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## Business Interruption Insurance - A Business Perspective

David A. Borghesi\*

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David A. Borghesi

## **Abstract**

Business interruption insurance policies are contracts of indemnity.

**KEYWORDS:** building codes, expenses, taxes

David A. Borghesi\*

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I. INTRODUCTION

Business interruption insurance policies are contracts of indemnity. The policy undertakes to restore the business to the economic position that

\* David A. Borghesi, a partner in the Chicago office of Arthur Andersen, heads the firm's insurance claims consulting practice. Mr. Borghesi assists clients in preparing and negotiating significant and complex business interruption insurance claims. He has served as an arbitrator in insurance claim and other business disputes, and has testified in numerous engagements involving lost profits and calculations of economic damage. Mr. Borghesi is a graduate of the University of Wisconsin-Madison, a certified public accountant, and a member of the American Institute of CPA's and the Illinois Society of CPA's.

Arthur Andersen is the leading global accounting firm providing audit and business advisory, tax and corporate specialty services through 33,000 personnel in Member Firms in nearly 300 locations in 66 countries.



it could have maintained for itself had there been no insurable loss. In broad terms, business interruption insurance reimburses an owner for: 1) the business' lost cash flow from operations; and 2) the additional costs and expenses incurred because of the business' inability to use damaged or destroyed insured assets. Before going into the specifics, a historical perspective on the evolution of insurance coverage is instructive in understanding the context of today's business interruption insurance policies.<sup>1</sup>

## II. HISTORICAL PERSPECTIVE

Inherently, the concept of insurance is to spread risk of loss caused by events which are specifically unpredictable but generally inevitable to a homogeneous group. Thereby, losses that could be catastrophic to an individual are spread over a larger group. Annual assessments, or insurance premiums, of the many pay for the losses of the few. Typically, insurance was first identified with losses pertaining to tangible property. Because physical assets can be replaced, insurers could determine the level of premiums based on the probability of loss and the value of the tangible asset. However, with the incurrence of losses to commercial enterprises, it became apparent that another form of economic loss, loss of business income generated by the use of the tangible business property, was also at risk.

It also became clear that there was no direct relationship between the amount of property damage and the amount of business income loss. For example, a small property loss to a vital section of a manufacturing plant could result in the total suspension of all operations resulting in economic losses far in excess of the damage to the property. Owners soon found out that, while the property could ultimately be repaired or replaced, without the stream of normal income, the business could be lost forever.

The precursor to the modern business interruption policy is an older form called use and occupancy insurance. As can be readily understood, the use and occupancy insurance became an enhancement (also referred to as an *Endorsement* or *Rider*) to existing property damage policies. Insurers

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1. For additional material covering business interruption and other related topics, see FRANK S. GLENDENNING, *BUS. INTERRUPTION INS.* (Nat'l Underwriter Co. 1980); Alan G. Miller, *Business Interruption Insurance*, 24 *DRAKE L. REV. INS. L. ANN.* (Dec. 1975); R.M. Shannon, *Coping with Insured Losses... An Accountant can Increase Loss Recovery*, *BUS. INS. MAG.*, Oct. 29, 1979.



thereby tied business interruption insurance directly to the use or occupancy of the property insured for physical loss or damage. Unlike insuring physical property, wherein a value of that property could be readily determined, valuing the loss of its use was more subjective and depended on the profitability of the business.

But, how was the insurance company to determine the level of premium if the insurer could not determine the maximum and probable exposure of accepting the risk? Under the typical use and occupancy insurance contract, the insurer agreed to pay a flat per diem amount for every day the business was interrupted. The insurer and the insured would agree upon the level of per diem reimbursement based upon the insured's historic business activity and prospects for its future operations. Additionally, the length of time over which per diem reimbursements could be obtained would be contractually limited.

However, this approach was found to be unacceptable to insurance companies, particularly when partial losses occurred and during times of economic recessions when per diem values significantly overcompensated businesses. During a steep business recession, would an unscrupulous or desperate owner cause a loss to reap a financial windfall? Consequently, most of today's business interruption contracts are based upon the concept of *actual loss sustained*. Under this concept, each loss event must be measured to determine the actual economic impact.

