

Business Interruption Insurance

So! You have suffered a financial loss, have you? And you think it is covered by your Business Interruption insurance policy?

This article introduces you to Business Interruption (BI) insurance and the preparation of a claim so that you are able to deal more confidently with the insurers and their loss adjusters despite your need to tackle something that is outside your experience, and to negotiate with those who are already expert in the field.

It is based on 30 years of experience as a specialist in BI insurance claims and litigation involving economic losses.

The Basic Principles of BI Claims

BI insurance policies respond to financial losses of a precise nature. You might hear it described as “loss of profits” insurance or “consequential loss” or more usually, “business interruption” insurance (or simply “BI”). All three terms are encapsulated in the simple description:

**BI policies insure the loss of profit
consequent upon a business interruption.**

Not all business interruptions trigger a valid claim. If your financial loss is the result of an interruption to your business caused by fire damage at your business premises it is almost certainly insured. If not, you will need to determine whether it was caused by a peril that your policy excludes or perhaps it resulted from damage to property of a type that your policy excludes. This aspect is described in more detail under “**Which Interruptions are Insured?**” (see below).

Not all financial losses are insured, even if the circumstances of business interruption (i.e. the peril and the type of property that was damaged) are within the policy coverage. It is only the loss of trading or operating profit that is insured, and this can only result from:

Either a reduction in sales

Or an increase in expenses

Loss of asset value and reduction in market capitalisation are not covered. Loss of goodwill, market share and intellectual property are not covered except to the extent to which they are reflected in a reduction in sales or increased operating expenses.

... and so, what is covered?

The basic policy response is specified in the Gross Profit Item, sometimes described as “Insured Profit”, which introduces its cover as follows:

*"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:"*

I have described the calculation of the amount payable under the heading below, "**How Much Does the Policy Pay?**"

In addition to the Gross Profit Item, most policies insure the costs of preparing a claim plus an item called "Additional Increased Costs of Working", which pays for increased costs that are outside the scope of the basic Gross Profit cover. Other specialist items might be in your policy but they are not described in this brief article.

Which Interruptions are Insured?

If your loss arises from a fire at your business premises you probably don't need to read this section. It is almost surely insured. Otherwise, read on.

As already said, BI policies insure the loss of profit consequent upon a business interruption. This general statement must be qualified in many ways, because not all business interruptions are insured. A typical Contractual Clause in a BI policy would be:

*"The Company (i.e. the insurer) will indemnify the Insured in respect of each item in the Schedule the amount of **loss resulting from interruption or interference to the Business if during the period of insurance any building or other property or part thereof used by the Insured at the premises for the purpose of the Business be destroyed or damaged by:**"*

To be insured, your business interruption must have been the result of Damage. I have used a capital "D" because Damage is a defined term. It must be caused by an insured peril and it must be Damage to insured property.

In current policies that means the peril or cause must be one that has not been specifically excluded by the definitions in the policy and the damaged property must be of a type that has not been specifically excluded. For example, a typical definition of Damage is:

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

This definition is followed by a list of excluded perils:

"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)

Examples of excluded property are motor vehicles, land, timber and crops, and property in the course of construction. These exclusions are not unique to BI insurance.

Excluded perils might include war, earthquake, nuclear events, pollution, gradual deterioration and many other events, none of which is unique to BI insurance. Flood is usually not an excluded peril in New Zealand.

If your BI policy does not insure the consequences of machinery breakdown, this will be specifically mentioned in the excluded perils.

There is another highly relevant policy requirement called the Material Damage Proviso.

"..... the Company will not be liable for any loss under this Policy unless the Insured's property destroyed or damaged at the premises is insured against such damage and the Company by which such property is insured shall have paid for or admitted liability in respect of such damage."

If your business interruption has been caused by damage to property that you own, it must have been insured against the damage and a claim accepted.

The MD Proviso has no relevance to an interruption caused by damage to property that you do not own (and therefore do not insure). An example of this is damage to your landlord's building. If damage to the landlord's building causes an interruption to your business your BI claim is not affected if the landlord failed to insure the building.

