Assurances

Business Interruption Insurance

Frank Gray

Volume 30, numéro 1, 1962

URI : https://id.erudit.org/iderudit/1103439ar
DOI : https://doi.org/10.7202/1103439ar

Aller au sommaire du numéro

Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

Citer ce document

Gray, F. (1962). Business Interruption Insurance. *Assurances*, *30*(1), 7–19. https://doi.org/10.7202/1103439ar

Résumé de l'article

Voici le texte d'une causerie donnée par M. Frank Gray à une assemblée de l'Ontario Insurance Adjusters' Association et qui a paru dans la revue de l'Association intitulée « Without Prejudice », en novembre et décembre 1961. Nous la présentons à nos lecteurs avec l'autorisation de l'auteur. Elle nous a intéressé par ce qu'elle présente de nouveau au sujet des dernières modifications apportées aux assurances de profits au Canada, en particulier. N. de la r.

Business Interruption Insurance

By

FRANK GRAY, C.A.

Underwriters Adjustment Bureau

Voici le texte d'une causerie donnée par M. Frank Gray à une assemblée de l'Ontario Insurance Adjusters' Association et qui a paru dans la revue de l'Association intitulée "Without Prejudice", en novembre et décembre 1961. Nous la présentons à nos lecteurs avec l'autorisation de l'auteur. Elle nous a intéressé par ce qu'elle présente de nouveau au sujet des dernières modifications apportées aux assurances de profits au Canada, en particulier. N. de la r.

I was very pleased to be asked to address your meeting this evening on the subject of adjustments under business interruption policies. The subject is one that I have had an opportunity of specializing in over the past few years and which, in my opinion, offers a field of great interest and fascination to an adjuster. All too often, however, adjusters, in common with many agents and underwriters, make little or no effort to understand the subject on the general theory that only an accountant can be expected to understand such technical terms as gross earnings, standing charges, turnover, etc. As many of you will have found by experience, the subject is by no means as mysterious as some people think and while accounting knowledge is helpful, it is frequently less important than commonsense and a knowledge of the insurance contracts. It is true, of course, that the services of a trained accountant are necessary on certain types of business interruption claim, particularly in claims involving manufacturing concerns with highly developed cost systems. The accountant is, however, not an insurance specialist and it is the adjuster who should decide the scope and direction of the accounting investigation.

Recent Changes

In view of the fact that the standard business interruption forms available in Canada have been recently revised, I thought it might be helpful if I commented on the more important changes which have been made.

These changes reflect mainly the so-called Use and Occupancy forms. The Profits form remains essentially unchanged. If I may digress for a moment, some explanation of terminology might be helpful. In Canada the term business interruption includes both the type of earnings insurance developed in England, which is known as Profits Insurance, and the type developed in the United States which has traditionally been known as Use and Occupancy Insurance. As part of the recent revision the description Use and Occupancy has disappeared and has been replaced by the term Gross Earnings. This change follows practice in the United States where only the one type of insurance is written. It is, however, unlikely that the term Use and Occupancy will drop out of use in Canada since it provides a useful means of distinguishing between the two types of insurance and for this reason it is convenient to use the term in this talk.

A considerable simplification has been made in the Use and Occupancy forms by eliminating the old Two-Item form. This is clearly a forward step, since the necessity of choosing between two forms which basically provided the same protection but were worded quite differently has in the past confused many people. The only difference of consequence between the two older forms related to coverage of ordinary payroll, which was optional under the Two-Item form and mandatory under the Gross Earnings form. Under the old set-up, it was, therefore, necessary for an Insured who did not want to insure his ordinary payroll, or wanted to do so on a limited basis, to use the Two-Item form. Under the new Gross Earnings forms which are two in number, one for manufacturing risks and one for non-manufacturing risks, all payroll is automatically covered. Ordinary payroll can, however, be excluded by attaching the Ordinary Payroll Exclusion Endorsement or covered for a limited period by attaching the Ordinary Payroll Limited Coverage Endorsement. The same choice of payroll coverage is, therefore, still available with the added advantage that there is one blanket amount of insurance, instead of one amount on payroll and a separate amount on the balance of the risk, as was the case with the Two-Item form. In the event of a claim this means that the entire amount of the coverage can be applied, if desired, to a loss of gross earnings other than ordinary payroll.