### III. POLICY FORMATS

Business interruption insurance is written to cover virtually any type of commercial business in existence today. Generally, the insurance industry categorizes business entities into one of two types: 1) manufacturing; 2) mercantile (e.g., retail or service enterprises). There are historical reasons as to why these two basic business categories were identified by the insurance industry. Much of the difference comes in the operating nature and the extent to which the size of the labor force can readily be adjusted to meet the differing needs of each business. However, the main difference arises from the use of the property being insured.

For a mercantile operation, coverage is premised on lost sales or revenues resulting from the inability to use or occupy property in the selling or leasing effort. However, damage to a manufacturing plant interrupts an owner's ability to produce products. The manufacturing process creates the business' profitability. The coverage for a manufacturer is therefore premised on lost productive capacity. In this regard, insurance policies



typically refer to coverage as the *net sales value of lost production*. Ultimately, however, the measure of loss is based on sales lost as a result of lost productive capacity. Valuation concepts will be discussed in greater depth later.

Regardless of the type of business, business interruption insurance is written in two basic formats. One format is called *gross earnings*<sup>2</sup> and the other is called *net profit plus continuing expenses*. A gross earnings form measures a business interruption loss by taking the amount of lost sales and subtracting direct costs which were not incurred. Conversely, the net profit plus continuing expense form measures a loss by taking net profit and adding to that those fixed expenses which continue. Theoretically, either format will arrive at the same loss measurement. This can be demonstrated from a typical income statement:

|                      |           |                             |             |
|----------------------|-----------|-----------------------------|-------------|
| Revenues             | \$100     |                             |             |
| Less:                |           |                             |             |
| Direct Material      | 30        |                             |             |
| Direct Labor         | 10        | Revenues Less               |             |
| Other Variable costs | <u>5</u>  | <u>Non-continuing Costs</u> | <u>\$55</u> |
| Less:                |           |                             |             |
| Occupancy            | 5         |                             |             |
| Depreciation         | 10        |                             |             |
| Other Fixed Costs    | <u>15</u> |                             |             |
| Net Profit           | <u>25</u> | Net Profit (Loss)           |             |
|                      |           | Plus Continuing Expense     | <u>\$55</u> |

One should note that the insured does not necessarily have to generate a net profit to recover on a business interruption loss. This is especially true when a business has a high component of fixed and continuing expenses.

#### IV. CRITERIA FOR BUSINESS INTERRUPTION COVERAGE

Because business interruption insurance coverage historically derives

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2. One should not confuse the insurance terminology of "gross earnings" with the accounting terminology of gross margin or gross profit. The use of gross earnings was formulated by the insurance industry as a common yardstick for measuring risk and assessing premium dollars. Although gross earnings has a stated definition, the measurement of loss before co-insurance requirements, if any, is not impacted by the definition or use of the term, gross earnings.



from the use of property, coverage is not normally afforded unless coverage under the property damage contract is afforded. Within this context, to have a recoverable business interruption loss under standard insurance contracts typically found today, five criteria must be met. The insured must have: 1) physical damage; 2) to insured property; 3) caused by a covered peril; 4) resulting in a measurable business interruption loss; 5) for the period required to expeditiously restore the damaged property. One could look at each of the five as a link in a continuous chain. Breaking any of the links would render the loss nonrecoverable.

Before discussing valuation concepts, one should look at each of the first three criteria: *physical damage to insured property by a covered peril*. Physical damage is usually easy to discern. The policy normally identifies the property being insured with adequate specificity. With respect to a covered peril, each policy must be viewed for its specific language. Generally, policies are based on either stated risks or all-risk coverage. In the first instance, those risks or perils which are covered are specifically indicated in the policy. Consequently, any peril or risk not mentioned would not be covered. In the all-risk policy, all risks, except those which are specifically excluded, would be covered. Obviously, in the latter, the list of exclusions can be very lengthy and detailed with some specificity.

