

BUSINESS INTERRUPTION COVERAGE

A Basic Primer



TORT AND INSURANCE PRACTICE SECTION
AMERICAN BAR ASSOCIATION

BUSINESS INTERRUPTION COVERAGE A Basic Primer

From Papers Presented at
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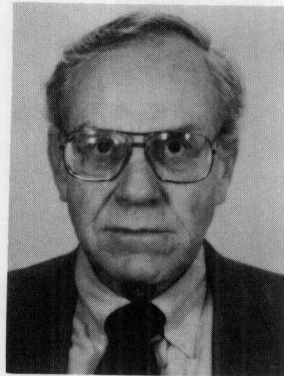
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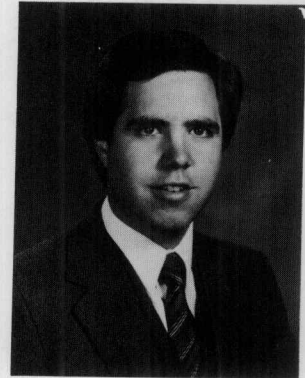
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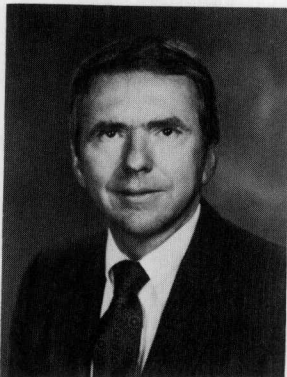
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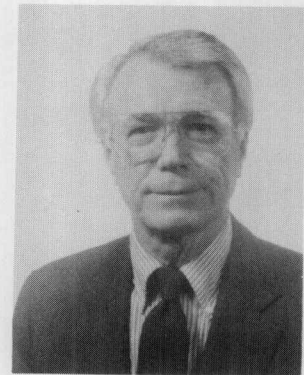
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PREFACE

The papers that make up this monograph were first presented by the Property Insurance Law Committee at the Tort and Insurance Practice Section's Second Annual Midwinter Meeting in 1984. As the material continues to be of value to practitioners in property insurance law, we have undertaken to update these materials as necessary and make them available on a wider basis.

William J. Schaeffe
Chairman
Property Insurance Law Committee

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TYPES OF BUSINESS INTERRUPTION COVERAGE AVAILABLE

This presentation will cover the various types of insurance available to protect against loss of earnings, with particular emphasis on the most commonly used types. The most commonly designated "one and only" insurance is the type of insurance available under a variety of circumstances. The protection can range from off-premises service interruption to loss of income. This paper will deal primarily with the types of coverage which are related directly to an interruption or delay caused by damage to property, generically called "time element" coverage. The most frequently encountered forms are those that insure against loss of gross earnings or loss of fixed overhead, as described in detail.

Alan R. Miller

The courts have often stated that the primary purpose of a business interruption policy is to place the insured in the same position as if no loss had occurred. This general statement must be qualified by reference to the specific contract provisions which control the rights and obligations of the parties. With the continued proliferation of easy-to-use policies, these contractual provisions are expressed in different language in

TYPES OF BUSINESS INTERRUPTION COVERAGE AVAILABLE

This presentation will cover the various types of insurance available to protect against loss of earnings, with a particular emphasis on the most commonly used types. What was formerly designated "use and occupancy" insurance is now broadly available under a variety of designations. The protection can range from off-premises service interruption to loss of tuition. This paper will deal primarily with the types of coverages which are related directly to an interruption or delay caused by damage to property, generically called "time element" coverages. The most frequently encountered forms are those that insure against loss of gross earnings or loss of earnings, and these will be described in detail.

The courts have often stated that the principal purpose of a business interruption policy is to place the insured in the same position as if no loss had occurred.¹ This general statement must be qualified by reference to the specific contract provisions which control the rights and obligations of the parties. With the continued proliferation of easy-read policies, these contractual provisions are expressed in different language in

different policies. Nonetheless, there are common threads which run through virtually all business interruption policies, with respect to both the measurement of the suspension period and the calculation of the amount of loss. In this paper, I will quote specific language from various policy forms which have been chosen only for convenience. In some cases that language is standardized, whereas in other cases it is parallel to provisions expressed in different words in other policies.

Some requirements apply to all business interruption claims. Specifically, there must be an actual loss resulting from damage to property caused by an insured peril. Each of these requirements is essential in triggering a business interruption loss.

