RILEY ON BUSINESS INTERRUPTION AND CONSEQUENTIAL LOSS INSURANCES AND CLAIMS

SIXTH EDITION

David Cloughton

Sweet & Maxwell

Riley on Business Interruption and Consequential Loss Insurances and Claims

Sixth Edition

by

David Cloughton B.A., (Hons.)
FELLOW OF THE CHARTERED INSURANCE INSTITUTE;
Executive Director of
Willis Faber & Dumas (U.K.) Limited;
Awarded the Morgan Owen Medal
and Prize in 1973

LONDON
SWEET & MAXWELL
1985

First Edition	1956
Second Edition	1959
Reprint	1961
Third Edition	1967
Fourth Edition	1977
Fifth Edition	1981
Sixth Edition	1985

Published in 1985 by
Sweet & Maxwell Limited of
11 New Fetter Lane, London
and printed in Great Britain by
Robert Hartnoll (1985) Limited,
Bodmin, Cornwall

British Library Cataloguing in Publication Data

Cloughton, David.
Riley on business interruption and consequential loss insurances and claims.—6th ed.
1. Insurance, Business interruption
I. Title
368.8'15 HG8060

ISBN 0-421-31920-8

Riley on Business Interruption and Consequential Loss Insurances and Claims

AUSTRALIA AND NEW ZEALAND
The Law Book Company Ltd.
Sydney : Melbourne : Perth

CANADA AND U.S.A.
The Carswell Company Ltd.
Agincourt, Ontario

INDIA
N. M. Tripathi Private Ltd.
Bombay
and
Calcutta and Delhi
M.P.P. House
Bangalore

ISRAEL
Steimatzky's Agency Ltd.
Jerusalem : Tel Aviv : Haifa

MALAYSIA : SINGAPORE : BRUNEI
Malayan Law Journal (Pte.) Ltd.
Singapore

PAKISTAN
Pakistan Law House
Karachi

EDITOR'S PREFACE TO SIXTH EDITION

This Sixth Edition is the first which is not entirely the work of Denis Riley who first put pen to paper over 30 years ago to produce what has since become a very popular reference book, known to the world simply as "Riley."

Editing such an established work has its obvious difficulties—what to add, what to omit, what to amend, what to leave unaltered. However, I approached the task with three basic objectives. The first was to leave relatively unchanged the "philosophical" content of the book which is largely timeless in its application. The second was to introduce the changes or innovations that had come into the U.K. market since the last edition. The third was to develop further the comments on overseas market attitudes, methods, problems, etc., which Denis Riley had originally made.

I have not attempted to make any alteration to the U.S. Business Interruption Insurance references (other than to bring in a typical worksheet) or to comment on Canadian practices: in both cases, no significant changes appear to have taken place since the last edition.

As one intimately concerned for many years with consequential loss insurances throughout Western Europe I have utilised my experience and knowledge to make a considerable extension to paragraph 65. This now includes an in-depth study of the *modus operandi* of all the 15 countries in Western Europe with each separately indexed.

The Appendices have been expanded so that they now go through the whole of the alphabet from A to Z. A specimen Industrial All Risks wording was a necessity, as was that for Declaration-Linked. Other new Appendices are Advance Profits and Research Establishment specification wordings, a specimen Machinery Policy form and a simple U.S. Gross Earnings claims settlement.

One further slight change of emphasis may be seen in an attempt to move away from what might be called "tariff-based" approaches towards those of a wider market. The "rules" set out in various parts of the book relate to decisions made by the U.K. Consequential Loss Committee at a particular time, and although followed by the majority of those insurers who are not members of the CLC they are not necessarily universally applicable. The CLC in fact will cease to exist as from June 30, 1985, with the dissolution of the U.K. Fire Tariff organisation.

Apart from the foregoing, I hope that I have preserved and perhaps strengthened a work which has always been noted for its ease of reference and its essential readability.

April 1985 DAVID CLOUGHTON

PREFACE TO FIFTH EDITION

There are relatively few businesses which in the event of damage being caused by fire or other perils at their premises or possibly those of their suppliers or customers would not suffer financially either through a loss of trade or the additional expenditure involved during the period following the occurrence. Protection against such financial loss by means of consequential loss insurance—alternatively termed business interruption insurance—has developed progressively during the present century until it may now be said that in the United Kingdom it is taken out by practically all prudent business undertakings as an essential complement of their material damage insurances.