Some not so unique loss experiences include the following:

- 1) Because of a fire to its plant, a major customer cannot purchase products from you. You shut down your factory as a result of the lost sales.
- 2) Hurricane Andrew, in August 1992, did not significantly damage your facility. However, because of widespread power outages and contaminated water supply, your business was unable to continue normal operations for a period of time.
- 3) The Los Angeles riots, in April 1992, resulted in curfews. Your property was not damaged but customers and employees could not get to your store. Your store could not operate during its normal and most profitable business hours.
- 4) In April 1992, numerous office buildings in downtown Chicago were evacuated under order of civil authority. Chicago River water inundated the basement levels of buildings as a result of a breach in an underground tunnel system. Your law offices on the 21st floor were uninhabitable for a period of two weeks because



civil authorities ordered the electrical power shut off until the flooding situation could be alleviated.

- 5) A food manufacturer must shut down its operations because of viral contamination. Operations were ceased for three weeks to sterilize the production facility.
- 6) A local radio station leases an antenna and transmission equipment from a major network television affiliate. Vandalism causes the collapse of the antenna tower, resulting in the radio station going off the air.

Suffice it to say that, in each of the above losses, coverage would be dictated by the specifics of the insurance policy. Because larger businesses generally have a stronger negotiating position, they are able to work with insurance companies, either directly or through insurance brokers, in developing *manuscript* policies. Manuscript policies are developed to offer broader coverage and address perils which are specific to a business' operation. Coverage for contingent business interruption caused by a physical loss at a major supplier or customer or for differences in conditions are available, but at a cost that a business owner may not be willing to pay.

Smaller businesses typically purchase insurance directly from an insurance company sales force or through independent insurance agents. Most often, these policies are standard forms offered by the insurance company and provide limited customization. Many standard policies would preclude coverage for the loss experiences described above.

## V. BUSINESS INTERRUPTION VALUATION CONCEPTS

Once it is determined that coverage is afforded under an existing insurance policy, valuing the business interruption can be a daunting task. There are four critical concepts inherent in any business interruption calculation based on the standard wording found in most contracts:

- 1) Actual loss sustained.
- 2) The business interruption period.
- 3) Expenses incurred to mitigate the loss.
- 4) Continuing versus non-continuing expenses.



These concepts must be addressed regardless of the type of business or the form of the business interruption policy. It should be noted that these concepts typically are more complex for manufacturing concerns than for mercantile businesses.

### A. *Actual Loss Sustained*

As previously stated, the purpose of business interruption insurance is to place the business in the same economic position that it would have maintained for itself had there been no loss. This is deemed to be a recovery of the actual loss sustained or the true economic loss. Measuring the loss entails considering many interrelated business activities such as sales, production and inventory levels. These activities must be considered because, even though there is physical damage and a loss of productive capacity, there may not be a related economic (i.e., actual) loss. The insured may be able to use excess capacity at other production facilities to prevent a loss of sales. Likewise, available finished goods inventory may prevent lost sales during the period of restoration. Consider the following:

A department store in downtown Chicago must close its store because of the Chicago flood. However, the company experiences increased sales in its store in a nearby but unaffected location. Did the one store's increase in sales result from a migration of customers and therefore a make-up of lost sales? Or did the increase come from the fact that the loss occurred just prior to Easter when sales increases might normally be expected?

The more frequent issue involves the concept of whether there has been an absolute loss of sales or a delay in sales, made up at a later date. Following are some examples where actual loss sustained was at issue:

- 1) A shipyard with a long term contract to build multiple vessels sustains a loss and cannot produce steel plate for the fabrication of the hulls. The long-term contract is eventually satisfied over the next five-year period, but the completion is delayed by six months. The delay is entirely attributable to the insured loss. At the end of the contract, the shipyard is not at full capacity because of a lack of new contracts at that time. Was there an actual loss sustained? Should the insured be required to wait until the contract completion to determine or measure its loss?



