Business Income Insurance

by Ronald J. Papa, SPPA

Ametals manufacturer suffered a fire loss to key machinery in its manufacturing process. Although operations were interrupted for less than three weeks, the company suffered more than $1.5 million in lost earnings and extra expenses.

Fortunately, this particular company— with due credit to their insurance broker— had purchased adequate business interruption insurance before the potentially devastating event occurred. Equally important, perhaps, the client sought outside professional assistance which proved to be critical when an impasse was reached with the carrier over the true value of the claim.

Many companies are not as fortunate as this one. Because when it comes to property insurance, the real and personal property are often the principal concerns. In fact, the key to surviving a disaster may very well depend on the firm's loss of income protection.

Over the years, this coverage has evolved and undergone several name changes— being known as time element, loss of use, and loss of use and occupancy (U&O) coverage, as well as by the more familiar name of business interruption insurance. The newer ISO Commercial Property forms refer to it as business income insurance.

In this article I am going to discuss the key components and considerations of this important coverage— primarily from an adjusting point of view. The post-loss perspective provides excellent food for thought for any business that is realistic in contemplating its insurance needs. I like to compare this approach to preparing for a disaster to that taken by the accomplished golf professional who plays each hole in his head backwards, visualizing the putt, the approach shot, and the drive in reverse order! In much the same way, good risk management planning involves creating various scenarios of what might happen if a deliberating loss occurs— preparing for all the "hazards" that lie ahead. Whether it be pre-loss or post-loss, a business interruption loss calculation requires a good understanding of the key fundamentals. Following are several areas that should be considered when evaluating a potential business interruption exposure or actual loss.

Protecting the Lifeblood of a Business!

Let me begin by reviewing why business income insurance is so important.

The necessity of insuring tangible assets like buildings, machinery and equipment is readily accepted by business owners and managers, with firm reinforcement of the coverage requirement by the banks when mortgages exist. What is not appreciated in all cases— even by mortgagees— is the critical need for business income insurance to protect the lifeblood of the business when a disabling loss occurs. It goes without saying that one of the most important advantages of owning any asset is the right to its use and to the revenue it generates. If this revenue stream is not properly insured when a loss occurs the results could be catastrophic to those having rights to the property. (In addition to the obvious effects on the owners or lessees, the unfavorable impact extends to others, like employees, customers, vendors, mortgages, etc. All could suffer economic loss as well.) While it's proper that the value of the asset itself be insured, losing the ability to generate revenue could easily force an owner out of the business.

Gross Profit— The Basis of the Coverage

The aim of business income insurance is to provide a business, whose operations have been interrupted by a loss, with income equal to what the firm would have enjoyed had the loss not taken place. The gross profit or earnings— the primary source for meeting operating expenses— is the focus of the coverage. According to policy language, coverage applies to reduction in "gross earnings" less "expenses which do not necessarily continue."

A mistake often made in evaluating a potential business income claim is considering only the net profit. This approach is woefully incorrect. For example, let's say a business had $7 million in sales per year, gross earnings of $5 million, and a net profit of a respectable $500,000; and management expected that six months is as long as the company would be out of business. It would be foolish for the firm to buy $250,000 of coverage at 100 percent coinsurance since it would collect only five cents on the dollar! A quick look at the formula by which such a business interruption claim is calculated shows why:

Amount of insurance x loss = claim
Coinsurance % x Gross earnings

or

$250,000 x $250,000 = $12,500
100% x $5,000,000

Consequently, business income insurance is generally sold on a “gross profit” (or “earnings”) basis rather than “net profit” basis. The industry recently changed the general definition of coverage from “gross profit less discontinuing expenses” to “net profit plus continuing expenses.” Since the policy form writers insist there is no intended diminution in coverage, the calculations will have the same result.

Period of Interruption

The period of interruption is defined as the “reasonable amount of time necessary for the insured to resume business.” Obviously, the time required will vary not only by the amount of damage suffered but also by the nature of the company’s operations. Most policies will not cover the entire period needed to rebuild the business to the level that would have been enjoyed had the loss not occurred, but only to the point where goods or services are being produced again— presuming the markets are still there. Consequently, under the standard forms quite a void could exist for many insureds. For example, a restaurant forced to close for repairs over a lengthy period may need additional time to rebuild its popularity and gain back its clientele— beyond the period it takes to just repair the damage and open its doors again. To prepare for such an eventuality, an extended period of indemnification may be obtained for an additional premium. (1) The business income claim is one of the most difficult to prove because of its theoretical nature. (2) As the period of interruption is analyzed, other factors can occur that the insured might want to consider, like changes in marketing and pricing.