As a result there is a constant demand for information and guidance on the part of those concerned with affecting, maintaining or claiming under such insurances. Towards meeting this situation information beyond that in a students' textbook is required, exemplified by the statement from a leading insurance company that in 1978 over 40 per cent. of consequential loss claims had to be settled for less than the full amount of the loss. The need is for a book of ready reference on the subject for business people requiring immediate and practical answers to practical problems.

The present book is an attempt to meet that need and to deal fully yet as far as possible in a readable form with the principles, conditions and available scope of modern consequential loss policies—including the pitfalls—as related to the practical task confronting those who have to arrange, advise upon or supply information in connection with such contracts or the settlement of claims under them. It is hoped that accountants whether in private practice or in the employ of industrial concerns, company secretaries and directors, insurance brokers, underwriters, insurance company officials (particularly non-specialist fieldmen) and loss adjusters will find it of practical value as a book of quick and easy reference.

With this object in mind the method of numbered subject-paragraphs has been used. This combined with a compendious index in which the numbers of the principal paragraphs on any matter are shown in heavier type and cross-references are given in the text wherever it is considered they will be useful, makes reference both speedy and direct. Additionally the index includes paragraph references for a considerable number of trades, so that a person dealing with a particular firm's insurance may have his or her attention directed to any problems mentioned in the text as being specially applicable to the trade in which that firm is engaged. In the appendix specimens are given of policy forms and specifications only in current use and illustrations of claim settlement calculations are given to show the varying factors which are most frequently encountered in actual losses.

Of necessity there has to be a certain amount of generalisation in dealing with a subject of the complicated nature of consequential loss insurance and this carries attendant dangers. There are many diverse circumstances in the world of industry and commerce, accountancy practice varies considerably in the treatment of company accounts, and above all it is impossible to visualise all the unpredictable conditions which after a fire materialise in connection with any individual business. Hence it is essential to consider any such insurance in the context of the circumstances of the particular business and to apply the accepted principles in the ways which seem most appropriate, which may mean that one cannot always "go by the book."

As the general principles and conditions applicable to consequential loss insurance in many Commonwealth and other overseas countries differ relatively little from those appertaining in Great Britain, its contents should be a useful guide also for those who have to deal with insurances abroad. In furtherance of this certain additional information about and a specimen policy form applicable to consequential loss practice overseas have been included.

It is hoped that the book will also be of service in countries which are members of the European Economic Community, where the growth of bi-national and multi-national concerns operating across national boundaries, with factories in different countries, has added a new dimension to the conduct of consequential loss insurance. As in this and other ways commercial and industrial activities throughout western Europe become increasingly integrated there will be a growing need by practitioners and those who have anything to do with such insurances for knowledge of the principles and technicalities of the British system and the way it functions. The problems facing businessmen and insurers in the protection of profits are similar. As the United Kingdom has long been regarded as a leader in this specialised field of insurance some of our methods may well be adopted by insurers in Continental countries to their advantage pending the time when a standard European form becomes a reality.

What may be said of western Europe yesterday might be said of the world tomorrow as more and more nations expand in spheres of finance and industry to join the United States of America and Japan in having global interests which, in particular, are interdependent with industrial activities in the United Kingdom. Significantly in 1981 Japanese companies were operating seven factories in Wales alone.

The book is based on my practical, day-to-day experience over very many years as a Consequential Loss Superintendent of the Commercial Union Assurance Group. The present edition is a complete revision throughout the book to incorporate the considerable and important innovations in consequential loss insurance in recent years and also the effects of the current U.K. government legislation regarding contracts of employment.

A major change from previous editions is the incorporation of Chapters 6 and 15 and of several individual paragraphs, devoted entirely to business interruption insurance in the U.S. and Canada, and many other references to it throughout the book. This resulted from a request by the publishers who were informed that the existing material in this book would be very useful in North America if it could be expanded to include matters of special relevance to business interruption there by detailing and evaluating U.S. methods.

