

Business Interruption Insurance

Expert knowledge means success

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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

Business Interruption Insurance provides for two loss situations - (1) the loss of income due to interruption of the operations of a business, and (2) the additional expenses incurred resulting from efforts to continue business operations. With the knowledge gained from experiencing floods over recent years, many business owners are faced with at least five major problems (but there may be many more):

1. Getting the business back to normal as soon as possible.
2. Keeping customers - making sure that they don't drift towards competitors whilst your business is out of action or gains a reputation for being in a flood area.
3. Managing cash flow and meeting obligations – such as bank loan repayments and hire purchase commitments.
4. Making an insurance claim to recover all the losses suffered.
5. Making sure that when the existing insurance policy expires, that renewal insurance can be obtained on terms that don't bankrupt the business – many business owners in flood areas are already discovering that their insurance company either won't provide cover at all or want a premium at up to ten times the previous cost.

Are there things that can be done in the UK to cope with floods and their disastrous impact on businesses located in the flood plains? Maybe - the steps taken in the US in establishing the National Flood Insurance Program might be replicated in the UK.

Insurance Accountants

The adjustment of claims for business interruption (often called "Consequential Loss") insurance has become an important service rendered by some chartered accountants. Insurance accountants engaged in forensic and litigation work differ from regular accountants through:

- their greater familiarisation with insurance policies rather than generally accepted accounting principles;

- the characteristically adversarial nature inherent in their work place; and
- a required ability to think in terms of hypothetical and alternative situations.

The problems that insurance accountants are most likely to encounter arise from the insured's misunderstanding of insurance policies and the cover they provide. These problems concern:

- Coverage of continuing operating expenses.
- The period of indemnity as opposed to the period of interruption.
- The calculation of the appropriate multiplier for measuring losses.
- The obligation of the insured to minimise loss.

Insurance Accountants:

- May be engaged by the business which has an insurance claim to help prepare it.
- May be engaged by insurance adjusters or other claims professionals to review a claim for reasonableness and accuracy.
- In cases when a dispute arises that leads to litigation, an insurance accountant may be asked by either side's lawyers to prepare reports and, if required, to act as an expert witness.

There are three fundamental differences between insurance accounting and "normal" accounting:

1. An insurance accountant must understand and be comfortable with concepts that are defined and inherent in insurance policies rather than GAAP. The basic difference in insurance claims accounting is that the principle of direct cost accounting is generally followed in business interruption claims and property claims rather than GAAP.
2. An insurance accountant must perform his/her work in a fundamentally adversarial environment even though insurance companies usually wish to retain claimants as customers and both sides have a strong economic interest in avoiding litigation.
3. Insurance accountants need to consider alternative scenarios and hypothetical results. This aspect is most pronounced in business interruption claims analyses. Here the question is not what the enterprise earned but how much it would have earned had the insured event not occurred. Obviously, there is no one correct answer to this question but a varying degree of plausibility among competing theories.



What is Business Interruption Insurance?

If floodwater intrudes into your business premises or there's a fire or other severe loss, it's likely that you may not be able to open up for business. Without cash flow from the business, not only will you be unable to pay your bills but you'll also lose any profit you might otherwise be making. Even though you may have insurance to repair the damage to the building and contents, your business may go bust because you have no income or cash flow while the property is being repaired. Bills such as mortgage or lease payments, hire purchase repayments and taxes **don't go away after you** have a major loss.

Business Interruption insurance is designed to reimburse you for any lost profit and pay for those expenses that may continue even though your business stops. If your building or contents are damaged and you can't carry on your business operations, business income insurance will cover the following losses:

- Loss of income created by your inability to carry on your business normally.
- Payment of expenses that continue even if your operations were forced to stop.

Not all accountants are suited to insurance claim work. The skills needed are fairly general: an inquisitive mind and investigative instincts. The key activity is verifying data or theories presented in a claim; the resources available are claimant's records and business knowledge.

Many problems are traced to the insured business owner-manager not understanding the actual coverage under the insurance policy. Many people wrongly assume that the insurance policy will make up the difference between the actual results after an interruption caused by an insured peril and its likely results had the incident not occurred. Yes, in some cases, that might be true but some insurance policies do not provide such cover.