But if you did not insure your contents and they are damaged, causing a business interruption, the Material Damage Proviso will preclude you from claiming your interruption losses.

I will now comment on a range of possible perils and property that might be involved in your business interruption. Nothing I say on this subject has general application. It must be tested against the specific wording of your policy.

1 Machinery breakdown.

Your BI policy might be a specific Machinery Breakdown BI Policy or your "All Risks" policy might insure machinery breakdown.

If not, then a fire resulting from a machinery malfunction is insured but the business interruption that results from the machinery breakdown alone is not insured.

What is the difference between machinery breakdown and other accidental damage to an item of machinery?

I am an accountant/loss adjuster, not an engineer and so I might over-simplify this issue.

If an external event damages a machine it is not a machinery breakdown and the nature of the external event (e.g. impact damage or flood) determines the policy response. If the damage was the result of a malfunction within the machine, without the intervention of an external cause, it is a machinery breakdown.

To be insured for the BI your machine must be insured for the breakdown and your BI policy must also insure (not exclude) machinery breakdown.

2 Flood

If your economic loss is the result of flood damage you must determine whether the property that has been damaged is excluded by your policy's definition of Damage. For example, the loss might be the result of damage to land, crops or livestock, all of which are usually excluded property types.

It might also be that the peril was flood but that the real cause of your business interruption is flood damage at the premises of your suppliers or customers, flood damage which disrupted the supply of electricity, gas or water, or which prevented you or your customers from accessing your premises.

These interruptions are not covered by the core policy clauses. However the three situations mentioned are usually insured by policy extensions, which are not unique to floods and so I have given them specific mention as follows.

3 Damage at other premises

If the Damage, which has interrupted your business, occurred elsewhere than at your premises it might be insured by one of the three extensions, which are fairly standard in New Zealand policies.

Damage at the premises of suppliers or customers

Damage that has interrupted the supply of water, gas, or other public utilities

Damage that prevents you and your customers or suppliers from accessing your premises

However, these policy extensions are quite specific in that the interruption to your business must still result from Damage as defined. That is, it must have been caused by a peril that your policy does not exclude and it must have been damage to property of a type, which your policy does not exclude.

For example, if the disruption to supply of electricity results from machinery breakdown of the supplier's generating plant, your BI policy will not respond unless it, too, insures machinery breakdown.

If your business is the supply of chemical fertiliser to farms and their purchases decline following a flood, is your loss of sales a result of damage to the land of the customers (farmers) such as silting or erosion? Your BI policy almost certainly lists land as excluded property.

If the interruption to your business is the result of earthquake damage to roads and bridges, which isolates your factory from its suppliers, customers or staff, it is not sufficient that earthquake is an insured peril. Roads and bridges are potentially excluded property categories and so damage to them does not comprise Damage as defined.

Under this subheading I must also mention that extensions to non-specific suppliers and customers, utilities and prevention of access are usually limited to, say, 10% of the sums insured under each policy item.

When the interdependence of modern businesses is considered with all the potential causes of damage, the possible range of causes of an interruption to your business is huge. If your economic loss is not the result of fire damage to your business assets at your premises, nor a consequence of one of the factors specifically mentioned, you should discuss the circumstances of your business interruption with your insurance professional.

He or she will be able to comment with authority on liability, with reference to your BI policy. It is the contract between you and your insurers and general principles or industry standard practice are of no value unless they are in accordance with the precise words of your policy.

How Much Does the Policy Pay?

You will recall I have said that the only two ways your business can suffer a loss of trading or operating profit are as a result of lost sales and increased expenses. This is exactly what the Gross Profit Item of your policy deals with.

*"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:"*

In Respect of Reduction in Turnover

Dealing first with the reduction in turnover, if your business is reimbursed for the sales it has lost minus the expenses that it has saved, it will have sufficient funds to pay all the expenses that were not saved with precisely the same profit or loss remaining, as it would have achieved through normal operations.

This reimbursement is specified as follows:

*"(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.**"*

There are three key elements here.

