Limiting the Interruption in Business Interruption Insurance

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"You cannot plan the future by the past."

> *-Edmund Burke (January 12, 1729–July 9, 1797), Irish statesman, author, orator, political theorist, and philosopher*

"Yesterday is not ours to recover, but tomorrow is ours to win or lose."

> *-Lyndon B. Johnson (August 27, 1908–January 22, 1973), 36th US President from 1963–1969*

"Carpe diem."

> *-The literal translation from Latin is "seize the day." The origin source for the Latin phrase is Roman lyric poet Quintus Horatius Flaccus (65 BC to 8 BC), more widely nown as Horace*

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Consider the following loss scenario.

September 15, 2010. It is the beginning of the financial planning process for ACME Manufacturing Company, a maker of critical components for the automobile manufacturing industry and other businesses located within a radius of 50 miles of its main manufacturing location. KEY Company, located 10 miles from ACME's main site just announced it will contract with ACME to exclusively manufacture certain parts for one of its key machines, which will boost ACME's estimated 2011 sales by 15 percent and annual profit by more than 10 percent. The ACME risk manager is just completing the final activities of ACME's property insurance renewal that will be effective on October 1, 2010. The risk manager is satisfied with the overall renewal terms offered "as is"—same coverage and premium as expiring terms and conditions. He decides to review the renewal coverage terms with ACME's business continuity team, led by the CFO, which includes senior members of business lines, human resources, legal, and the risk manager.

August 15, 2011. A major windstorm hits an industrial center in the Midwest with tornadic winds, heavy hail, and rain. Local rivers flooded causing people to vacate homes and businesses. ACME Manufacturing experienced heavy building damage from winds and flooding that in turn caused damage to critical manufacturing equipment. Electrical power will be out for days—maybe for 2 weeks. ACME has several vital suppliers in the local area that have been severely affected by the storm and will be offline at least as long as ACME. In addition KEY Company located about 10 miles away, has experienced significant devastation, and it is uncertain if it can return to normal business activities within 6 months.

August 18, 2011. The first day ACME's risk manager is allowed access to his office at the main ACME manufacturing location. He reads an e-mail from ACME's CFO requesting an outline of how and to what extent ACME's insurance will respond to this disaster and how to pay ACME employees, a very skilled workforce, during the period of reconstruction.
How will the risk manager respond to the CFO? How you would respond?

Time Element Insurance

There are many facts to consider in the ACME loss scenario and hopefully one that is more hypothetical than real to any member of our risk management community. But events happen that are often beyond our control. Risk management as a practice begins with exposure analysis and is the only way for any risk management professional to implement appropriate techniques, including effective use of insurance. Only when loss exposures are identified, understood, and continually monitored will the risk management professional be in a position to address catastrophic loss and disruptions in the organization's ability to create a profit.

The ACME/KEY loss scenario is a means to examine ways that time element insurance can be used to replace interrupted income streams, regain profits, and pay continuing expenses (including payroll) to financially stabilize the organization while it rebuilds or repairs damaged buildings and contents. What is "time element" insurance? The IRMI *Glossary of Insurance & Risk Management Terms* defines time element insurance as:

> "*A property insurance term referring to coverage for loss resulting from the inability to put damaged property to its normal use. This type of coverage is called "time element" insurance because the amount of loss depends on how long it takes to repair or replace the damaged property. The best known types of time element insurance are loss of business income and extra expense coverage."*

For our purposes, we will refer to loss of profits and continuing expenses as "loss of income" and increased operating expenses as "extra expense." This terminology is fairly consistent within the risk management community, although one may find insurers and their independently filed forms with a slight variation in title of coverage.

Why use the quotes shown above? Risk of loss evolves; it is rarely—if ever—static. Time element exposures such as sales, profit, operating expense, payroll, repair/reconstruction time do change, and the risk management professional must continually assesses how the organizations produces capital and what situations can impair revenue streams (sales, rents, royalties, grants, etc.) and increase operating expenses. To paraphrase LBJ and Horace, we need to look forward—yesterday is gone (whew!) but tomorrow is new and uncertain (oh no!) and, thus, we as risk managers must "seize the moment" to understand what is or will be new to our organization.

Quantify the Exposure

Risk treatment for time element exposures begins with a decision on methodology to estimate the loss of income exposure. A common approach is to complete a worksheet using the organization's current and projected financial statement information (profit/loss, cash flows, balance sheet) to annualize all income, expenses, and profit. We will assume a deduction method worksheet is used for loss of income purposes even though a "build up" methodology is sometimes used. Extra expenses as a result of an insured event can be difficult to identify as well as quantify, but worksheets are available for assistance. The terms used in time element coverage forms may not necessarily be the same terms used by a CPA or as found in a financial statement. The risk management professional needs to understand how to read a balance sheet and income statement in order to obtain data to complete a time element worksheet. A risk management professional should always seek assistance from the organization's finance staff if financial and accounting terminology is not understood. It is always better to seek help than to jeopardize an organization's insurance coverage, especially time element. For the duration of this article we will discuss only "loss of income" exposures and coverage issues.

