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SPECIAL QUESTION AND ANSWER ISSUE ON BUSINESS INCOME INSURANCE

EDITOR'S NOTE

Business Income insurance, which covers loss of business income and continuing expenses following an insured loss, can be critical not only to a company's prosperity, but to its very survival. An introduction to this complex insurance was addressed in our 1993 (AT93-1) issue of *Adjusting Today*.

That issue generated a steady flow of questions relating to more specific applications of its coverage. In this special issue of *Adjusting Today*, Paul Dudey, CPCU, responds to six of the most often asked questions.

The importance of this coverage and its correct application cannot be understated.

In an effort to further education on this topic, we invite all additional questions you may have for consideration in future issues. Please submit your questions on the attached reply card or forward them to the address on the back page.

Stephen J. Van Pelt, Editor

Business Income Insurance

ANSWERING TOUGH QUESTIONS ON COMPLEX COVERAGE

Paul O. Dudey, *CPCU*

The 1993 issue of *Adjusting Today* (AT 93-1) featured an excellent article on the subject of Business Income insurance. Since that time, this article has generated a flurry of questions on this highly technical subject. In this article we respond to some of them.

Question One

Can you explain the difference between adjusting a retail claim on a Selling Price basis vs. using ordinary Business Interruption (Business Income) insurance?

Answer:

The settlement method for a retail claim will depend largely on the type of property involved in the loss. The standard Retail Selling Price clause provides that property sold but not delivered shall be valued at its selling price less unincurred costs (delivery costs, etc.) and customary discounts. Thus, in a fire involving the store's will-call merchandise, the merchant can recover the profit from the sale of these goods along with its "actual cash value" (ACV).

But any other loss of sales due to the fire must be recovered under the Business Income

(continued on next page)

insurance, and any increase in expenses to maintain operations or hasten return to operations is covered by Extra Expense insurance, or, to the extent only that the Business Income loss is reduced by such expenses, by the additional expense feature of the Business Income insurance.

This is in contrast to the Manufacturer's Selling Price clause. Here the Business Income insurance applies to prevented manufacture by the insured rather than loss of sales. So the Manufacturer's Selling Price clause applies to finished goods manufactured by the insured but not yet sold or delivered, allowing recovery of the selling price (less unincurred expenses and customary discounts) of the finished goods, because this profit is not covered by the Business Income insurance.

Question Two

How does one adjust a Business Income claim when the insured business is losing money?

Answer:

The approach to the claim settlement is the same as with a firm operating at a profit. However, it is necessary to ascertain what the extent of the loss of income for the period of interruption would have been had no interruption occurred, deduct this amount from the continuing expenses during the period of interruption, and pay the difference.

Historically, the Business Interruption policy language was not clear in this regard, giving rise to the argument that the income loss could be ignored and the full amount of continuing expense for the period of the interruption could be paid. This was never the intent, and the true intent was made clear on the newer Business Income forms.

Question Three

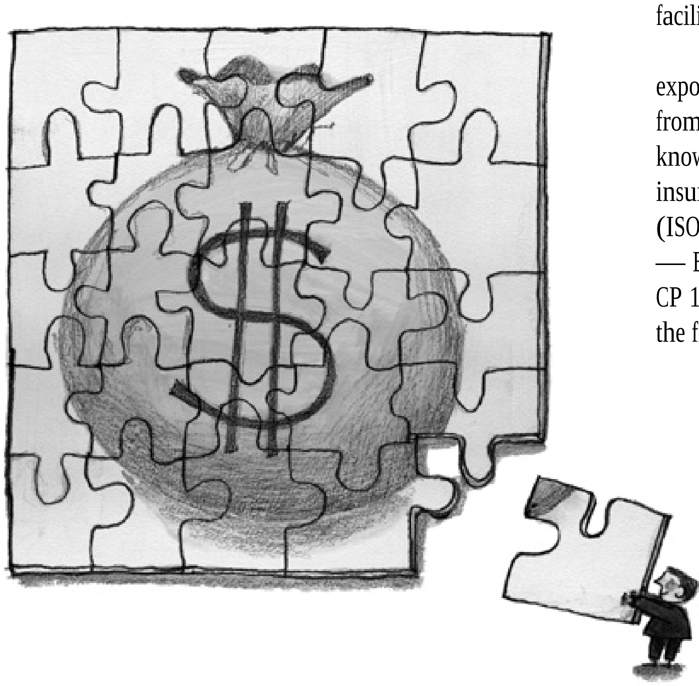
What about an otherwise profitable firm that has a new subsidiary faced with substantial start-up or research and development costs, so that the combined result is an operating loss for the firm?

Answer:

If the subsidiary is included with the parent firm, the same approach would apply as in the answer given to the last question. However, an alternative approach could be used.

Exclude the subsidiary from the parent's Business Income insurance, and write a separate valued Business Income policy for the subsidiary. The valued amount of insurance can be based on the ongoing expenses of the subsidiary plus some estimate of the future loss of income that an interruption at the subsidiary would produce, using a worst-loss scenario.

Also, if the loss of valuable research and development (R & D) records would require replication of R & D work already performed, some amount could be added for this loss, or this loss could be covered using Valuable Papers insurance.



Question Four

How can a business protect itself when a major supplier is shut down by fire or other peril, so that the business cannot obtain needed materials to operate? What about the shutdown of a major customer?

Answer:

Neither of these cases is covered by the business's own Business Income or Extra Expense insurance, unless the supplier or customer is an affiliate or subsidiary of that business. (In that case, blanket Business Income coverage can be provided over both facilities.)