ACTUAL LOSS SUSTAINED

An insured may sustain damage to his property yet suffer no business interruption. For example, in one case the insured business was a motel and restaurant which the court found to be "doomed to failure absent an immediate infusion of additional financial backing."² The court found that there was no actual monetary loss because the establishment was "floundering" and as a result no business interruption loss was sustained. It appears probable that the business in this case was terminated at the time of the fire.

Similarly, in another case, the court refused to allow recovery for payroll which was not paid following a loss and stated "that in order for there to be a liability for business

interruption loss, the claimant must show an actual monetary loss."³ Business need not be operating at a profit in order to recover on a business interruption loss since the policy also covers fixed expenses, but if there has been no monetary loss because of the nature of the business there can be no recovery.

DAMAGE TO PROPERTY

Business interruption is insured only when it results from physical damage to property.⁴ Cleland Simpson is a good example of a business interruption loss for which there was no coverage because there was no physical damage to the property.⁵ There, the Mayor of Scranton, Pennsylvania declared a state of emergency and ordered all stores closed because of the risk of serious fire damage in the wake of a flood which had cut off the water supply. As a result, there was no access to the premises for three business days. The court stated that it could not "read into the policy that the risk includes prohibition of access because of apprehension of either the possibility or probability of a fire which never occurred." Howard Stores involved water damage to a retail store.⁶ The insured restocked the store through transfers from other stores which it owned and then claimed a loss of sales based on the declining sales in the other stores. The New York Court of Appeals held there could be no business interruption recovery because there were no earnings lost at the damaged store

and because the insurance policy was not intended to include business interruption at stores where no physical damage occurred.

Generally speaking, the damaged property must also be property of the insured. There are, however, exceptions to this requirement. These exceptions will be discussed later and include contingent business interruption, service interruption, commissions and profits, and interruption by civil authority. In Datatab, Inc., for example, there was no physical damage to the insured's data processing equipment on the fifth and sixth floors of a building, but the equipment was shut down because of water in the basement.⁷ The court construed the physical damage requirement to apply not to the insured's property but to the "premises."

BY A PERIL INSURED AGAINST

The physical damage to property required in order to trigger a business interruption loss must also result from an insured peril. Customarily the business interruption form tracks the property damage form. It is possible, however, to have a separate business interruption policy with its own insured risks which may or may not be identical to the property damage perils. A business interruption policy is similar to the property damage policy in the respect that it does not insure against all loss, but only loss caused by insured risks.⁸

EARNINGS AND GROSS EARNINGS INSURANCE

The predominant business interruption insurance forms in use today are the earnings and gross earnings forms. These forms serve essentially the same purpose; that is, they provide for the recovery of net profits, fixed expenses and extra expense incurred in reducing the loss. While the forms serve the same general purpose, there are specific differences in the method of loss calculation. Generally speaking, the earnings form follows a "build-up" approach; that is, it starts with net profits and then adds the operating expenses which are not abated during the suspension (fixed expenses). One common approach in setting forth earnings coverage is to provide for the payment of the actual loss sustained not exceeding "the reduction in earnings less charges and expenses which do not necessarily continue" This is followed by a definition of earnings as "net profit plus payroll expenses, taxes, interest, rents and all other operating expenses earned by the business." Another approach is to specifically set forth what is covered by way of continuing expenses by providing that the policy insures for the actual loss sustained of

(A) NET PROFIT, before deducting income taxes, which is prevented from being earned due to the interruption of production or suspension of business operations or services; (B) FIXED CHARGES, including administrative expenses, interest on fixed indebtedness, advertising, taxes other than income taxes, insurance, salaries or wages of officers and employees whose services must necessarily be continued or who are employed under contracts guaranteeing annual compensation, vacation, holiday and sick leave pay, expenses of heat, light, and power, selling expenses of the plant and

other items contributing to the insured's overhead expenses as a whole, to the extent only that such charges would have been earned had no interruption of production or suspension of business operations or services occurred

By contract with the earnings form, the gross earnings from approaches the calculation of the loss from a "tear down" process. That is, instead of starting with net profits and adding continuing expenses, you start with gross earnings and subtract those expenses which do not continue during the suspension. A typical policy form states that the company shall be liable for "the actual loss sustained . . . not exceeding the reduction in Gross Earnings less charges and expenses which do not necessarily continue." Gross earnings are defined as follows:

- A. Total net sales, and
- B. Other earnings derived from operations of the business, less the cost of
- C. Merchandise sold, including packaging material therefor;
- D. Materials and supplies consumed directly in supplying the service(s) sold by the Insured, and
- E. Service(s) purchased from outsiders, not employees of the insured, for resale which do not continue under contract.

