

Advanced BI Subjects

Business Interruption Caused by Damage to Excluded Property During Natural Disasters

(Based on part of an address to the Insurance Law Association's Annual Conference in October 2004)

I will start by repeating a fundamental principle of BI insurance, which is that when it comes to deciding how much of an interruption loss is insured and how much is excluded, there is only one authority and that is the BI policy. If I hold an opinion on any aspect of a claim, which cannot be backed up by reference to the BI policy it has little persuasive credibility.

This paper addresses one of the rather complex issues of BI claims following natural disasters such as earthquakes, tsunamis, floods, cyclones and volcanic explosions. The essential characteristic of these events is that they damage a wide area, not just the property of a single insured, but also its customers, suppliers, public utilities and access routes.

I will base my explanations on the events of a storm in February 2004 but mention that a rewrite of this paper in 2009 has been precipitated by BI claims resulting from a severe monsoonal trough that hung over Fiji for about 10 days in January, causing massive and widespread floods and more recently, the devastating earthquake and tsunami in Samoa that demolished so many beach resorts and killed so many people.

A previous paper in the series (Module 4.6) has described the insurance issues arising from what has been informally referred to as "loss of attraction" or "depopulation". This one details the complications resulting from a combination of insured and uninsured property damage that both result from a single (flood) event and both cause concurrent interruption to the business.

The February 2004 storm caused severe flooding in the lower North Island of New Zealand. Rural communities suffered serious damage and the national media showed wide areas of flooded farm properties, eroded riverbanks and drowned livestock. This was a massive flood!

But BI policies do not insure the consequences of a flood. They insure the consequences of Damage for which a conventional definition from either a Material Damage or a BI policy is:

"Damage shall mean physical loss or damage unintended and unforeseen by the Insured."

Insurers limit this very comprehensive view of damage by stating that they will not pay for loss of profit consequent upon damage if it is caused by perils such as war, nuclear events, pollution, and many others, none of which is unique to BI insurance. Storm and flood are not usually excluded perils in New Zealand.

They also exclude the loss of profit consequent upon damage to various categories of property, like motor vehicles, ships, timber and crops, land, and property in the course of construction. Again, these are not unique to BI insurance.

“The Company will not pay the Insured any loss resulting from interruption or interference with the Business in consequence of:

- 1 *Damage to: ... (followed by a list of excluded property)*
- 2 *Damage caused by: ... (followed by several lists of excluded perils)”*

Not only must the damage conform to the definition in the BI policy, with its excluded perils and property, but also the damage must, itself, be insured and a claim accepted under a material damage policy. This is the Material Damage proviso, which I have described in detail in previous articles (see particularly Module 2.2: “Which Interruptions are Insured?”).

So what might a dairy company that processes milk from farms in the flooded area, expect from its insurers? My comments in this context are based solely on what I have seen in the media and what I know about standard BI policies. I am not disclosing anything that is pertinent to a particular company’s policy or its BI claim.

Dairy factories at Pahiatua and Hawera were physically damaged. Many of their suppliers (farmers) suffered physical damage to their premises (milking plant and buildings) and numbers of dairy cows were drowned. The gas supply at Pahiatua was turned off because a bridge carrying the gas main across a river was seriously damaged. Roads were impassable and the Manawatu Gorge was closed to road and rail. A train carrying milk was derailed. Power lines were down and as a result farmers couldn’t milk their herds.

Let us assume that one of the dairy factories was insured for BI with a conventional policy that covered the loss resulted from damage to buildings and property it used at its premises.

As far as the damage to its milk factory is concerned, this was damage to property used by the insured at its premises and provided storm was not an excluded peril and insurers accepted liability for the physical damage, so, too, the resulting loss of revenue would be insured.