- 2) A coal company loses its most significant mining equipment, a longwall miner, due to an insured event. It had been projected that, under current mining conditions, coal reserves would have been depleted at the end of five years. It is currently expected that, with alternative mining techniques and equipment, the coal reserves will be depleted by the end of eight years. The insurance company claims that there is no actual loss sustained because all the coal that was available to be mined will in fact be mined and consequently, no sales will be lost from those reserves. Would you agree with the insurer's logic?
- 3) A manufacturer of patented medical equipment sustains a loss and is unable to manufacture and sell its product for three months. For six months after the restoration period, production and sales increase significantly over budget and historical amounts. Is the increase in sales due to pent-up demand and therefore a "make-up" of lost sales?

In determining whether lost production can be made up later, with no loss of sales, consideration must be given to available finished goods inventories. Following is an example of how complex this issue can become.

A fertilizer production facility produces ammonia, a critical raw material for fertilizer production. The fertilizer business is very seasonal, with two peak sales periods, Spring and Fall. Fertilizer production is normally heavy during the late Fall and Winter months to build inventories for its peak selling season. The plant's ammonia production facility operates twenty-four hours a day except for normal operating downtime. In January, the ammonia facility sustained a fire, halting production for the entire month. Inventory at the time of the fire was high and no sales were lost during this one month period. The insurance company denied the claim based on the fact that there was no loss of sales, and therefore no actual loss sustained. But, the insurance company agreed to review the inventories and demand for fertilizer through the Spring selling season. At that time, the insured was able to demonstrate a loss of sales resulting from a depletion of inventory. Consequently, while the loss of production occurred in January, the impact of that loss was not realized until after the period of restoration.

For manufacturing companies, the destruction of finished goods inventories adds an additional factor to the determination of actual loss.



Most property damage insurance policies written for manufacturers call for finished goods inventories to be valued at a net selling price. This is consistent with the concept that the manufacturing process creates a business' profitability. The insurer considers the consequent payment for destroyed finished goods inventories the same as purchasing the goods as if the insurer were a regular customer. Essentially, the insured sold the inventory, thereby reducing its lost sales during the interruption period.

The concept of actual loss sustained can also involve measurement issues. Consider the following examples:

- 1) You are a fifty percent joint venture owner in a facility damaged by fire. Each party shares equally in expenses and the production of the facility is split equally between the owners. The joint venture records as revenue the amount it receives from each of the owners to reimburse expenses. Consequently, the joint venture shows no profit. It costs the owners substantially more to buy production from other sources. What would be the appropriate measurement of loss if only the joint venture carried insurance for the loss?
- 2) A commodity chemical manufacturer sustains a loss and is unable to produce the chemical. Because of a thin market and the lack of supply occasioned by the loss, the resulting market price of the chemical skyrockets. At what price should the loss of production be valued?
- 3) A hotel sustains total damage due to a hurricane. Other hotels in adjacent areas or those less severely damaged and repaired quickly are fully occupied. Average occupancy for that time of year is sixty percent. The insurance company agrees that there is an actual loss sustained and suggests that, had there been no hurricane, the normal occupancy rates would be the measure of damages. There is no dispute that had you not suffered the loss you would have received the same increase in business as your competitors. What is the actual loss sustained under these circumstances?

As can be seen from the above case examples, determining whether an actual loss can be sustained, or the amount thereof, is frequently not a clear-cut issue. Manuscript insurance policies may specifically define valuation criteria based on the particular circumstances of the companies involved.



Standard forms usually leave these valuation criteria open to judgment and ultimately to negotiation.

The projection of lost revenues is often a key factor in the ultimate determination of a business interruption loss. However, unlike replacing tangible property, determining loss of revenue can be subjective and open to differing viewpoints. In any event of loss, it is the insured's duty to prove up its loss to the insurance company. Consequently, how carefully the insured analyzes its financial and operational information becomes critical to its successful proof of damages.

Then, too, the calculation of loss must be communicated to the insurance company loss adjustment representatives. It is not uncommon for insurance company accountants to refute an insured's calculation of damages through an incomplete understanding of the business operation or a lack of detailed analysis. Consequently, a well documented and cogent claim can yield greater recovery than vague ideas and unsupported calculations.

### B. *Business Interruption Period*

Standard business interruption insurance policies cover loss of earnings computed from the time of the damage caused by the insured peril to the time that the property could be repaired or replaced and made ready for normal operations. This time period is commonly referred to as the business interruption period, the period of suspension or the period of restoration. Similar to the actual loss sustained, defining the period of time over which to measure the loss can frequently become a contentious issue, because it is a significant driver of the total magnitude of a business interruption loss.

