds of the salvage sale are credited to the stock claim it pays less than I believe it should and the BI claim pays more. But this insured did not have BI cover and so its stock claim had to be settled correctly.

This example illustrates a common but incorrect view of what comprises indemnity for damage to retailers' stock, which has been allowed to grow into normal practice because its inadequacy is covered up by the BI claim.

If it is alleged that there were no stock claim (because the salvage proceeds covered the cost price) the implication is:

- (i) There was no damage. Wrong! Smoke taint is great with barbeques, not on lingerie.*
- (ii) And there was no reduction in value. Wrong again! There was a 40% reduction in value because what would have sold for \$100,000 could now be sold for only \$60,000.*

So, if I think normal practice is wrong, how would I assess the value of the damage?

Let us agree that the stock claim should be settled on the basis of cost. There has been a 40% erosion of value. Therefore pay 40% of cost ($\$60,000 \times 40\% = \$24,000$) as the measure of damage and let the insured sell it to generate some contribution to its normal Gross Profit. This means that the retailer would achieve a total income of \$84,000 (\$60,000 salvage sale proceeds plus \$24,000 from the stock claim).

That would be fair! Why should the retailer sell the damaged stock, effectively for the benefit of its insurer, using its premises, staff and operational cost structure, for no return, as is implied if it runs the salvage sale, achieved \$60,000, which covers its original cost of the stock, and gets nothing from the insurer as a stock claim?

For those who are numerically inclined:

But for the fire:

Normal sales value	\$100,000	100%
Purchase cost	<u>60,000</u>	60%
Gross Profit margin	<u>\$40,000</u>	40%

After the fire:

Salvage sales value		\$60,000	100%
Original purchase cost	60,000		
less Stock claim	<u>24,000</u>		
Net cost of goods sold		<u>36,000</u>	60%
Gross Profit margin		<u>\$24,000</u>	40%

So instead of making a \$40,000 margin by retailing pristine lingerie this insured has made only \$24,000 by retailing smoke-tainted lingerie. From the retailer's perspective \$24,000 is better than nothing. (Remember that it had no BI policy.) From the insurer's perspective it paid \$24,000 to achieve salvage sales of \$60,000. Its net claim cost is therefore \$24,000 (plus adjusters' fees, of course)

Could it have done better elsewhere? This is a judgement call. Experience suggests that the sale to a salvage merchant might have returned about \$15,000 or to be optimistic, say \$20,000. This makes a net claim to the insurer of \$40,000.

Cost value paid to insured	\$60,000
less receipt from salvage merchant	<u>20,000</u>
Net claim cost to insurer	<u>\$40,000</u>

.... and the profit on the sale goes to the salvage merchant instead of reducing the retailer's uninsured loss of Gross Profit.

If your view of stock claims and salvage is that the insured should be paid out in full, leaving the insurer to deal with the salvage, would it not have been better for the insurer to pay \$60,000 to the retailer, thus settling the stock claim and then negotiate with the retailer who already has all the infrastructure and experience in retailing lingerie, to sell it on behalf?

We know now, that the retailer can sell it for \$60,000, which is a 40% discount on normal retail value. What would be fair for the insurer to pay to achieve this salvage return? The insured would normally make \$24,000 GP on \$60,000 of sales (i.e. a 40% margin) so is it fair for insurers to pay the same?

Or, if the salvage sale proceeds of \$60,000 were achieved in, say, a week but normally it would take three weeks to achieve \$60,000 of sales then the insured's GP is \$8,000/week and perhaps insurers should pay \$8,000 for it to handle the salvage sale or say, \$10,000 because it will have to work much harder to shift that much stock in just a week.

This table shows the insurer's position if it pays 40% for running the salvage sale (i.e. \$24,000) or a bit more than a week's GP (i.e. \$10,000). Both are substantially less than the option of selling to the salvage merchant.

Insurer's perspective			
Stock claim paid to insured		\$60,000	\$60,000
Cost of running salvage sale	40%	24,000	(1 week) 10,000
(also paid to the insured)			
Salvage sales proceeds		-60,000	-60,000
Net cost to insurer		<u>\$24,000</u>	<u>\$10,000</u>

This illustrates two fundamentals of loss adjusting.

- 1 The decision on how to dispose of the salvage to best advantage is a judgement call,
- 2 and in respect of how much to pay the insured to run the salvage sale, well, everything is negotiable.

Is it fair on the insured? Depending on the negotiation, in addition to receiving \$60,000 to replace its stock, the insured will make a GP of between \$10,000 (one week) and \$24,000 (40%) for running the salvage sale, which contributes to its overheads and net profit. The salvage merchant option would give it \$60,000 to replace the stock and nothing for its overheads.

I am simply a BI adjuster so why am I writing about retailers' stock claims?

It is because my contention is that they should be settled on their merits without reference to whether there is a BI policy or not. Therefore the comment that started this article has no merit, namely that there is no stock claim because the salvage sale proceeds equalled the cost value (or indemnity value) of the damaged stock. It is wrong for situations in which the insured has no BI cover and therefore it is also wrong where there is BI cover.

Why am I bothering to advocate something that contradicts the entrenched views of many adjusters and claims technicians? Because if they take the easy shortcut when there is a BI policy to pick up the short payment, they will believe that it is correct in

principle and will try to apply the same shortcut method to a claimant that does not have BI insurance.

It is simply a matter of paying the insured a fair sum for running a salvage sale to maximise the return on damaged stock for the insurer's benefit.

Does my proposed method apply correctly to the retailer that does have a BI claim?
Yes, of course!

The insured receives \$60,000 from the stock claim to re-purchase its stock. It is also paid its net BI claim allowing for a salvage sale adjustment, which reduces the BI claim by whatever sum the insurer pays towards the cost of wages and other insured expenses for the period of the salvage sale.

Are there any fishhooks?

Yes, my examples can include the following possible scenario that the adjusters and claims technicians will be careful to avoid.

In my example the insured has \$100,000 of stock and I implied that its turnover is normally \$20,000/week with a Gross Profit achieved of \$8,000/week. If the salvage sale generates sales of \$60,000 in a week (3 weeks' normal turnover) any margin earned by the insured in excess of \$8,000 is more than it would have achieved in that single week. And if it can replace its stock within the week and continue normal sales levels thereafter with no ongoing loss, anything paid by the stock claim in excess of \$8,000 for running the salvage sale will more than offset its loss of Gross Profit on normal sales for that week.

In these circumstances the adjuster should negotiate to pay one week's overheads for the use of the shop and staff to sell the salvage. He or she should not pay 40% of turnover achieved.

As I said, everything is negotiable and if stock and BI claims could be settled by application of a single, simple formula how would I have earned a living over the last 35 years?

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