Another important change relates to the time allowance for replacing stock. The limitations in respect to raw stock and stock in process for manufacturing risks and finished stock for mercantile risks have been eliminated. They are now covered without special restrictions in the same way as buildings and machinery. This broadening of the coverage could be very important in cases where stock is imported or for any reason difficult to replace. A recent claim which I adjusted illustrates the point. A departmental store dealing chiefly in goods imported from Hongkong, suffered a fire. Fire damage to the building was small but the stock of merchandises was heavily damaged by water and smoke. Repairs to the building were completed in 10 days while replacement of stock took some three months. Under the old forms the period of indemnity would, unless the normal 30 days limitation had been removed, have been limited to 40 days (10 days for building repairs and 30 additional days for replacement of stock). The new forms would provide protection for the full three months required to replace the stock.

The foregoing summarizes the major changes. There are other minor changes and revisions in the wordings and
10 rules which I have not thought of sufficient importance to go into today. The revisions are too recent to recognize whether actual use will show a need for additional changes. It is unlikely, however, that any serious problems will appear since the changes made are essentially similar to changes made some time ago in the corresponding American forms. There is, however, one point worth mentioning since, I understand, it has already led to some difficulty both in Canada and the United States and a change in the rules may be found necessary. The point I have in mind arises from the fact that the new forms do not permit a manufacturer in computing his insurable gross earnings to deduct any portion of the cost of light, heat and power, whereas the old Two-Item form required insurance only on that portion which continued under contract. This works a hardship on manufacturing concerns such as aluminum plants or electro-plating plants where the cost of power varies with production and is a major factor in the manufacturing costs, which can be compared with the cost of raw materials in other industries. Since it can be assumed that the cost of power in such concerns would reduce proportionately with a loss of production there is some logic in the view that it should be deducted in arriving at the insurable value, except for that amount which would continue under contract.

While the changes which have been made are in the main good ones, there is no doubt that any adjuster experienced in the handling of business interruption claims would like to have seen some more radical changes. There seems, for instance, no logical reason for the fact that business interruption wordings in Canada and the United States are attached to standard fire policies which are intended to cover loss of or damage to tangible property rather than earnings. This is not the case in England where a special consequential loss policy has been designed for use with the Profits wording. While it is true that the system seems to work, I have often wondered what the situation would be if more business interruption cases reached the Courts. There was a recent court case in the State of New York — Anchor Toy Corporation v. American Eagle Fire Insurance et al. which illustrates the point. The main question in dispute related to the policy requirement for making and filing proofs of loss and the court held that no proof of loss need be filed in support of a business interruption claim for the reason that the standard fire policy provisions simply did not fit insurance against business interruption. The following quotation from the judgment shows the reasoning followed : —

> " . . . The defendants issued policies extending coverage for business interruption. A cursory reading thereof discloses the patent ambiguity created by the failure to incorporate therein an intelligible requirement as to the rendering of proofs of such loss, if such were wanted by the insurers. The resulting confusion was caused by the carelessness of the writers of the policies. It is apparent that the standard proof of loss provision has no applicability because the loss insured against was a continuing one . . . "

While this case is now under appeal and the decision cannot be regarded as final, it certainly suggests that the situation would be clearer if all business interruption wordings included a provision dealing with the requirements for filing proofs of loss which would fit the circumstances of an earnings loss.

Very few business interruption cases appear to have reached the courts in Canada. There is, however, one recent case — Napier Theatres v. Globe Indemnity Company, et al., which indicates that Canadian judges share their American counterparts' lack of enthusiasm for the policy wordings. This case dealt with the operation of the standard co-insurance clause in combination with a special clause limiting the Insurer's liability to a period of four months. The court said that the limitation of four months was a limitation only and that the co-insurance factor applied to the actual loss which extended over a considerably longer period. This interpretation is, of course, contrary to the intent of the coverage as understood by adjusters and underwriters. In the course of the judgment, the court pointed out that the policies were not suitable for the risk insured against and that it was difficult to see how the policy could have been drawn to make the meaning more obscure. All in all, it would seem that we should be grateful that so few cases reach the courts.

The revised wordings have done nothing to clarify the relationship between the wordings themselves and the fire policies to which they are attached. The reverse is, in fact, the case since the "Lightning and Electrical Apparatus" Clause has been deleted, presumably on the grounds that it was redundant in view of the similar provisions which appear in the fire policy and the extended coverage endorsements.

This means that in the case of claims involving electrical damage, the provisions of the fire policy must be read in conjunction with the business interruption wording. The adjuster is, therefore, forced to refer to the fire policy for certain things while, at the same time, he must ignore other provisions such as the exclusion of motor vehicles.

In the remainder of the time at my disposal, I would like to make some general comments on the more common problems which arise in actual adjustment of claims.