Contract terminology calls for the restoration of the property damaged to be conducted with *due diligence and dispatch*. Consequently, the interruption period may be a theoretical period, rather than the actual period of time the owner takes to restore the property. This is especially true if the company chooses to rebuild or replace differently from the property "as was" just prior to the loss. Property damage insurance intends to restore an insured to an "as was" position at the date of loss. Consequently, any loss of revenues resulting from the additional time required to make improvements or modifications generally are not recoverable.

An insured usually has the option to make modifications or improvements during repairs or restoration to the property damaged. In many cases, modifications or improvements can be made concurrent with property restoration, thereby not extending the interruption period. However, determining a theoretical interruption period can become quite subjective.



Arguments made by representatives of the insurance companies to shorten the actual interruption period to a theoretical period have included:

- 1) The insured did not commence repairs with due diligence and dispatch, but waited several weeks to decide what modifications to make.
- 2) The insured did not start reconstruction until it received insurance monies on the property damage. This delay, caused by a lack of adequate financial capital, is not covered or addressed in the policy.
- 3) The insured could have taken steps to shorten the interruption period by expediting repairs or through better management of construction scheduling.
- 4) The insured was delinquent in obtaining available equipment and waited for custom equipment with improved operating capacity.
- 5) Other non-insurable and concurrent causes extended the actual restoration period, such as the inability to obtain environmental permits.

There are four major points to be aware of concerning the insured interruption period:

### 1. Policy Term

A business interruption time period is not typically limited by the term of the insurance contract. Many large property damage losses result in suspension periods extending beyond the end of the policy or its annual renewal date. Some policies may limit the suspension period to twelve months from the date of loss. However, many policies are open-ended with respect to the restoration period.

### 2. Production Start-Up

Business interruption insurance policies for manufacturing entities provide for additional time to restore work in process inventory levels, but do not provide time to restore finished goods inventories to their pre-loss levels. In theory, the additional time allows the manufacturer to restore productive assets back to normal production through a start-up phase.



Logically, an insured whose production function was operating efficiently prior to a loss should be compensated for the time necessary to achieve that same level of efficiency after a repair of the property.

The time to replenish finished goods inventories is not similarly insured because the production of such inventories had been completed. As stated previously, the property damage valuation for manufactured finished goods should be at net sales value to compensate the insured for the profit earned through the manufacturing process.

As discussed previously, by tying the business interruption value to the physical property, the standard policy does not cover loss of market beyond the restoration period.

### 3. Extended Period

Special endorsements may be obtained to contractually extend the length of the interruption period for a specified number of days (usually in increments of thirty days to a maximum of six months). Mercantile businesses, such as hotels and department stores, recognized that, after restoration, a rebuilding of customer traffic was necessary. Insurance companies have accommodated their clients by offering to extend the period for valuing the business interruption through the use of these endorsements.

### 4. Effects of Building Codes

As with property damage, the business interruption period is generally not extended due to the necessity of incurring additional time occasioned by ordinances or laws regulating the reconstruction or repair of buildings. However, a more recent trend is for insurers to cover both the increased cost of construction as well as the extended time for the effects of such building codes. Again, specific policy wording will dictate the coverage afforded. There are many other possible impacts on the restoration period which may or may not be covered in a specific insurance policy. Work stoppages, abnormal start-up periods and disagreements with contractors can be factors in assessing the period over which the business interruption is to be calculated. Because the business interruption value can be significantly greater than the property damage value, insurance companies will exhort the owner to take extraordinary measures to get the operations back to normal as quickly as possible. This would normally cause the insured to incur extra expense to mitigate the business interruption loss.



