

Advanced BI Subjects

Time Deductibles in BI Claims

Business Interruption policies usually state the length of a time deductible but make no further reference to it in the specification of “the amount payable”. This can create problems in the adjustment of claims or provide flexibility depending on one’s perspective.

Introduction

Time deductibles are used in many of the Automatic Extensions that are pre-printed into Business Interruption (“BI”) policies (Prevention of Access, Supply of Utilities, etc) and they are common in machinery breakdown BI policies. They are usually stated in the policy schedule as, for example, “Time Deductible 7 days” (or 24 hours; I have even seen several with 60 days). But it is rare to see them defined in the specification of what is payable, which requires claimants and adjusters to use reasonable discretion to resolve some anomalies. Perhaps I should say that it gives them wiggle room.

If they are defined at all it is usually something brief, like, “Insurers will not be liable for the loss as defined occurring within the first 7 days after the Damage”. This leaves a couple of elements in the calculation of “loss as defined” that don’t quite fit.

For a policy that tends to be quite prescriptive in the calculation of claims it is strangely silent about the treatment of increased costs incurred during the deductible period. It also leaves open the question of turnover or output, as the index of loss and what is the more equitable of the two for the claim as a whole, might not be so equitable when it is applied to the time deductible period.

Increased Costs

The cover for increased costs that is automatically included in any BI policy with a Gross Profit (or Gross Revenue or Rents) item is defined in sub-clause (b) of the item, as:

“(b) additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover during the Indemnity Period”

So it doesn’t matter when the additional expenditure is incurred. The timing is related to when the reduction in turnover is avoided. It must be a reduction in turnover that would have occurred during the Indemnity Period and most Indemnity Periods start with the date of Damage.

Because the loss as defined includes increased costs, does the loss within the deductible period include the increased costs incurred within the deductible period? Despite the apparent logic of concluding that it does, this could lead to an inequitable claim adjustment.

If the insured incurs increased costs within the deductible period that result in a reduced loss in respect of reduction in turnover in that period it is fair that the increased costs are not claimable. They reduced a loss that was not claimable.

But if increased costs within the deductible period reduced the claim in respect of reduction in turnover after the deductible period the insurers whose liability has been reduced, should pay the cost.

A petro-chemical company paid \$3 million to lease a temporary generator and airfreight it to the plant in Indonesia after its power supplier had a major generator failure. The cost was incurred during the 60-day deductible period and the temporary generator arrived on day 57. Almost the entire benefit accrued to the insurers in reducing the claim from day 61 on.

But the cost is an element of “the loss as defined” during the first 60 days.

It appears to be accepted practice world-wide that such costs are allocated according to which of the parties benefits; the insured in respect of reducing the loss during the deductible period or the insurer because of the benefit it derived after the deductible period. This obviously assumes that the timing criterion for increased costs that is defined in sub-clause (b) of the Gross Profit item can be extended to a deductible period. i.e. It doesn't matter when the costs were incurred. It only matters when the reduction in turnover was avoided.

An interesting twist to the example mentioned is that the hired generator failed after only 7 days of operation, which added a whole, new bunch of complications. But they are another story.

In conclusion, it is common practice that the uninsured loss during the deductible period does not necessarily include increased costs incurred during that period. Increased costs are apportioned to the deductible period and thereafter, according to when the reduction in turnover was avoided rather than when the costs were incurred.

Turnover or Output

However dangerous it might be to make judgements about the intentions of the parties to an insurance contract, we might assume that time deductibles are intended to enforce an element of self-insurance. But this intention is rarely evident from the policy if, indeed, there is anything about it in the policy other than its duration stated in the Schedule. The most comprehensive specification is likely to be:

“Insurers will not be liable for the loss as defined occurring within the first 7 days after the Damage”.

The loss as defined is the sum produced by applying the Rate of Gross Profit to the reduction in turnover (plus increased costs, minus savings in insured expenses). But if the insured is able to maintain turnover for the first, say, 30 days by selling down its stock of finished goods and the entire reduction in turnover occurs outside the deductible period there is no element of self-insurance. The insurer pays it all.