1 The Indemnity Period

This is the period during which your business has been affected by the Damage and will be the period for which you will need to calculate the reduction in turnover. Your BI policy's Schedule will state a maximum period of, say, 12 or 18 months. If there are ongoing effects of the Damage beyond the defined maximum period, they are uninsured.

2 Reduction in Turnover

However you might intuitively assess the value of your loss of sales, the policy contains a formula. I would say that the formula must be followed but sometimes to do so would involve an unnecessarily complex calculation and insurers will accept a simpler alternative.

I will describe the method specified by the formula.

You will see that the reduction in turnover is described in the quote from a standard or conventional policy, at the bottom of the preceding page, as

"the amount by which the Turnover during the Indemnity Period, in consequence of the Damage, falls short of the Standard Turnover."

Standard Turnover is defined as

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

If the period affected by the Damage is, say, June to November 2004 the Standard Turnover is the turnover achieved in June to November 2003.

Is it fair to measure your lost sales by comparing the actual sales with this historical figure? Almost certainly not!

Fortunately the BI policy recognises this and in one of its most important clauses, referred to as "**The Adjustments Clause**" it provides huge flexibility to adjust the historical Standard Turnover so that you can obtain the best possible assessment of the turnover that would have been achieved **but for the Damage**. The Adjustments Clause is linked to the definition of Standard Turnover.

"to which such adjustments shall be made as may be necessary to provide for the trend of the Business and for variations in or other circumstances affecting the Business either before or after the Damage or which would have affected the Business had the Damage not occurred, so that the figures thus adjusted shall represent as nearly as may be reasonably practicable the results which but for the Damage would have been obtained during the relative period after the Damage."

Some loss adjusters take a simplified view of this clause and confine themselves to an adjustment for trends. If the business was growing pre-Damage at, say +15% p.a. they assume that it would have continued to do so after the Damage. You will see immediately that this leap of faith is potentially flawed but at least it is simple and subject

to reasonable interpretation of pre-fire growth rates and fair negotiation, it usually results in an equitable assessment of the loss.

In fact almost any adjustment is valid provided it produces the most credible possible estimate of the turnover that would have been achieved but for the Damage.

The reduction in turnover is simply the amount by which actual turnover during the indemnity period falls short of what would have been obtained but for the Damage, i.e. the adjusted Standard Turnover.

Applying the Rate of Gross Profit

“(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 I have written that your business will be indemnified if the lost sales are reimbursed, minus an allowance for savings in expenses. It will then be able to pay all the expenses that were not saved, with the same margin left as it would have produced but for the Damage.

Several expense categories in your business will be so directly variable with turnover or output that they will always reduce by the same percentage as a reduction in turnover or output. For example, if there is a 60% loss of sales there will almost certainly be a 60% reduction in raw material costs or cost of goods sold, packaging, and probably freight. If there was a 15% loss of sale these expenses will have reduced by 15%.

Your BI policy will have identified such directly variable expenses and listed them as “Uninsured Working Expenses”. (They don't need to be insured because they will be saved proportionately if there is a loss of turnover.)

To illustrate the calculation specified in the policy, consider a business with two uninsured (directly variable) expenses, Raw Materials and Freight, which are 69% and 1% of sales, respectively (total 70%). Commensurate with a loss of sales, there will be a saving in Cost of Sales and Freight totalling 70% and the true measure of indemnity is provided by deducting the savings as follows:

Reduction in Turnover	\$3,600,000	
Less Savings		
Material Costs	-\$2,484,000	69%
Freight	-\$36,000	1%
	<u>\$1,080,000</u>	30%

The BI policy provides precisely this indemnity but by a different calculation. It defines a Rate of Gross Profit, which I will simplify by saying that, in the example it is 30% (i.e. Turnover minus Raw Materials and Freight).

By applying the Rate of Gross Profit to the reduction in turnover, the deduction is made for savings in these two expenses.