### C. *Expense Incurred To Mitigate the Loss*

Typically, it is a policy requirement that the insured make reasonable efforts to mitigate its loss through whatever means or resources available. Consequently, the policy obligates the insured to use its efforts to reduce the total amount of loss payable by the insurance company. These expenses incurred in reducing the total amount of loss are known as mitigating expenses, or more commonly, extra expenses. As part of the business interruption insurance policy, extra expenses are recoverable when and only to the extent that they reduce the business interruption loss that would otherwise be payable. Such extra expenses are typically incurred either to reduce loss of sales or to shorten the restoration period. The extra expense concept applies in both manufacturing and mercantile types of businesses and can be demonstrated by the following examples:

- 1) Over-time premiums paid to contractors to expedite the repairs.
- 2) Excess of air freight expense over normal freight expense to expedite receipt of materials or equipment.
- 3) Excess cost of more expensive replacement machinery (due to greater capacity or new technology) which may be readily available for installation, compared with replacement equipment of the kind and quality to that which was destroyed, but not currently available from the vendor.

These examples depict extra expenses incurred to reduce the restoration period, thereby decreasing the business interruption loss that would have been paid without these expediting efforts. The following examples depict extra expenses incurred to reduce the loss of production and/or loss of sales:

- 1) Rental of equipment or lease of facilities for temporary business operations during the restoration of damaged property.
- 2) Shipping excess finished goods to customers from other locations at an increase in freight costs.
- 3) Using alternate production facilities or methods which result in a higher cost to manufacture.



- 4) Purchasing goods at a price in excess of what it would have cost to manufacture those goods.

Each of the above four examples would result in an extra expense to reduce lost sales that would have occurred without taking these mitigating steps. However, there are limits to the amount of extra expense the insurer will be willing to pay. The following example makes this limitation clear:

A bakery is damaged by fire which renders the facility useless for one day. Doughnuts produced on any given day are sold on the same day. Management determines it needs 10,000 doughnuts, its normal production, for sales the day after the fire. Management also determines its variable cost to produce the 10,000 doughnuts to be \$3,000; however, it can purchase doughnuts from a competitor for \$4,000. These doughnuts are sold for \$5,000. Management elects to buy the 10,000 doughnuts at a cost of \$4,000 and sells them for \$5,000 which results in a \$1,000 profit. However, the normal profit would be \$2,000. In this example the insured's action resulted in no loss of sales despite the loss of production. However, due to the mitigating action taken, the insured did incur an extra expense. It paid \$1,000 more than it would have incurred to produce those doughnuts. Therefore the insured in this case would receive \$1,000 as an extra expense, representing an actual loss sustained to the insured.

Assume that, in the above example the doughnuts could be purchased from a competitor, but at a cost of \$5,500. Despite the loss of \$500 when sold, management may decide to take this course of action so as not to lose its customers. In this case, the extra expense incurred by the bakery is \$2,500. The insurance company will pay \$2,000 which is the amount that it would have paid had no action been taken by management. Under this scenario, the \$500 would be extra expense over and above that which the insurance company is obligated to pay. It should be noted that insurance for extraordinary extra expenses of this nature can also be purchased and again the specific policy wording will dictate coverage.

Separate or "pure" extra expense coverage (extra expense over and above mitigating expenses) is often available in much the same way that extended time period coverage is available. Typically, a maximum amount of coverage per occurrence is stated in the policy. This additional coverage alleviates problems in adjusting extra expense claims in situations where it may be difficult to ascertain whether the actual loss was sufficiently reduced. For some businesses, where revenues are not directly dependent upon tangible property, extra expense is an essential element of insurance



coverage. In these cases, extra expenses are those expenses incurred above normal to continue business operations or return them to normal. Oftentimes, companies with research and development facilities will carry this special type of business interruption coverage. Research and development facilities typically do not manufacture saleable products or generate current revenues. Consequently, it may well be impossible to measure the ultimate loss of sales due to the disruption of ongoing research and development. Yet, these facilities may be essential to the continued long-term success of a business, and it would be the company's desire to continue those operations, and return them to normal as quickly as possible.

Similarly, financial institutions, with large central office computer operations, would purchase this type of business interruption insurance coverage. Often, communication companies such as newspapers will choose to carry pure extra expense coverage and forgo business interruption coverage.