Another method of defining gross earnings is:

GROSS EARNINGS shall be defined:

- (a) for manufacturing operations as the net sales value of production less the cost of all raw stock, materials and supplies utilized in such production; or
- (b) for mercantile or non-manufacturing operations as the total net sales less cost of merchandise sold, materials and supplies consumed in the operation of services rendered by the Insured; plus all other earnings derived from the operation of the business.

Both the earnings and gross earnings policies typically insure the salaries of key personnel, but not the ordinary payroll. Coverage for the ordinary payroll can be obtained under either form through the payment of an additional premium. If it is obtained, the insured can continue to pay his hourly employees even during the suspension period.

Both the earnings and gross earnings forms commonly contained limited extra expense coverage, sometimes referred to as "expediting expenses or expenses to reduce loss." This provision states that the insured shall recover expenses incurred following a loss, and arising out of the loss, but only to the extent that these expenses mitigate damages. Thus, securing alternate production or alternate facilities during the period of restoration would be an extra expense, but would be compensable under the policy only to the extent that the business conducted at the substitute facility serves to reduce the loss.

Another difference frequently found in relation to the earnings and gross earnings forms relates to the amount of coverage. In the gross earnings form, there is normally a single limit of liability with a specific coinsurance percentage based upon annual earnings. In the earnings form, there is a 30-day limitation. These distinctions are not applicable to all forms involving earnings or gross earnings, but are commonly encountered.

One common type of extra expense form includes the premium charges for overtime incurred in order to increase manufacturing output or meet existing contracts. If these charges are incurred during the period of suspension they are an extra expense to the extent that they reduce the loss. Even after the period of suspension there may be a "make-up of production" which will reduce the actual loss sustained. That is, the insured may have been able to delay orders for subsequent delivery and is then able to "make up" these orders after completion of the repairs which then reduces the loss. The expense incurred in the "make up" is covered "extra expense" to the extent that it includes premium overtime charges.

EXTRA EXPENSE

In addition to the extra expense coverage afforded under the earnings and gross earnings forms, the coverage can also be obtained without the limitation that it operate to mitigate the loss. This form can be used in conjunction with the earnings or gross earnings forms, or can be used alone. It is well suited to certain types of operations such as utilities or administrative offices. An example of such a clause is:

The term "extra expense", whenever used in this form, is defined as the excess (if any) of the cost(s) incurred during the period of restoration, chargeable to the operation of the insured's business, over and above the cost(s) that would normally have been incurred to conduct the business during the same period had no damage or destruction occurred. Any salvage value of property obtained for temporary use during the period of restoration,

which remains after the resumption of normal operations, shall be taken into consideration in the adjustment of any loss hereunder.

The extra expense coverage is normally qualified with language such as "reasonable and necessary extra expense in order to continue as nearly as practicable the normal operation."

The above three forms constitute the backbone of the business interruption coverages. They also contain the same general time coverages and exclusions. In some cases, the definitions and exclusions are merely a reinforcement of the insuring agreement itself and the fact that the business interruption must be the direct result of the physical damage rather than the indirect, remote or consequential result. The basic provisions are set forth in the following paragraphs.

PERIOD OF SUSPENSION

Since business interruption insurance is time element insurance, it is necessary to measure the specific time for which coverage is provided. The usual method is to establish a hypothetical period based upon the time which would be required with the exercise of due diligence to physically repair the damage or restore the property. A typical clause provides:

For only such length of time as would be required with the exercise of due diligence and dispatch to rebuild, repair or replace such party of the property herein described as has been damaged or destroyed, commencing with the date of such damage or destruction and not limited by the date of expiration of this policy

This clause has been interpreted in many cases which will be discussed in detail in a presentation following this. The key points are that the calculation of the time is based upon a physical restoration period rather than a return to normal sales level, and further that the calculation is hypothetical and can be made whether the insured repairs the fire damaged property, moves to substitute quarters or discontinues business. In any case, it is the hypothetical period which controls.

EXCLUSIONS

Some of the commonly encountered exclusions are described in the following paragraphs. These exclusions are not uniform, and may not be found in all policies. The absence of an exclusion, however, does not mean that the item is covered. Rather, the exclusion may simply restate a limitation already contained in the insuring agreement. The specific exclusions discussed are idle periods, finished product, law or ordinance, suspension of contract, etc., strike at the premises, and other remote or consequential loss.

IDLE PERIODS

This exclusion states that the suspension period shall not include any time during which the business would have been operated for some reason other than the loss, and typically provides:

This endorsement does not cover . . . any period during which goods would not have been produced, or business operations or services