When a business interruption claim occurs it is axiomatic that some object has suffered physical damage in consequence of which earnings have been affected. There is no fixed relationship between the amount of the direct damage and the related earnings loss. Damage to a piece of key equipment may cost little to repair but seriously affect production. On the other hand, extensive physical damage may have relatively little effect on operations. Regardless of the relative amounts of loss it is always advisable to have the same adjuster attend to both the direct damage and business interruption claims. This procedure has a number of advantages. The insured has only one person to deal with instead of two and duplication of work is avoided. Since expenses which apply to both claims must be analysed as to their nature before either claim can be closed there is less danger of duplication or omission if the same adjuster is responsible for both claims. For these reasons, adjusters are usually reluctant to accept a business interruption claim unless they have also been assigned the related direct damage claim.

An Insured's first claim is generally more difficult to adjust than subsequent ones, since there is often a lack of understanding of the policy provisions and all too often insufficient insurance. Since most business interruption forms provide for a co-insurance penalty, under-insurance directly reduces the loss payable. This is without doubt the most common problem which arises in loss adjustments. A study made in the United States shows an average co-insurance penalty of 15½% and while actual statistics are not available for Canada, there is no doubt the situation is much the same. Obviously, very few people deliberately choose to be under-insured as is evidenced by the fact that a concern which has suffered once from under-insurance rarely makes the same mistake again. While experience is, of course, the best teacher there is no real need for an Insured to learn in such a painful fashion. Very often the existence of under-insurance results from a failure to appreciate that co-insurance penalties are

applied on the basis of values for the year following a loss and that the amount of insurance must be adjusted to keep pace with changing conditions. Since a loss can occur on the last day of a policy term, this means that an Insured just look ahead two years when computing the values. This is not such a problem as it might appear since the Insurance Companies encourage adequate coverage by offering an endorsement providing for a rebate of premium if actual figures show the insurance in force was more than required.

Situations can also arise, particularly when coverage is written on the Profits Form, where the amount of insurance is adequate to meet the co-insurance requirements but does not fully protect an Insured against his loss. Under the Profits Form an Insured may elect to insure all standing charges or a selected list and there is a tendency to insure only those changes which would continue during a total and lengthy shutdown. This approach, which is often found even in large corporations, overlooks the fact that the majority of interruptions are of a short and partial nature and that, under these cicumstances, most expenses of the business continue in full. Unless sufficient insurance is carried to cover all expenses of an overhead nature, and Insured cannot reasonably expect to recover his whole loss in the event of a short or partial interruption.

The question of overhead on labour and material si one that has plagued insurance adjusters from time immemorial.

Accounting is not an exact science and the methods used by accounts to measure cost vary with the circumstances of an industry. As a result items of expense which are treated as direct costs in one set of books are considered overhead in another and vice versa. The adjuster must, therefore, examine each case on its merits, recognizing that overhead figures are developed in many ways, and is not always prepared to accept the method used in any particular case. The adjuster is particularly concerned with the possibility that overhead included 15
in a direct damage claim may duplicate the amount claimed under a business interruption policy or which could have been claimed if the insurance had been carried. Since business interruption insurance is designed to cover the net profit and continuing overhead expenses of a business, there is an obvious danger of duplication. Similarly, it is not reasonable for an Insured to expect to collect overhead expenses in a direct damage claim simply because he chooses not to insure his earnings.

While the principle involved in this question of duplication is not difficult to understand, it is frequently overlooked in the preparation of a claim. A common example is the question of overhead on materials. Many concerns charge out materials from stores at laid down cost plus an overhead loading of say 10% which represents the fixed expenses of operating the stores department. Since these fixed expenses are made up of items such as salaries, taxes, etc., which are insurable under a business interruption policy, they should not form part of a direct damage claim. When an insurance claim is being prepared the point is, however, easily overlooked, though most corporate accountants accept the soundness of the theory once it has been brought to their attention.

The same principle applies in the case of overhead distributed on the basis of direct labour or any other yardstick.

Individual cases are, of course, not always clear-cut and it is necessary to consider the particular circumstances. Apparent duplications may not always on examination prove to be such. If, for instance, outside help must be employed to replace maintenance personnel diverted from their normal duties and the outside charges include an overhead factor, this would be in addition to the normal overhead cost. Under these circumstances, it would be correct to include the overhead of the

maintenance department in the direct damage claim. Very often the overhead charge turns out on analysis to be made up in part of fixed expenses and in part of variable expenses. In such cases, the variable portion is, of course, a proper charge since the business interruption coverage contemplates fixed charges only.