#### D. *Continuing/Non-Continuing Expenses*

The fourth critical concept in valuing a business interruption loss is determining which expenses continue and which expenses diminish as a result of the loss. You may find it helpful to refer to the income statement displayed in the prior "Policy Formats" section while reading the following.

Financial analysts, economists and accountants typically describe the behavior of cost as either variable or fixed. Variable costs (sometimes referred to as direct costs) will increase or decrease with increases or decreases of sales or production. For ease of analysis, most variable expenses are viewed in terms of a constant or linear variation. As an example, commission selling expense may be viewed as a specific percentage of sales dollars. Direct labor may be viewed as a constant variable of production hours worked. The cost of producing a chemical may be stated as a constant amount of dollars per pound of production. As one can see from the above examples, direct or variable expenses would typically be non-continuing expenses as viewed by the insurance contract. Consequently, if a business interruption causes a retail department store to lose sales, non-continuing expenses such as the cost of goods purchased, the commissionable selling expenses, and any other supplies or materials (such as packaging and gift wrap) directly related to those lost sales would be deducted from lost revenues in determining the business interruption value.

At the other end of the spectrum, certain costs are considered fixed or continuing. That is to say that there is no change in the normative dollar amount of an expenditure, despite fluctuations in revenues. Such examples



would include real estate taxes on property, depreciation, amortization, and the salaries of company executives. In many business interruptions, these expenses would continue at their same dollar levels, and consequently, there would be no deduction for these expenses when determining the business interruption value.

While certain expenditures are more easily categorized as either fixed or variable, a large number of expenses fall somewhere in the middle. Certain expenses tend to increase or decrease in a stair-step fashion over smaller changes in revenues or time periods. As an example, energy cost, because of the demand component in utility bills, may not vary on a constant percentage basis with changes in usage. Similarly, supervisory cost in a factory may not diminish in the same percentage as would the direct payroll during a factory interruption.

The insurance policy makes a distinction, which can be viewed as a more precise definition, of how expenses react under situations of total or partial suspension of business over varying lengths of time. As an example, a fire in a piece of equipment may result in a suspension of operations for several months. It is unlikely that the real estate property taxes related to the entire plant would diminish during a short restoration period. However, if the entire plant sustains major fire damage requiring a rebuilding period of several years, it would be expected that the company would request and receive a tax abatement during the restoration period.

As a further example, let's look at depreciation. Accounting depreciation by its very definition is the historic cost of tangible assets apportioned over the useful life of the asset. If an asset is entirely destroyed by an insured peril and the insurance company reimburses the loss through property insurance, is it reasonable to assume that depreciation continues on an asset that is no longer in existence? Would depreciation necessarily discontinue if a partially damaged machine were repaired without extending its useful life? Answers to these questions are not always clear-cut in the more complex loss situations.

The treatment of payroll costs in a business interruption claim is often a confusing issue for management of the insured. Historically, insurers viewed factory labor as being a direct cost of production. Over relatively short business cycles, factory labor costs increase or decrease with corresponding changes in the level of production. Consequently, for business interruption values, direct factory labor is considered a non-continuing expense. In insurance parlance, this is called "*ordinary payroll*," as distinguished from executive payroll which is generally considered a continuing expense.



Interestingly, mercantile businesses were not considered to have ordinary payroll. Generally, where business interruptions of short duration impacted a mercantile business, management believed that it was necessary to maintain its sales staff, as well as key salaried employees, if they were expected to reopen at the pre-loss level of service after the restoration period. Consequently, ordinary payroll was not an issue for business interruption values of a mercantile type of business.

Manufacturing companies must consider whether ordinary payroll must be maintained during the period of restoration, even if there is no production work for the employees. Companies may wish to keep employees on the payroll because of a shortage of skilled labor in a geographic area or because of specific knowledge and training invested in the employees.