The following areas can cause difficulty:

- Only continuing expenses covered - the policy may say that the insured is entitled to recover for continuing operating expenses and profit, but the expression "operating expenses and profit" doesn't quite mean what people might like. The insured can only collect on continuing operating expenses plus profit, not for expenses, which did not continue following the loss. The rationale for these interpretations is the principle that business interruption insurance is meant to pay the amount of the loss, not reward the insured with reimbursement for phantom expenses.
- Period of indemnity versus period of interruption - the period of indemnity is the time during which the insurance policy covers the insured's loss. Often, this is different from an insured's perception of the period the business is interrupted.
- Projecting the future: Multiplier problems - most business interruption claims have a speculative and therefore highly debatable element: What would have happened to the insured's business had an interruption not occurred? Measurement problems can be very tricky. A key question is always choice of the appropriate multiplier - the rate of increase or decrease in production or sales applied to the period following the loss compared to what happened beforehand.
- Insured's obligation to minimise loss - insurance policies do not provide coverage for losses that could have been prevented by good management and common sense.

- Actual loss sustained - the key phrase in most business interruption insurance policies, is "actual loss sustained." The intention is to make clear that the insurance policy is meant to indemnify the insured only for actual losses sustained under the provisions of the insurance policy and not to create a profit out of the claim.

It's important to note that insurance claims are based upon calculations of the loss suffered - by referring to trading results before and after the interruption event. That's fine for an established business with a long track record, but what about a new business? A new business with no prior income and expense history can still make a claim under business interruption insurance, if it can demonstrate (through accounting calculations etc.) loss of profits during the period of business interruption.

Loss Assessors & Loss Adjusters

Insurance companies are generally not unreasonable but they are there to make money. They know that, at times, they're seen as the proverbial soft touch with a deep pocket. Insurers invariably appoint loss adjusters to assist them and to protect their interests.

- The Loss Assessor acts for you, the insured. He is independent. You pay him:
 - To fight your claim and represent your interests.
 - To ensure you receive your full entitlement and the maximum settlement which your policy allows.
 - To save you time and worry.
 - To take over your claim including helping you with the claim form to arguing and negotiating with the Loss Adjuster (see below).
- The Loss Adjuster is employed by the Insurance Company. He is not really independent. The insurance company pays him to:
 - Try to avoid (sometimes) paying anything at all by repudiating liability.
 - If the insurance company does have to pay, then to make sure it pays you only the minimum.
 - His task is to establish, what (in his opinion) the insurance company should pay under the policy.

Free Guidance

The Environment Agency publishes a number of online guides to help individuals and businesses prepare for and deal with floods including:

- How to develop a flood plan
- Reasons to prepare for flooding
- Prepare for flooding
- Simple flood preparations
- Installing flood defences
- During a flood
- Cleaning up after a flood
- Business flood guide

For more information visit <http://publications.environment-agency.gov.uk/PDF/GEH00111BTJI-E-E.pdf>

The Purpose of Business Interruption Insurance

The purpose of business interruption insurance is to provide the business owner with what the business itself would have done if there had been no loss. The loss of income insurance pays for loss of earnings when operations are curtailed or suspended because of property loss due to an insured peril. This insurance cover is called "Loss of Profits", "Consequential Loss" or "Business Income Insurance". The insurance provides coverage if the business premises, key business equipment, or other business property becomes unusable because of a fire, explosion, flood or similar covered property peril. As a result of these disasters, most businesses will suffer:

- Loss of net profit that would have been earned but for the disaster, and
- Reimbursement for expenses that continue even though the business is not operating normally (e.g., debt payments, taxes, salaries, and employees).

Extra Expense Insurance provides reimbursement to an insured business for the extra expenses reasonably incurred to continue the operation of the business when the described property has been damaged by a peril covered by the contract. This insurance is normally used by businesses where continuity of operation, regardless of cost, is a necessity as, for example, any business that would permanently lose customers if there were any suspension of operations.

Why Have Business Interruption Insurance?

In the event your business is forced to suspend operations temporarily because of fire or other similar circumstance, Business Interruption Insurance can provide the necessary money for salaries to pay key employees, taxes, interest, utilities, and even lost profits. Similarly, if your business is interrupted because of a fire or other peril affecting a supplier or major customer, that interruption can also be covered.