Payroll

The largest item in the expenses of a business is usually payroll and one would expect that particular care would be taken in deciding the extent to which it is desirable to cover payroll in a business interruption policy. Adjustment experience shows, however, that this is frequently not the case.

A businessman has a choice of insuring payroll in three ways: —

(1) the entire payroll
(2) the important employees only
(3) important employees plus limited coverage for a selected period on ordinary payroll (all other employees).

When the entire payroll is insured, the situation is clear. When, however, ordinary payroll is excluded or covered for a limited period, problems can arise because of the difficulty in determining which employees are important and which are not. In a short interruption all employees are important, but only certain ones are important enough to keep during a lengthy total shut-down. When a loss occurs, the insured is entitled to claim only those salaries and wages which (a) continue, and (b) are insured. If nobody knows which employees it was intended to insure, there is uncertainty as to both the amount of loss and the value for co-insurance purposes. If the interruption is short, the insured tends to take a broad view of the payroll coverage when making his claim and is then likely to find that the amount of insurance is inadequate and he is penalized by co-insurance. Such situations are easily avoided if care is taken when the insurance is written to place on record a definition of the payroll categories which it is the intention to insure.

Special Problems

Most business interruption insurance is written on standard forms which are, however, applied to a great variety of situations. The adjuster, as a result, is frequently faced with the problem of relating broad principles to specific problems. A good example of this is the following.

Some years ago, I had to deal with a claim for a race track. The insurance coverage was written on a gross earnings form which defined gross earnings as being the difference between net sales and cost of merchandise sold. Neither sales nor merchandise appear in the accounts of a race track and it was, therefore, necessary to agree on a suitable interpretation of the policy wording before the loss could be calculated. This was not as difficult as it might sound since the intent of the insurance was obviously to insure the net profit and those expenses which might be expected to continue in the event of an interruption. It was, however, necessary to analyze the expenses of the race track and determine which were variable and could be considered as merchandise and which were of a fixed or overhead nature.

Actual Loss Sustained

There is an underlying concept in Use and Occupancy insurance on manufacturing risks that the measure of recovery is loss of production and for this reason any loss resulting from damage to damage to finished stock is excluded in the forms applicable to manufacturing concerns. In order to cover the risk of loss from damage or destruction of finished stock it is, therefore, normal in the case of manufacturing concerns carrying Use and Occupancy insurance to insure finished stock at selling price. For the same reason it is usual in the adjustment of losses to compute the loss of earnings on the basis of the sales value of production lost rather than the loss of sales. Because production is the yardstick normally used there is a tendency to assume that a loss of production automatically results in a loss of sales and earnings. While there has been much debate on this question over the years I think it is now well established that loss of production is merely one method of measuring a Use and Occupancy loss and that if sales are not lost, the insurance recovery should be limited to extra costs incurred in recouping or replacing the production loss. In other words, the policy being one of indemnity which limits liability to the actual loss sustained, the onus is on the insured to demonstrate that a loss of production has resulted in a monetary loss.

It is interesting to note that the new Use and Occupancy forms include a change in wording which is intended to emphasize this point. The new forms now state as part of the Resumption of Operations clause that a manufacturing concern must make use of raw, in process or finished stock if, by so doing, the loss can be reduced. The older forms were less specific in this regard and used the more general description property, equipment or supplies.

This condition does not, of course, mean that an Insured would be expected to reduce his inventory below the level necessary for normal operations. It does, however, mean that if inventories are at such a high level that sales and earnings are not affected by a production loss, it is extremely doubtful that an Insured could prove an actual loss had been sustained.

It will be realized that the foregoing comments are not pertinent to Profits insurance which by definition bases the loss of gross profit on the reduction in sales.

Conclusion

The life of a business interruption adjuster is never dull. Because of the intricacies of modern business each claim presents new problems and the adjuster must be sufficiently flexible in his approach to make the broad principles of the insurance contracts fit a great variety of circumstances. In no other part of the adjusting field is so much a matter of opinion. The basic factor in any claim is always a matter of opinion since in essence the amount of a claim is arrived at by subtracting the actual results after a fire from the probable results had there been no fire. Obviously, the probable earnings can never be completely proven and must be developed by intelligent assessment of past earnings and current trends. If the estimate of future earnings is wrong the answer is wrong. It has, however, been my experience that in the great majority of cases, it is possible to work out the various problems which occur to the mutual satisfaction of all concerned.