In much the same way as specialized coverages can be obtained for extra expenses and extended business interruption period, ordinary payroll coverage can also be purchased. Typically, the coverage is stated in terms of the number of days of coverage, usually in increments of thirty day periods. Therefore, if at the time of loss, the insured had an annual ordinary payroll cost of \$1,200,000, then thirty days coverage would equal \$100,000. In the above example, the insured can retain twenty-five percent of its ordinary payroll for up to four months before coverage is exhausted. It should be noted that the insurer will not automatically make a payment just because coverage is purchased. The company must make a rational case for continuing to incur payroll expense, especially during an extended restoration period. Furthermore, if the company elects to lay-off all of its ordinary payroll, then the expense is, in fact, non-continuing and will be deducted from lost revenues. Any purchased ordinary payroll coverage would then go unused.

Oftentimes, ordinary payroll laborers are used for clean up and property restoration in lieu of hiring third-party contractors. Such payroll cost would be reimbursed through the property damage insurance coverage. For purposes of business interruption values, this payroll cost is deemed to be discontinued as the insurance company "paid" the payroll. The insurance company would not be expected to reimburse the insured under property damage coverage and again under ordinary payroll coverage. Consequently, it is necessary to be mindful that claims for property damage and business interruption can be necessarily interrelated.



## VI. OTHER ITEMS

There are a few additional issues which typically arise in a loss situation:

### A. *Income Taxes*

The computation of the business interruption value is predicated on a calculation on earnings before income taxes. If a company insures properties located across national borders, consideration should be given as to whether income tax rate differentials represent a significant risk of loss depending on where the insurance proceeds are paid.

### B. *Extra Expenses*

Even with extra expense coverage, not all expenses above normal are reimbursable. Management may determine that certain expenses are prudent and reasonable. However they may not have been incurred with the objective of reducing the insured loss or returning operations to normal. Claim preparation costs, including consultant's fees, management's time and travel expense, are generally not covered. Goodwill expenses, such as a hotel's forgiveness of current room charges for guests who are displaced to other hotels, would generally not be covered. Additional security may also be questionable as to recovery.

### C. *Interest on Claimed Amounts*

Interest foregone on claimed amounts is excluded from business interruption insurance calculations. Interest expense computed upon the claim itself is not covered by the policy. The policy requires an insurer to make a claim to the insurance companies and as such: a) the insurance company does not have the ability to determine the amount of loss or to verify its reasonableness until such claim is made, and b) the insurance company usually has sixty days to respond after formal proof of loss is made. Most insurance company representatives will work with the insured to advance payments or pay partial loss adjustments on an interim basis for property damage. However, partial payments on business interruption losses during the period of restoration are infrequent because business interruption values are more subjective than property losses by their nature and because losses suffered early in the restoration period may be made up at a later point in time.



## VII. SUMMARY

After a major business interruption loss there are three initial hurdles to jump over before an insurance claim can be successfully prepared and negotiated.

Understanding the policy coverage is a necessary first step. The foregoing portions of this article have dealt almost exclusively with this issue.

The second and sometimes overlooked hurdle is understanding the adjustment process from the insurance company's perspective. In much the same way that a car salesman does not service the car sold, the individual who sold you the insurance policy will not be responsible for settling your loss. The insurance industry has a cadre of full-time insurance adjustment professionals. Over time they have developed a stable of professional consultants including engineers, accountants and lawyers to represent their interests. In contrast to the insurance companies with knowledgeable and experienced personnel, a major business interruption loss can be a once-in-a-career event for management of the insured. While it may appear that the deck is stacked against the insured, an understanding of the expectations of the insurance company and the nature of the settlement process can level the playing field.

The third hurdle is applying adequate project management to the insurance claim task. Frequently, the insured does not have personnel with the available time to address claim preparation. Coping with the more immediate effects of the loss alone can be overwhelming. Consequently, claim preparation often takes a low priority to current business activity. Oftentimes the responsibility of claim preparation is delegated to middle managers, who do not relish this unfamiliar and seemingly thankless task. In major loss situations, reassignment or turnover of personnel can cause a lack of continuity during a lengthy claim preparation/settlement process. Delays and miscommunications result. The insured with a focused and knowledgeable project manager has the best likelihood of achieving the ultimate goal—obtaining the maximum amount of insurance recovery due the insured over the shortest period of time possible.

Path of Destruction



FLORIDA'S PATH OF DESTRUCTION—HURRICANE ANDREW (Historic Publications, Aug. 1992).