Corporate Exposure: Business Interruption Insurance

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All organizations should consider purchasing business interruption insurance. It is offered as an endorsement to a standard fire protection policy and, considering the noted frequency of fires and related property damage losses, it should not be ignored. Property policies cover "direct" losses caused by perils identified in the contract. Often, however, the "indirect" losses far exceed the direct costs.

For example, let's consider a fire in a small manufacturing plant. The standard fire policy will cover the damages caused by the fire and any other damage for which the fire is the primary cause. Damages incurred from either smoke or water used to fight the fire would also be covered. But there is no coverage for loss of revenue, costs associated with the organization's inability to rebuild on its original site, and so on. The carrier is liable only for direct losses; indirect losses are considered consequential and therefore not covered.

What the Policy Covers

To cover "indirect losses," the insured must turn to a business interruption policy. With business interruption coverage, the carrier is liable for losses incurred during the period of time it should take the insured to rebuild, repair, or replace the damaged property. The organization cannot intentionally proceed slowly to incur additional losses. It must exercise "due diligence" in restoration of the business function. The carrier's liability ends on the date and time it should have taken the insured to be back in operation. In essence, if it is determined that a six-month period of time was reasonable for the insured to resume operations, the carrier will terminate coverage at that point. If the organization purchased extended coverage, it will protect the insured beyond the normal or typical recovery time—but this coverage is expensive. Bear in mind coverage can continue beyond the policy termination date. If the loss occurs on the last day of the policy, the insured would be covered for as long as it takes to rebuild and restructure its operation in accordance with policy terms.

Naturally, expenses incurred to minimize losses will be reimbursable under the policy. If you were to purchase wooden planks to secure your building from the elements, you would be reimbursed provided you can show proof of the expenditures. In fact, the policies require you to take steps to minimize damages or losses after a fire. Failure to do so could void reimbursements or a portion of your claim.

Business interruption coverage can also protect against payroll losses subject to certain limitations.

Co-Insurance

Although typically there is no deductible on business interruption coverage, there are co-insurance clauses that are applicable. Co-insurance essentially means the insured agrees to carry a specified minimum amount of insurance at all times. If the organization fails to maintain stipulated amounts or ratios, it will have to absorb a portion of any loss.

Traditionally, co-insurance requirements of anywhere from 50 to 80 percent are found in business interruption policies. If the organization's earnings in the year following a loss would have been $1 million and the company had elected a 50 percent co-insurance option, the insured would have had to maintain at least $500,000 of insurance. If the organization in such a situation carries less insurance, the insured is a co-insurer and shares in any losses. If the company in the example above had only $300,000 of insurance, the organization is entitled to only three fifths of any loss.

Understandably, it is not simple to forecast earnings and maintain appropriate co-insurance levels. Because of this, many policies have agreed-amount endorsements, which establish a fixed dollar amount of insurance to be maintained instead of a percentage of prospective earnings.

Selecting Coverage

The selection of appropriate endorsements, coverages, limits, and reporting value calculations must be carefully evaluated with your management and your insurance broker. We have known organizations that have waived business interruption coverage after careful consideration—and done, with appropriate finance options, this may be a wise decision. These companies follow a risk management philosophy of investing business interruption premiums into both the elimination of risk potentials and establishing redundancies in the operation to allow the firm to continue with minimum interruption if a loss were sustained.

Certainly, given the complexity of contracts and the ever-increasing diversity of property losses realized, the decision to purchase property insurance and business interruption coverage demands careful consideration. Applied Risk has created a property-business interruption profile that may assist you in your review. For a free copy, phone Applied Risk at 914-365-2444 or FAX your request to 914-365-2478.

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