Given that most BI policies now include an option to use output as the index of loss instead of turnover, if the "Output or Alternative Index" clause allows the insured to choose the index it will obviously choose turnover in the hope that the lost sales are delayed until after the deductible period and are therefore claimable. The choice can be made after the event in which case the insured will know which index produces the greater claim.

Most policies' output options are expressed as "whichever produces the most equitable result".

My assumption in the adjustment of BI claims is that an insured is entitled to use the flexibility built into the "loss as defined" specification to produce a calculation of claim that as nearly as possible indemnifies it for its total financial loss resulting from its business interruption. However this implies that it would be entitled to use turnover if, by doing so, it can delay the "loss as defined" out of the deductible period and into the period of that is claimable.

I think that this distorts the presumed intention that the insured should bear the first 30 days (say) of loss of Gross Profit. This intention implies that output should always be used as the index because output more immediately reflects the impact of a business interruption. In contrast, a loss of output resulting from insured damage might not cause a reduction in turnover for some weeks or even months if sales can be maintained from a cushion of stock of finished goods. This situation is a likely feature of a highly seasonal business.

But there is little in BI claims adjustments that is without exceptions or variations. Many years ago I dealt with a machinery breakdown claim by a paper pulp manufacturer. The breakdown occurred in a chip conveyor but pulp production continued throughout the 7-day deductible period using chips out of the stockpiles. Neither turnover nor output was affected within the 7 days and the insurer had to pay the entire loss.

In another claim a manufacturer (not in NZ) did not agree that it should use output as the index of loss during its 30-day deductible because it had only agreed to accept the deductible in the knowledge that it always had sufficient stock in its warehouses and delivery pipelines to avoid any loss of turnover during that period. Its Output clause allowed it to use turnover or output, whichever was the more equitable and it argued that because turnover was the correct index for the claim as a whole, it should also be used to calculate the loss during the 30-day time deductible. Most of the loss (of turnover) was therefore within the claimable period.

Time has a Range of Dollar Values

Perhaps the manufacturer could have argued that its intention was simply to eliminate small claims because only major interruptions would create a loss (of turnover) after 30 days.

I have to suggest that a time deductible is a blunt tool for this purpose because its value is largely unknown until after the event. If it occurs when seasonal demand is low there might be no initial loss or at least a loss that is less than the average Gross Profit of the

period. At the seasonal peak it might be considerably more than the average Gross Profit of the period.

Most interruption losses are partial losses and so the deductible is again less than the normal Gross Profit produced during the period.

I have seen other definitions of a time deductible, such as "The Gross Profit that would have been earned but for the Damage during the (say) 30 days after the Damage". This eliminates a situation in which the deductible is reduced in partial interruptions. However it is still imprecise because it might span a seasonal low point in demand or a scheduled maintenance period, both of which reduce its value. Or it could occur at the peak seasonal demand, increasing its value.

Sometimes the deductible is defined as, "30 days equivalent of the average daily loss during the Indemnity Period." This is a highly unsatisfactory definition. Most interruptions start at their greatest severity and reduce progressively until business gradually returns to normal. The longer the partial (reducing) loss continues, the smaller is the average daily loss and the smaller is the deductible.

Conclusion

The less that is defined in a BI policy, the greater is the flexibility with which a claim can be calculated. You might assume that someone who is as excited by an Excel spreadsheet as I can be, would be a rule-based personality type and want everything defined tightly. But I do enjoy being allowed a bit (a big bit) of flexibility to produce an adjustment that correctly indemnifies an insured for its real financial loss.

I have never had difficulty selling the concept to insurers or to an insured that increased costs incurred during a deductible period should be apportioned according to the relative benefits that derived from them. I am less comfortable with the choice of turnover or output as the index of loss knowing that the assumed intention of a time deductible can be frustrated by delaying the loss until it is outside the deductible period.

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