If this is not the case, either of these exposures can be covered by Business Income from Dependent Properties coverage (formerly known as Contingent Business Interruption insurance). The Insurance Services Office (ISO) offers two endorsements for this coverage — Broad Form CP 15 08 and Limited Form CP 15 09 — either of which can be added to the firm's Business Income form.

The Broad Form extends the firm's own Business Income insurance to include one or more of the supplier's or customer's properties, with the same limits of insurance as at the firm's location.

The Limited Form is used, whether the firm carries its own Business Income insurance or not, to cover with separate limits of insurance. It would also be used when a different insurer is used for this insurance than for the firm's own Business Income or Extra Expense coverage.

There are four separate exposures that can be covered:

A. A *contributing* location — a supplier to the insured;

B. A *recipient* location — a major user of the insured's output;

C. A *manufacturing* location — used by an agent of the manufacturer whose products are shipped by the manufacturer directly to the agent's customers under a contract of sale; and

D. A *leader* location — a major operation that attracts customers to the satellite insured's location.

A large-scale example of these types of losses occurred when the World Trade Center was attacked on September 11, 2001. That disaster produced many losses for insureds outside the World Trade Center property. Only those insureds with the foresight to have Business Income from Dependent Properties coverage were covered for their losses.

It should be noted that the insurance for a contributing location does not apply to suppliers of utility services (electricity, water, steam, heat, communications, etc.) to the insured. To cover off-premises service interruption, the Off-Premises Service–Time Element endorsement is used. The type of service interruption to be covered must be stated: communication or power supply (with or without overhead transmission lines), water supply, or whatever.

Question Five

In a period of high inflation, how can a business anticipate the proper amount of Business Income insurance to carry to guarantee adequate coverage for the worst possible loss that might occur?

Answer:

Even at times when this is not as great a problem as it has been, such as when the nation experienced double-digit inflation, we still experience creeping, rather than galloping, inflation. This can still present problems which must be recognized.

The first step, which is already acknowledged by the question, is to recognize that the problem exists. Having done this, then take any of several steps to alleviate the problem. These can include:

A. Review your Business Income values frequently, at least each time new quarterly figures are available, and make any upward adjustment called for by these new figures.

B. Consider the future trend of the business: How much growth is anticipated? Are new products being introduced that will accelerate sales? Are increases planned in the sales force? Will the firm be going into new territories? With what expected results? Then adjust the Business Income values accordingly.

C. Use the Agreed Value coverage to replace Coinsurance. This is done by filing a current Statement of Business Income values for the previous 12 months, as well as anticipated values for the year ahead, and buying insurance based on the anticipated values.

A word of caution here: When the Agreed Value feature is used, it is imperative that new values be reported annually within the reporting time shown in the endorsement. If a report is not filed on time, the Coinsurance provision again applies until a new report is filed. And since, if the business is expanding or inflation is rampant, or both, the amount of insurance carried will be inadequate to satisfy the Coinsurance requirement, and a Coinsurance penalty can result.

One bit of good news though: Coinsurance would apply to the policy year when the loss occurs. Formerly, under the older Business

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Interruption forms, it applied to the 12 months immediately following the date of loss, producing a potentially greater Coinsurance penalty than with the current forms.

D. With smaller businesses, Coinsurance problems can be avoided by the purchase of either Maximum Period of Indemnity coverage, giving coverage for 120 days following interruption, or Monthly Limit coverage for whatever maximum number of months the business might be shut down. These are both optional coverages under the current Business Income forms. But even here, the limits of insurance provided must be adequate for current needs, if an underinsured loss is to be avoided.

Question Six

The coverage offered by the Civil Authority clause of Business Income policies is troubling: 1. Is the length of time given for the coverage long enough? 2. Are there potentially severe exposures not covered by this clause? If so, how can they be insured?

Answer:

The current standard Civil Authority clause provides three consecutive weeks of coverage, beginning 72 hours after the time of loss to property away from the insured's premises for Business Income insurance, and immediately for Extra Expense insurance. Except for the newly added 72-hour waiting period, this is an improvement over the two weeks of coverage formerly offered. The current clause also applies to loss or damage to property "other than at the described premises." Previously it applied to property "adjacent to" the insured's property, a much more limited provision.

The September 11 World Trade Center disaster brought into play the need for this coverage. Following the collapse of the towers, a substantial area around the towers was cordoned off, preventing access by tenants of adjacent buildings even though their premises had sustained no actual damage.

Whether this three-week time period would be adequate in any given case would be hard to say. It would depend on what the potential exposures from nearby properties were. If, during a drought, brush or forest fires might rage unabated though not damaging the insured's property, perhaps the Civil Authority time limit could be exceeded. The World Trade Center disaster provided an illustration of this problem.

The Business Income rules do not provide for extending the time limit. Underwriters might be prevailed upon to extend it, although requests for extension might be viewed as "adverse selection," and a substantial added premium called for, if the coverage were made available. This is especially true since the World Trade Center disaster provided chilling evidence of the need for Civil Authority coverage under the Business Income insurance.

With regard to the second question, the Civil Authority clause applies only to property lost or damaged by a cause of loss covered under the Business Income or Extra Expense insurance. This leaves unprotected some major exposures, notably earthquake and flood. If Time Element coverage is added for these exposures, check to be sure that they include Civil Authority coverage.

Had the World Trade Center disaster been determined to be an act of war rather than terrorism, and excluded under the war risks exclusion common to Business Income coverage, there would be no Civil Authority coverage either.

Obtaining the Proper Coverage

As demonstrated throughout this article, prudent business owners need to evaluate all potential losses that could befall them. They need to think beyond their premises and guard against less obvious threats such as losses at other businesses that may affect them, how inflation can change their valuations and how their own earnings can affect the outcome of a claim. Recovering financially after a loss requires more than just basic insurance, rather a customized plan suited for your specific needs.

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