Projecting Sales

The first consideration is determining what sales would have occurred had no loss taken place. To project sales, trends must be established and supported by the results of previous years’ experience and market conditions, as well as by factors that might influence sales and production achievements. Some adjusters review sales trends and assume that if sales had fluctuated by five percent over the previous years, the same trend will automatically continue in the fourth year. It would be disadvantageous to the insured not to consider the positive impact of the recent changes like the addition of a second shift, the introduction of an additional product line, or even the modernization of equipment and systems that impact the trend. Changes in the marketplace must also be considered when making such projections. Remember: business interruption policies are based on sales that would have occurred, not sales that could have occurred!

For example, if a snow storm occurs during the interrupted period, affecting sales in the local market, the insurer would be correct in calculating its effects on the claim settlement. The storm would have occurred whether or not the business sustained the loss. Depending on the type of business, however, the results could vary greatly. A snow storm would have helped the insured if the company sold snow blowers, but hurt them if it sold bathing suits! On the other hand, if a new competitor emerged in the marketplace as a result of the insured's loss, the carrier would not be correct in taking this into consideration (the event would not have triggered had the loss not taken place).

In the claim of the metals manufacturer cited at the beginning of this article, the insured ultimately received a settlement virtually three times the insurance company's opening valuation. Key to the business interruption claim presentation was establishing realistic production/sales projections, based on the company's sustained growth over recent years, using accepted statistical methods for projecting those results forward. In addition, recent modernization and equipment changes had improved the company's production dramatically.

Deducting the Cost of Goods, Establishing Value

Should the policy contain a coinsurance or contribution clause, the calculation of insurable value is a very important consideration! Sales, minus the cost of goods sold, yields gross profit, which is the true starting point of the claim. Once sales are projected, the anticipated cost of goods/services must be subtracted. In most industries this factor is generally constant over a long period of time. However, if the insured has made or plans to make changes in the gross profit percentage would certainly be in order.

Except in cases involving independent contractors, labor expense is not taken into account in calculating gross profit under most policy forms. An ordinary payroll exclusion— which lowers the amount of insurance needed for an insured to meet the coinsurance requirement— may be purchased for an additional premium. However, if the insured needs to retain non-key employees during the period of interruption, such an exclusion would not be a wise purchase. If a firm is out of business for only 60 days, for example, it may opt to retain all its employees. Being out of business for 180 days might make that choice impossible. Consequently, 60-day payroll coverage might be appropriate.

Under the old forms, projected gross earnings (gross profit) formed the basis of the claim, with payroll not considered an expense, and the projected 12-month gross earnings period calculated from the date of the loss. The newer ISO forms, however, leave less exposure for the insured, allowing the insured to calculate the projected gross earnings from the inception date of the policy. This point has great significance for a growing business! Otherwise, every month the insured might have to reevaluate the amount of business income insurance they should be carrying!

Considering Discontinuing Expenses

A key, if not the most important calculation in a business income claim, is subtracting expenses which “necessarily” discontinue. The word “necessarily” appears in most policies and its importance can hardly be overrated.

Consider the case in which an insured is forced to shut down permanently as the result of a devastating loss. Many insurers would attempt to stop (or discontinue) most expenses. However, the insured would need to calculate expenses that would have occurred if the company had returned to business. For example, if the company had been operating from a leased location, rental payments might actually cease for only nine months out of 12. The insured would need to continue to lease the property while renovations were made and the merchandise restocked. Therefore, in making these calculations only nine and not 12 months rent would be saved.

Depreciation is another factor that can often be used to the disadvantage of the claimant because many insurers prefer to use the insured’s income tax return for the depreciated value of property or equipment it reflects. Values on a tax return are often highly misleading! The IRS policy of allowing an asset to be depreciated over an accelerated period of time does not necessarily reflect the actual life span or value of that asset.