Although it may seem presumptuous for this to be undertaken by an "offcomer" I have been assured that an in-depth study which I have made following conversations with friendly insurance officials and information acquired during visits each lasting several weeks to North America that an expression of opinions by an outside observer would be received with open minds and welcomed. The comparisons made between their methods should be of interest and I hope of some help to those involved with profits insurances in many other parts of the world where the two forms—U.K. consequential loss insurance and U.S. business interruption insurance—compete for favour. In retirement one can look at problems objectively and my conclusion is that insurers in both countries can learn a good deal from one another's methods.

Finally I would express my thanks and indebtedness to the many friends engaged in insurance activities in the U.K., U.S., Canada and elsewhere whose help has been invaluable in the production of this Fifth Edition.

June 1981 DENIS RILEY.

CONTENTS

Appendices

CHAPTER 1

A METHOD OF MEASURING LOSS OF PROFITS —THE BASIS OF UNITED KINGDOM CONSEQUENTIAL LOSS INSURANCE

1. Loss of turnover

When buildings or their contents are damaged by fire or kindred perils, the condition and value of the property before the damage and the cost of its restoration or replacement are tangible factors on which can be based an assessment of the amount to be paid under the insurance covering them. What method of general application is there to ascertain for the purposes of protection by insurance the intangible, often hypothetical, loss which commences when the fire engines have driven away—the loss of future earnings?

Experience shows that the proportionate effects of a fire upon the earning capacity of a business can be readily and accurately measured, in most cases, by comparing the turnover in the months following the damage with that in the corresponding period in the twelve months preceding it, subject to appropriate adjustments for special circumstances or trends of business. For example, if a fire causes interruption of business throughout October, November and December the loss of turnover during those months can be found by means of a comparison with the turnover for October, November and December in the preceding year. In general, the loss of turnover during any other period, of whatever length, can be used as a yardstick for measuring the interruption of trading provided that provision is made for any necessary adjustments.

As turnover figures can usually be ascertained satisfactorily for each day or week, or at the outside each month, this method provides a sensitive index for measuring the proportionate effects of a fire without waiting until the end of a financial year. It also shows the loss sustained when the end of an insured's financial year falls within the period of interference, a loss which could not be ascertained by a comparison of the profit earned in each of the two years. For instance, if damage takes place three months before the end of a firm's financial year and the business is affected from that date until three months into the next financial year, there might be little or no difference between the profit earned in those two years although altogether something approaching six months' profit may have been lost. In circumstances of that kind a comparison of the profit and loss accounts cannot show the amount of loss sustained, but the shortage of turnover throughout the period of interruption is ascertainable and would provide an accurate basis for measuring the insured's loss.

Moreover, the use of turnover as an index provides for businesses of a seasonal nature in which sales are not constant throughout the months of the year and it is also suitable for businesses in which turnover is either increasing or decreasing because trends can be assessed for calculating the loss of sales consequent upon a fire.

2. How turnover can be used as a yardstick

But loss of turnover is not synonymous with loss of profit. How can the yardstick of turnover be used to assess the net effect of a fire upon the earnings of a business? In this way: each £ of turnover may be assumed to bear an equal share of:

(a) prime costs, conventionally entered in the first section of a trading account, such as purchases, whether for resale or for use in manufacture, productive wages, consumable stores, fuel for trade purposes, power, and other process charges. These may be described as variable or working expenses, that is, they vary proportionately with the rise or fall of turnover;

(b) overhead expenses such as administrative, selling and distributive costs which generally appear in the second section of a trading account and in the profit and loss account. Because they are not controllable as are prime costs they are for insurance purposes referred to as standing charges, a term which aptly describes their nature;

(c) the residual net profit.

Should turnover fall in consequence of damage by fire the prime costs will, by and large, be reduced proportionately and no loss will be sustained by the business under (a) above. Standing charges, however, as they do not vary directly with turnover will not fall proportionately; therefore in the event of a reduction in turnover (b) above will bear an increased incidence beyond its normal ratio. This relative increase in the amount of the standing charges will have a corresponding inverse effect by reducing the residue (c) above, that is, the net profit. At the same time there will be a concurrent loss of net profit taking place due to there being a smaller volume of turnover on which it can be earned.

However, if compensation is provided by insurance during a period of interruption caused by fire, for the amount of (b) and (c) normally borne by each £ of turnover, on every £ of turnover lost, the revenue of a business will be restored to the extent necessary to cover the normal amount of standing charges and net profit.