With Business Interruption Insurance in place you may be able to keep key employees and speed up the return to business after a fire or other insured peril. There are variations of this type of insurance and the extent to which it will cover your risks.

The Unthinkable Can Happen

All owners of small businesses naturally hope that their company will never be faced with a sudden and unexpected interruption. However, like car and home insurance, business interruption insurance should be purchased just in case the unthinkable happens. Failure to do so could leave both you and your employees at risk.

The problems following a loss of property, equipment or stock are frightening. Proper business interruption insurance can ensure the survival of the business both during and after the rebuilding process.

Service Businesses compared with Product Businesses

Some businesses, such as a consulting service business where the services are delivered at client's premises, may be able to resume operations relatively easily when their business is interrupted by natural disasters. In this situation, business-interruption insurance should cover the policyholder's additional expenses incurred in relocating employees, rental of temporary facilities, and procurement and installation of computers, telephones, and other necessary office equipment.

Other businesses, like computer or other manufacturing businesses, can't relocate easily. In that case, Business Interruption Insurance protects against both a direct loss of income and the extra expenses incurred in paying fixed costs, retaining key employees, and replacing equipment and machinery.

Internet-Based Businesses

Businesses that rely upon the Internet to conduct business should attempt to ensure that their Business Interruption Insurance would respond to the on-line perils that could cause a shutdown of or delay in their Internet business activities. Internet businesses should consider buying business interruption insurance that does not tie insurance coverage to some physical act or event.



Buncefield – the case for Business Interruption Insurance?

The Association of British Insurers has reassured firms located in the Hemel Hempstead area that any damage caused by the explosion and fire at the Buncefield oil depot on Sunday 11 December 2005 will be covered by standard business insurance policies.

Spokesman Malcolm Tarling added that those firms who have taken out denial of access or business interruption cover will be entitled to extra compensation.

The effects of Buncefield go much further than fire damage with data loss and unavailability of premises causing serious disruption to all the affected businesses.

The internet clothing retailer Asos had to close its website and asked for trading of its shares to be halted while it investigates the damage to its warehouse near the site of the Buncefield explosion. Fortunately, the company was "adequately insured for the disaster".

Basic characteristics and conditions for a Claim:

- There must be:
- Physical damage due to an insured peril - such as flooding, or damage due to storms or fire.
 - A reduction of business results from the damage.
 - The business would have continued to operate during restoration.
 - A loss is suffered during the policy term.
 - But for the loss arising from the damage and the consequential business interruption, profits would have been made.

Businesses transacting commerce on the Internet may suffer losses when enabling technology fails, cyberspace congestion limits capacity over the Internet, or other system mishaps take place - in other words, losses due to business interruptions.

Commercial Property

Commercial property insurance claims frequently involve more than a mere loss of tangible business property. Economic damages in the form of loss of income from suspended operations, or from extra expenses suffered as a result of the loss are also typically sought by business owners.

The Extent of Cover

Business Interruption Insurance is designed to indemnify an insured business against losses arising from its inability to continue the normal operations and functions in the event of a disaster.

Cover under a Business Interruption Insurance policy is triggered by the total or partial suspension of business operations due to the loss, loss of use, or damage to all or part of the buildings, plant, machinery, equipment, or other property as the result of a covered cause of loss.

Cover is generally provided for the "period of restoration", which is usually considered to be the period which would be required to rebuild, repair or replace the damaged property at the described premises with reasonable speed and similar quality. It usually commences with the date of such damage or destruction and it is not usually limited by the date of expiration of the policy.

Business Interruption cover is generally provided by a rider or endorsement to a commercial property insurance policy. It typically provides that the insurer is not liable except for losses caused directly by a covered cause of loss, i.e., a hazard or peril insured against as a matter of contract. Actual profits and business expenses covered by the policy are usually determined in a manner which gives due consideration to the character of the business along with the manner in which it conducts its business activities.

Business Interruption Clarification

Loss of Profits

- Business interruption insurance compensates for income lost if your company has to vacate the premises due to disaster-related damage.
- Business interruption insurance covers the profits you would have earned, based on your financial records, had the disaster not occurred.
- The policy covers operating expenses that continue like electricity even though business activities have come to a temporary halt.
- Make sure the policy limits are sufficient to cover your company for more than a few days.
- The price of the policy is related to the risk of a fire or other disaster damaging your premises.