The loss of revenue resulting from damage at the premises of suppliers is usually also insured by a Suppliers Extension in a BI policy and for now we will assume that the dairy factory’s policy is no less comprehensive than most. In respect of damage at suppliers’ premises the Material Damage proviso is not relevant because the property is not the insured dairy company’s property. It is therefore irrelevant whether the damage at the farms was insured or not. But for the dairy factory’s BI claim relating to loss of revenue caused by interruption to the supply of milk, the damage that disrupted supply must conform to the dairy company’s BI policy definition of Damage – i.e. not caused by an excluded peril and not comprising damage to excluded property.

The loss of revenue or increased costs caused by loss of gas supply is also usually insured by a Utilities Extension. Similarly, for the dairy company's BI claim the damage that cut gas supplies cannot have been caused by an excluded peril or be damage to excluded property or else that element of the dairy company's loss will not be insured.

Prevention of Access clauses differ quite markedly. Some cover only the loss resulting from Damage (i.e. as defined in the particular BI policy) in the vicinity of the premises, which prevents or hinders access to them or use of them. Others also cover loss caused by Damage to roads and bridges over a wider area.

But think back to the pictures on TV and in the papers. Farms inundated, pasture silted over, houses washed away, stock drowned or washed miles downriver. None of these comprises Damage as defined by a conventional policy.

Livestock is excluded property.

Land is excluded property.

Crops are excluded property.

I have speculated briefly that pasture is not a crop because it is not harvested, but concluded that it was either a crop or it was part of the land, both being excluded property.

So the loss of revenue and increased costs resulting from pasture damage and stock losses (temporary or permanent) would have to be excluded from a BI claim.

I recall that the exclusions of pasture and livestock were first raised following Cyclone Bola in March 1988. Then I was a loss adjuster acting for the insurers of two dairy co-operatives in Taranaki and in addition to the elements of interruption mentioned above, I adjusted out of their claims, the results of wind burn and salt spray from the sea, which damaged pasture in coastal areas. As cows are conceptually machines for turning pasture into milk, damage to pasture results in less milk output.

I was told that foliage blown from macrocarpa shelter belts was eaten by some unwise cows and that as a result they aborted their calves and therefore didn't produce any milk in the following season. Fortunately the effect was outside the maximum indemnity period of both those dairy cooperatives and so I didn't have to evaluate that particular element of their consequential losses.

We now come to the issue of overlapping causes of interruption in a very complex situation in which several insured and uninsured causes contributed to the loss of milk supply and loss of revenue. What is the measure of the loss if 25% of a farmer's herd disappeared downstream, which is not insured, and additionally the milk collection tankers could not get to the farm vats because of damage in the vicinity, which is insured¹?

¹ I have made this simplifying assumption for the purpose of this paper.

From the basic policy item, which is the Gross Profit item, I quote the specification of a claim in respect of the reduction in turnover.

"Item 1: Gross Profit

The insurance under this Item is limited to the loss of Gross Profit due to (a) reduction in turnover and (b) increase in cost of working and the amount payable as indemnity under this Item shall be:

"(a) in respect of reduction in Turnover, the sum produced by applying the Rate of Gross Profit to the amount by which the Turnover during the indemnity Period, in consequence of the Damage, falls short of the Standard Turnover."

You will recall that:

" 'Standard Turnover' means the Turnover during the period in the twelve months immediately before the date of damage which corresponds with the Indemnity Period"

Therefore, if the BI policy were in a conventional form the historical Standard Turnover for its claim would be the sales value of products derived from the milk collected from mid February 2003 to say, May 2003.

But, as said previously, BI policies do not insure historical profit. They insure future profit. And when historical Standard Turnover is adjusted to *"the results which but for the Damage would have been obtained during the relative period after the Damage"*, the adjusted standard sales value (derived from milk collection) is that which would have been collected from mid-February to the end of May 2004, but for the Damage. Here I used "Damage" in the restricted sense as defined in the policy, and therefore subject to the excluded categories of property.

In respect of the farm that lost 25% of its herd, even if the (insured) Damage (i.e. preventing access the property to collect the milk) had not occurred, only 75% of normal milk volumes would have been collected. (Remember also that for this paper I have assumed that prevention of access is deemed to be Damage as defined.)