<u>Claim in Respect of Reduction in Turnover</u>				
Rate of Gross Profit	x	Reduction in Turnover	=	
30%	x	\$3,600,000	=	<u>\$1,080,000</u>

If the interruption to your business has been severe or protracted there might be savings in other expenses, such as Repairs & Maintenance or Wages. These savings will also be adjusted in your claim. The difference is that the deduction for savings in expenses that are listed as "Uninsured Working Expenses" in your policy will be made automatically but other savings will be deducted only if they can be specifically identified.

These other savings are mentioned at the end of the Gross Profit Item as follows:

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

Increase in Cost of Working

Clause (b) of the Gross Profit Item provides automatic reimbursement of increased costs but within a narrow definition:

(b) in respect of increase in cost of working, the additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover which but for that expenditure would have taken place during the Indemnity Period in consequence of the Damage, but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided."

To be payable an increased cost must comply in every way with this definition. For example:

- 1 It cannot comprise solely an increase in the ratio of an expense to turnover because that might arise only by virtue of the reduction in turnover itself, which is indemnified by the claim under Clause (a); "*in respect of reduction in turnover*".

2 Its sole purpose must be to reduce the loss of sales during the indemnity period, thereby reducing the claim under Clause (a). Thus it must either reduce the severity of the interruption or shorten the duration of the interruption.

3 Judged with hindsight, the increased costs must prove to have been economic;

"... but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided."

This highlights the fact that your insurers' interests in and commitment to your business cease with the end of the maximum Indemnity Period which you selected and which is stated in the Schedule to your policy. In contrast, your interests are in the long term survival of your business and it might well be in your interests to incur additional expenditure with that in mind, which does not qualify for full reimbursement under the Gross Profit Item. This leads to

Additional Increased Costs of Working

If your policy includes this item it will have a separate sum insured (limit) and you will have paid an additional premium for it. There are many versions of the item and in general they cover additional expenditure beyond that which is recoverable under the automatic provisions of Clause (b) of the Gross Profit Item.

Claims under this item might include:

- 1 Increased costs reasonably incurred but which, despite your best endeavours, do not generate enough additional turnover to satisfy the economic limit.
- 2 Increased costs incurred, which are not directly or solely for the purpose of reducing the loss of sales **within the indemnity period**. An example is increased advertising costs incurred towards the end of the Indemnity Period to regain market share. Such advertising might not produce a measurable benefit until outside the Indemnity Period.

Claims Preparation Costs

Your responsibility is to present a statement of claim with all the documentation and explanations necessary to establish its credibility to the required commercial standard of proof (i.e. on the balance of probabilities). You may have neither the time nor the specialist expertise to do so.

Your insurers will appoint loss adjusters to act for them. These claims specialists will be expert in various fields such as fire causes, engineering, quantity surveying and accounting. Their role is to investigate the circumstances that lead to the damage and business interruption and to report them to your insurers, drawing their attention to any policy conditions or exclusions, which might have an impact on liability.

Once liability has been accepted the insurers will instruct the adjusters to determine the value of the claims for property damage and business interruption. The former is largely

determined by monitoring the costs of repairs or replacements but adjusting them to exclude any element of betterment, and ensuring that only the most cost-effective repair/replacement methods are used.

As a loss adjuster myself, I am proud of the professionalism and integrity of those who have, by their experience and expertise, gained the confidence of insurers for major and complex claims. Although appointed by insurers, their success is in managing the potentially difficult claims process to a mutually satisfactory result, which provides claimants with their full entitlement under the policy.

They will usually provide guidance and assist in the presentation of your claim but if you want the input of other professionals the costs are, subject to some limits, recoverable under the BI policy's Claims Preparation item.

Conclusion

In 9½ pages I cannot convey enough to make you an instant expert in BI claims but I hope that this explanation of the basics of BI will help you to understand your entitlement under your policy and to have confidence that it will produce a reasonable indemnity for your BI loss.

I will conclude with a quote from a senior claims manager:

Our aim is to use our financial resources and the loss adjusters' expertise to put our insureds back into business as quickly as possible.

Brett Fawcett
October 2004 (modified August 2009)