Extra Expenses

- Extra expense insurance reimburses your company for a reasonable sum of money that it spends, over and above normal operating expenses, to avoid having to shut down during the restoration period.
- Usually extra expense insurance will only be paid if the extra expenses help to decrease business interruption costs.
- In some instances, extra expense insurance alone may provide sufficient coverage, without the purchase of business interruption insurance.

Business Interruption Insurance	Who does it apply to?	What is it?
Loss of Rent	Landlords	This insurance indemnifies for lost rent and other income derived from tenants. Standard insurance covers a period of twelve months or the time required to restore the property, whichever is less.
Loss of Gross Profit	Business Owners	This insurance covers a business up to net income before taxes and continuing expenses. If gross profits are under-insured, the insurance company may adjust the claim downwards in the event of a loss. This insurance can be purchased for periods extending beyond the standard twelve-month policy to allow the insured to be indemnified until such time as gross profits return to pre-claim levels.
Gross Earnings Insurance	Business Owners	This is similar to gross profits insurance (see above) but can only be purchased for maximum of one year.
Extra Expense Insurance	Business Owners	This insurance allows a business owner to resume regular operations more quickly by providing funds for such items as temporary rent at an alternative outside location, additional labour cost, etc. This type of insurance does not provide sufficient coverage on its own and is usually offered only in conjunction with other insurance coverage mentioned above.
Professional Fees Insurance	Business Owners	This insurance pays for the fees of professional assistance to prepare proof of loss should a claim be required. This type of insurance can only be purchased in conjunction with other insurance coverage mentioned above.

Action if You Suffer Damage to Your Business

First Things First

- Give notice of loss - let your broker/agent or insurance company know that you've suffered a loss. You can do this by telephone, by letter, by e-mail, by fax or even by visiting the insurance company's offices in person.
- Show proof of ownership and damage - documentation, photos, invoices etc of what you've lost and what it was worth or its original cost.

Next Steps

- Contact your insurance broker/agent or company immediately and report the damage. Give your name, address, and policy number, as well as the date and time of loss. If they ask you to do so, follow up with a written explanation of what happened.
- If possible, photograph the outside of the premises, showing the flooding and the damage. Also, photograph the inside of the premises, showing the damaged property and the height of the water.
- If you repair small items, such as TV aerials, window coverings, or fences before the loss adjustor arrives, it may be difficult to prove the damage.
- Make temporary repairs and take other steps to protect your property from further damage. Patch roofs temporarily. Cover broken windows with boards or plastic. If items of equipment are exposed to weather or water, move them to a safe location.
- Damaged property which presents a health hazard or which may hamper local clean-up operations should be disposed of. Be sure to adequately describe discarded items so that, when the adjuster examines your losses and your records, these articles are included in the documentation.
- Keep accurate records of what you spend. Save receipts for what you spend and submit them to your insurance company for reimbursement.
- Good records speed up settlement of your claim. Compile a room-by-room list of missing or damaged goods, and include manufacturer's names, dates and places of purchases and prices. Try to locate receipts or proofs of purchase, especially for major appliances, and note manufacturers' names, serial numbers, prices, and dates of purchase.

- Make a list of all actual losses, including office equipment, machinery and furniture.
- Try to document the value of each loss. Invoices, receipts etc will evidence your ownership of the items damaged, when they were purchased and the original cost of them.
- If you don't have back-up records (they may have been lost in the fire or storm damage you suffered) you will have to estimate the value and give purchase place and date of purchase.
- Contact a reputable and reliable firm to have your damage repaired. Ask your broker or insurance company for advice.
- Complete a claim form promptly and properly when you receive it but don't be in a hurry to settle your claim. Although you may want to have your damage claim settled as quickly as possible, it is sometimes advisable to wait until all damage is discovered. Damages which have been overlooked in an early estimate may become apparent later. If you are dissatisfied with the settlement offer, talk things over with your broker/agent and adjustor. It's also helpful to check your insurance policy to see what settlement steps it outlines.

New Planning Guidelines

Five steps that local authorities should follow in order to make maximum use of new rules to prevent inappropriate building on non-flood plains and to better manage flood risks in their areas have been published by the Dept for Communities & Local Govt in new planning guidelines. The five steps are:

- Identify what the flood risks are.
- Avoid risk by prioritising non-flood areas for new developments.
- Critically assess whether the need for a new development outweighs flood risk and follow Environment Agency advice.
- Control flooding using sustainable drainage and good design.
- Ensure that all new buildings that have to be in flood-risk areas are resilient and safe.