By inference, the insured loss is measured against a standard, which is first adjusted for the uninsured circumstances (livestock deaths) and the claim is limited to only the additional loss after all uninsured losses have been allowed for.

So the historical milk collection volumes in 2003 have to be adjusted downwards for all uninsured results of the flooding and only if an insured factor caused additional loss of milk collection would it comprise a claimable loss.

This the critical distinction, namely that BI policies respond not to a peril, but to the additional loss consequent upon the Damage as defined in the policy after first excluding losses resulting from uninsured factors even if they are themselves results of the same peril.

Putting this into the specifics of the February event, BI policies respond not to the flood but to the additional loss consequent upon the Damage as defined in the policy after first excluding losses resulting from damage to pasture and loss of livestock even though they are themselves results of the same flood.

Now I want to refer briefly to the doctrine of proximate cause in the context of livestock being excluded property.

As a direct result of not being milked on schedule, cows dry up for the balance of the season or at least their milk production drops. The severity of the long-term loss of milk production is related to the severity of the initial disruption to milking.

Let us assume that at some of the suppliers' premises the disruption to milking was caused by Damage as defined (damage to milking plant or loss of power). This is a fairly safe assumption from the media pictures. As a direct result of the physiological effect of not being milked these cows produced less milk right through the remainder of the season (to the end of May 2004).

The proximate cause of the ongoing loss of milk production from the surviving herd is not damage to the excluded property (livestock). It is not damage resulting from an excluded cause. There has been no subsequent intervening event and the loss of milk even to the end of the season, is the natural consequence of the insured damage (to the milking plant). It is not relevant that cows are involved in the production chain and that they are excluded property. The loss did not result from damage to the cows.

Therefore, once damage at the suppliers' premises was repaired, we still need to distinguish between the ongoing loss of milk production resulted from pasture damage and the loss of milk production resulting from the long-term physiological effect on cows that were not milked for several days.

Finally, on the subject of milk production, there is a flip side to these adjustments.

The area had been a bit dry in January and early February and pasture growth had slowed as a direct result. Cows are just machines for turning grass into milk and milk volumes were down for that stage of the season. After the ground had been thoroughly soaked there was a period of warm weather and where land had not been washed away or silted up, pasture growth and therefore milk production increased. Therefore the standard against which the ongoing insured loss is measured is not what would have resulted but for the flood, but the increased milk production that would have resulted from the extra pasture growth, but for the insured damage.

The suppliers whose herds were adversely affected in the longer term by disruption to their milking schedules were unable to benefit from the extra pasture growth and the "but for the damage" situation would have to be that which had been adjusted up to higher production volumes as a result of the same peril, i.e. flood, which caused the loss.

In conclusion I must say that insureds usually react with dismay or anger when adjustments arising from the same peril for which they are insured, erode a portion of

their claims. They do not appreciate the subtle distinction between the results of the peril and the results of the damage. Simply, as a result of the notorious “fine print” the policy response fails to meet their expectations.

Conclusion

I am aware that I have introduced several concepts in a few short pages that I have been dealing with for many years and it might require more than this brief explanation to convince you that BI claims following the widespread impact of natural disasters are a bit of a lottery.

However, within all the variations in the possible circumstances of interruption, some insured and some not, there are several fundamental concepts.

- 1 BI policies do not respond to the loss resulting from the peril, itself.
- 2 BI policies do respond to the loss consequent upon Damage as defined, but subject to all the restrictions of excluded property and excluded perils.
- 3 The Damage must be to property used by the insured at the premises for the purpose of the business or be deemed to be so, in respect of suppliers and customers premises, utilities and prevention of access.
- 4 The standard against which the loss is measured must be adjusted up or down so that the adjusted figures represent the results that would have been achieved “but for the Damage” as defined. Every other interruption factor, which is not insured is eliminated and only thereafter is any additional loss attributed to the Damage.

And how do you measure all these necessary adjustments? Well I have to keep some trade secrets in order to remain gainfully employed.

Brett Fawcett
October 2004 (updated 2009)