To cite an example, from an IRS perspective an oak conference table may be depreciated over a five-year period and, as a result, have no value at all if it was over five years of age. In actual practice that table would probably last at least 20 years, so depreciation taken on this asset should be 1/20th per year rather than 1/5th. This will not affect not only the property claim but the business interruption claim as well. Using 1/20 per year would yield a higher business interruption claim because the actual expense of doing business would be less than using the 1/5 amount reflected on the income tax form. (3)

I thoroughly agree with the insurance accountant who, during a recent industry seminar, noted that the first thing the prudent adjuster needs to do is recast the profit and loss statement normally used for tax purposes, to meet the manner in which the insurance policy covers such operations!

Expediting and Extra Expenses

The insured has a duty to minimize the business interruption exposure and resume all operations possible under the circumstances. However, the insurer does not have a right to force the insured to operate the business or deal with competitors in ways the insured feels do not reflect wise business decisions. The insured must remember that the insurance company is primarily concerned with the business during the interrupted period, whereas the insured must consider the livelihood of the business for years to come. As a result, the insured must make the prudent decisions that are best for the business. Expediting an extra expense coverage can provide the insured with the latitude to make those decisions.

Expenses to reduce a loss— also known as “expediting expenses”— will have a substantial effect on a business interruption claim. For example, if the insured were to have parts flown in rather than delivered by truck, in order to reduce the business interruption loss, the increased loss would be covered under expediting expenses. They are covered only to the extent that they actually reduce the loss. For example, if it costs $1,200 to save $1,000 of business interruption, the insurer would pay only $1,000 as an expediting expense. However, if the $1,200 is spent reasonably in an effort to resume operations, the $200 difference would be covered under “extra expenses.” The prudent business person might actually spend $1,200 to save $1,000 when the long-term benefits in protecting market share justify the additional expense.

Extra expense coverage which expands the basic business interruption coverage can provide benefits for many businesses, especially those that can ill afford to be closed for any amount of time. Banks, newspapers, and the like try to operate regardless of cost, or they could lose their markets completely. Other businesses must resort to subcontracting work to maintain their market position and reduce their loss of earnings. This is precisely what happened to our metals manufacturer, who had to use the facilities of a competitor— at substantially higher costs because of variances in production standards and procedures. However, the firm recovered nearly $800,000 in expediting and extra expenses as a result of the detailed analysis and calculations.

Executive Overtime

Another point to be considered in business income claims is the time spent by staff trying to resume operations under adverse conditions. This often involves not only hourly employees but salaried personnel and officers as well. If part of an officer's time is needed to plan strategies for operating under the interrupted conditions, additional time should be calculated in the claim settlement (4). If after a loss officers must concentrate on minimizing the business income claim instead of handling their normal tasks, such loss of expertise needs to be addressed in the calculation of the claim. (It should be noted that carriers normally resist this type of claim by maintaining that unless additional compensation is actually paid, there is no actual loss!)

Advanced Payments May Speed Recovery

The manner in which the business interruption claim is handled, and the business's recovery effort made, will have a profound impact on the company's ability to thrive after the loss. Immediately after a loss, expenses generally skyrocket as revenues plummet. To prepare for the cash flow problem, the insured should be cautious and plan for every eventuality when initially estimating their business interruption claim, and based on those calculations, request a meaningful advance payment. Most insurance carriers will respond to a reasonable request for an advance payment because it is in everyone's best interest for the insured to invest monies to limit the claim to the fullest extent possible.

Understanding the Coverage is Paramount

When trying to control financial risk, insurance is the cornerstone. And business income insurance can prove to be the foundation for survival of a business whose operations have been interrupted by a devastating loss. If the insurance policy will not occur losses the business might incur, the owners/managers must re-think their strategies.

What's more, just having business income insurance isn't enough. Understanding it— both when the coverage is purchased and when a claim is adjusted— is every bit as critical. Misunderstanding it can not only magnify loss, it can be a fatal blow when such a loss strikes an otherwise healthy business!

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1. In Beautycraft v. Factory Insurance Association 431 F.2d 1122 1970, the court held that "under the provisions of the policy… a theoretical as opposed to actual replacement time was provided as the basic time standard of a business interruption loss…"

2. A recent legal decision (Grevas v. United States Fidelity & Guaranty Co. 152 Ill. 2d 407, Dec. 1992) holds that depreciation on tax returns is merely a tax credit and should not be considered when calculating net profit.

3. Travelers Indemnity Co. v. Pollard Friendly Ford Co. 512 S.W. 2nd 375. In this case, the company used its own employees after a storm to perform clean-up tasks and other duties such as watching the property around the clock to protect inventory… ignoring their usual responsibilities.

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