The "loss of income" exposure is defined in the business income coverage form, which for our purposes will be Insurance Services Office, Inc. (ISO) form CP 00 30 04 02[1], and can be expressed simply as:

Loss of Pretax Profit + Continuing Expenses = Insurable Loss of Income

Why use pretax profit? Because any loss of income payment received by the organization will be treated as "income" and therefore may be subject to federal and state corporate income tax. This formula is expressed in business income worksheets such as CP 15 15 06 95[2] filed by ISO. This formula creates the expected annual values for the coverage period (policy period); the worksheet is not to be completed in terms of what the risk management professional expects the period of interruption to be, i.e., 90 days, 120 days, etc.

Insurers may use ISO filings or independent filings for business income coverage but the business income form and its worksheets are fairly uniform in intent of the terms "income" and "continuing expense." If the property insurance policy coverage territory is defined to be the United States (including its territories and possessions), Puerto Rico, and Canada, then the business income worksheet should be completed for only these country exposures. A separate business income worksheet and coverage form/policy (building, contents, and loss of income) will be needed to obtain local (admitted) and/or difference-in-conditions (DIC) (non-admitted) insurance coverage for countries not considered part of the US policy definition of covered territory.

Value To Insure

To set prudent business income coverage limits, the risk management professional must understand when *business income coverage* begins and ends and if the coverage is subject to a coinsurance clause. ISO business income form CP 00 30 04 02 terms and conditions are similar to that found in most business income forms. The ISO coverage grant states that business income coverage begins 1–72 hours after the time of direct physical loss or damage, and for extra expense coverage, immediately after the time of direct physical loss or damage. The damage must be caused by or result from a covered cause of loss on an insured premises. (The coverage waiting period may be less or more than 72 hours depending on insurer. A business income waiting period should always be viewed in terms of actual dollar impact on the organization's retained amount to understand the "deductible" effect the waiting period will have on the organization's cash flow for normally expected profits and continuing expenses.) Under the ISO form, coverage ends on "the date when the property at the described premises should be repaired, rebuilt, or replaced with reasonable speed and similar quality; or the date when business is resumed at a new permanent location …," whichever is earlier.

The limit chosen by the risk management professional needs to be an amount equal to that subject to catastrophic loss (fire, windstorm, earthquake) for the amount of time (worst case) that the organization may have its operations suspended but in no event in an amount that does not satisfy a coinsurance clause. If a disaster is thought to have an impact of more than 1 year on operations, then the limit should assume more than a 12-month exposure. If it is thought that in a worst case loss scenario that the organization may have operations suspended for 15 months, then the 12-month exposure from the worksheet should be increased by 125 percent (i.e., 15/12 = 125 percent).

Extended Period of Indemnity

Business income coverage will end when the damage is repaired, rebuilt, or replaced or date business is resumed at a new permanent location. While policy wording is specific as to the end date of business income coverage, it does not necessarily mean that the organization's "business" in terms of sales, income, or profit is back to normal. Certain industries may suffer a period of reduced sales, income, and profit even after all damage is repaired, rebuilt, or replaced. Retail establishments (restaurants, clothing stores, dry cleaners, etc.), as an example, may have to "wait" for prior clientele to come back after being out of business for a period of time.

The ISO form CP 00 30 04 02 takes this continuing exposure into consideration by extending business income coverage for 30 consecutive days past the actual date of final repair, rebuilding, or replacement. The risk management professional will need to consider the organization's susceptibility to rebuilding its customer base and need for more than 30 days of extended coverage. Some insurers will provide an insured an extended period of indemnity option up to 365 days. There is a cost for this added coverage, so the risk management professional should seek an appropriate extended time limit to be insured after comparing coverage to cost of insurance.

Schools, such as colleges and universities, may need a special extended period of indemnity to address a loss of students even after the school's facilities are repaired. The period of time needed to resume normal operations and normal income through tuition and fees may be long if students leave for other campuses to fulfill their needs for higher education.

Payroll

A major expense for any organization is employee payroll and benefits (if directly related to payroll and paid by the organization: FICA payments, union dues, and workers compensation premiums) and one that must be reviewed and understood prior to loss as to the extent, if any, that should be continued during the period of restoration. An organization can decide to treat all payroll and benefits as a continuing expense and not remove it from the worksheet and thereby include all within the limit insured. Some organizations may decide that it can lay off certain employees that are not critical for the organization's recovery during the period of restoration. Each organization is different in terms of employee skills, local job markets (low or high unemployment), and cost to retain new employees when prior ones are not available for rehire.