'Planning Policy Statement 25: Development and Flood Risk - Practice Guide' is available at <http://tinyurl.com/6kof8b> (DCLG Publications; tel: 0870 1226 236).

Advice and information will be available from Spring 2009 to help individuals and businesses protect their properties and possessions from flooding from a new interactive website and phone line service developed by Defra in collaboration with the Environment Agency. Defra will also consult on options for increasing the use of property-level measures to reduce the impacts of flooding, drawing on the findings of six pilot schemes in which householders were offered up to £5,000 to implement measures.

Protecting Against Adverse Weather etc

Climate change experts predict an increase in extreme weather events and it is likely that severe floods will be a regular occurrence and something that the UK will have to learn to live with.

In August 2007, Sir Michael Pitt was asked by the Government to carry out a review of the flood-related emergencies that occurred during the summer of 2007. On 17 December 2007, the Secretary of State for the Environment, on behalf of the Government, accepted the urgent recommendations in the interim report, and pledged to work with all relevant organisations to implement them. These recommendations include improving an understanding of surface water flooding and areas most at risk from it. Surface water flooding (caused by sudden heavy rainfall, which cannot drain away adequately) was one of the main contributions to the 2007 flooding.

The extent of flood damage and the extent to which action is taken to prevent flood damage will affect the approach taken by insurance companies to insuring properties in high flood-risk areas. There is currently a willingness to carry on insuring certain categories of residential and small business property but this may change and much depends on the Government's approach to flood defence work.

For these reasons, managing flood risk will be an important issue over the next few years, the issue being made particularly pressing because of the additional three million new homes promised by the Government by 2020 to address the chronic housing shortage. It is essential that these new properties are not built in areas that are at a high risk of flooding and that they do not exacerbate the existing flood risk either through the additional demands on drainage or by the additional coverage of land with impermeable surfaces preventing the proper drainage of surface water.

Severe losses can also occur through other adverse weather damage and water leaking from burst water pipes and these can be minimised by taking a few simple and inexpensive precautions.

Storm and Flood

- Make sure roofs, guttering and pipes are frequently inspected and necessary maintenance completed;
- In areas liable to flooding, specialist advice should be obtained and precautions taken to minimise the damage;
- Stock, machinery and contents which are susceptible to water damage should, where possible, be stored on upper floors. If this is not possible storage on pallets or shelving, and raising goods off the ground, may lessen the possibility of damage.

Burst Water Pipes

- All water pipes, tanks etc., should be adequately lagged. Tanks should not be lagged underneath, to allow heat to reach them;
- Because lagging cannot prevent freezing in sustained sub-zero temperatures, use generalised heat on the premises: create a warm boxed-in zone around pipes, immersion heaters in storage tanks and heat from flowing water within the pipes;
- Install temperature sensors outside the building to activate the heating;
- Maintain adequate heating. If the building will be unoccupied for a prolonged period, drain the water system;
- Ensure that all stopcocks are in working order. Find out how to drain all systems and make someone responsible for the sprinkler system, its water supply and pump room.

Lightning

Tall buildings, chimneys etc., should be protected against lightning in accordance with British Standard 6651 Protection of Structures against Lightning.

EU Floods Directive

The European Commission has published a new directive (The Floods Directive 2007/60/EC) on the assessment and management of flood risks. It aims to reduce the consequences to human health, the environment, cultural heritage and economic activity caused by floods. Member states are required to carry out preliminary flood risk assessments, prepare flood hazard and risk maps, and produce flood risk management plans.

The Floods Directive came into force in November 2007 and member states have until 26 November 2009 to transpose it into national law. The Floods Directive applies to all types of floods such as rivers, flash floods, urban floods and coastal floods. Its purpose is to establish a framework for the assessment and management of flood risks. It aims to reduce the consequences to human health, the environment, cultural heritage and economic activity caused by floods. The Government is planning to publish a consultation on the draft legislation in February 2009 in readiness for the legislation coming into force later in 2009.

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Further Information

This guide is for general interest - it is always essential to take advice on specific issues.

We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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