The typical approach for most organizations is to decide what class(es) of employees should be paid during the period of restoration and which ones should not. Most insurers use the term "ordinary payroll" to define that which may be excluded totally or paid for a specific period of time (90 days, 180 days, etc.) by the named insured. Ordinary payroll is a term defined by ISO in form CP 15 10 06 07[3] as "payroll expenses for all your employees except: officers; executives; department managers; employees under contract; and additional Exemptions, shown in the Schedule as: Job Classifications; or employees." It is possible that certain employees by name or class may fall within the definition of "ordinary payroll" but the organization deems their contribution to be needed during the period of restoration. An exemption to the broad definition of "ordinary payroll" can be used in order to continue payroll and benefits for these key employees. ISO Form CP 15 04 06 07[4] Discretionary Payroll Expense is used for this purpose.

Contingent Exposures

When one thinks of business income exposures and coverage, it is usually in terms of insured damage and suspension of the *organization's* operations at *its* premises as the insured location for building and contents. But in a complex trading world, a risk management professional must review all income streams, expenses, and processes to identify all exposures that may lead to a loss of business income. It is entirely possible that the most significant business income exposure to an organization is not related at all to its premises but that of another such as key supplier, key customer, adjacent building, or even key object such as bridge or roadway. The risk management professional must think in terms of contingent exposures; what can happen elsewhere to disrupt operations at any of my organization's locations? Consider the following scenarios and their possible solutions.

Key supplier—An adverse event at key component supplier (significant fire) may in turn lead to lost sales to an organization if it cannot make critical purchases from other suppliers.

Key customer—An adverse event at key customer (significant fire) may lead to lost sales to your organization.

Solution—Contingent business income coverage for the organization may be available to address these exposures through policy forms such as ISO CP 15 08 06 07[5] "Business Income from Dependent Properties."

Adjacent building—Fire occurs at major building down the street from your organization's facilities. While there is no damage to any property of your organization, it nevertheless loses sales for a period of time when local fire department declares area unsafe and stops all incoming traffic to your organization.

Solution—Civil authority coverage is typically provided in a business income form. The risk management professional will need to review the exposure to determine if the insured period of time is sufficient for a foreseeable event and if the waiting period before coverage applies is appropriate. Changes in coverage will need to be considered and sought as deemed necessary.

Key object—A bridge to one of the organization's key operations is only way in and out of the location. If a flood washes the bridge away, there will be a significant potential for curtailed sales as the organization waits for the bridge to be repaired and normal operations can resume.

Solution—Coverage for lack of ingress/egress may be needed and available although coverage may not be available from all property insurers. The risk management professional will need to review the exposure to determine if an insured period of time and waiting period for a foreseeable event is acceptable and cost effective.

Utility Interruptions—An impairment in incoming utilities such as electricity, water, telephone, and Internet may cause a loss of income to the organization even if no direct property damage results.

Solution—Various coverage forms are available from ISO and through independent filings of insurers that address an interruption in incoming utilities as stated above or even an interruption in outgoing services, such as sewer and other waste water. The risk management professional will need to review each specific exposure to determine if an insured period of time and waiting period for a foreseeable event is acceptable and cost effective.

Conclusion

ACME's risk manager presents the CFO with a 3-page executive summary in which the organization's building and contents damage is summarized by estimated cost of repair, deductible expense, and expected time of suspended operations as outlined in ACME's business continuity plan (BCP) that had been updated just a few months before the August 15, 2011, loss event. The report includes estimated recoveries for loss of business income from ACME's damaged locations and that of a contingent nature of its key customer. The risk manager had studied the exposures created by use of KEY and decided contingent business income coverage was necessary. Cash flow subject to waiting period is identified and well within the CFO's prior guidelines on risk tolerance (self-assumption of risk by deductible and waiting period).

No dependent property coverage was purchased for possible interruption in ACME operations due to loss of operations by local suppliers since ACME's BCP had determined sufficient parts were available from alternate suppliers. Ordinary payroll is insured for 30 days with a 120-day exemption for several key employees. The CFO is satisfied with how ACME property insurance program responded to the loss especially that considered business income coverage.

[1]IRMI Online subscribers have access to all ISO forms, including CP 00 30 04 02.

[2]IRMI Online subscribers have access to all ISO forms, including CP 15 15 06 95.

[3]IRMI Online subscribers have access to all ISO forms, including CP 15 10 06 07.

[4]IRMI Online subscribers have access to all ISO forms, including CP 15 04 06 07.

[5]IRMI Online subscribers have access to all ISO forms, including CP 15 08 06 07.

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