3. Basis of consequential loss insurance

The simple principle that reduction in turnover after a fire is a reliable guide to and a suitable index for measuring the proportionate effect of the fire upon the earnings of a business, and that the actual loss can be ascertained by applying to this reduction the ratio which standing charges and net profit together normally bear to turnover, is the basis of most of the consequential loss insurance transacted in the United Kingdom.

As the ratio of variable charges to turnover is generally constant the balance of charges and net profit combined must also be constant even though the relative proportions of the latter two may vary. Recognition of this factor is given for insurance purposes by dealing with "gross profit," that is, net profit and standing charges combined instead of treating them separately. The effect is the same whether gross profit is defined in the policy in that way or as being the amount of turnover less variable expenses as explained in para. 4.

A U.K. consequential loss policy undertakes to provide an indemnity for the loss during a period of interruption after fire. So far as the loss due to reduction in turnover is concerned the policy agrees to pay, on the amount of turnover lost, the percentage which the gross profit insured bore to the turnover in the last financial year before the fire. This percentage is called the rate of gross profit but it is necessary to explain at the outset that the definition of gross profit given in the policy attaches to it a meaning which generally differs in several respects from the gross profit shown in the accounts of a business. A more detailed explanation as to how and why it differs is given in later chapters. It may however be stated at this point that some portion of the direct costs in the trading account, such as wages or power, might for various reasons require to be included in the insurance on gross profit. On the other hand it may be unnecessary to insure some items shown in the profit and loss accounts, such as discounts allowed and agents' commission, which will vary proportionately with a fall in turnover.

The method just described for providing an indemnity embodies one fundamental and important difference between U.K. consequential loss and U.S. business interruption insurances. In the latter the indemnity for loss of gross earnings (the counterpart of gross profit) is described as the "actual loss sustained" without stipulating reduction in turnover or any other yardstick as a basis for calculating a loss; see para. 92.

4. Old and new definitions of gross profit

From the inception of this form of insurance the accepted method of determining and defining insurable gross profit was by the addition of the amount of the standing charges to the net profit. But in the late 1950s a simpler method was introduced in which the total of the variable expenses is deducted from the turnover. This innovation necessitated a new definition of insurable gross profit which is in a sense a reversal of the traditional one. The latter started at the end of the accounts with net profit and added back the amount of the insurable standing charges. The new one starts at the head of the accounts with turnover—the money receivable for goods sold and services rendered—and then deducts the total of the variable charges, the difference between the two amounts being the insurable gross profit. Hence the newer specification wording in which the "turnover less variables" definition of gross profit is used is called the "difference" basis and because it is a more logical method and generally a simpler one it has become standard practice for insurers to recommend it wherever appropriate.

But as the "net profit plus standing charges" form is still in use in the U.K. and more so abroad and in the Canadian "Profits" form it is necessary to keep in mind that whilst the two methods work on the same basic principles and produce the same end-results in claims they treat gross profit from opposite directions. The variable charges which in a difference definition of gross profit are termed the uninsured working expenses are the reverse of standing charges. An alternative name for them which is often used is specified working expenses but, since all expenses in the manufacturing section of accounts which may normally be thought of as working expenses are not necessarily variable charges for the purposes of a consequential loss insurance (for instance, see para. 203 on power and para. 204 on fuel), the term uninsured working expenses seems preferable in order to avoid misunderstandings.

Whether the old or the new definition of gross profit is used in a specification it is necessary to understand why the various charges incurred in the running of a business are or are not, as the case may be, to be included in the insurances of different businesses. They will be dealt with accordingly in subsequent chapters so as to give guidance for application under either definition.

5. How consequential loss insurance works

At this point a very simple illustration may be useful to show how under a consequential loss policy the basic principle of measuring the loss resulting from damage by fire—application of the rate of gross profit to the reduction in turnover—restores an insured's financial result at the end of a period of interruption, *i.e.* the net trading profit, to what it would have been but for the fire. *(The illustration is on the opposite page.)*

6. Increased ratio of standing charges

Mention was made in para. 2 that a reduction in turnover will affect net profit in two ways. The more obvious is that with a smaller volume of business on which net profit can be earned there will be a corresponding reduction in the amount of net profit. But the more serious aspect may be the increased ratio of standing charges caused by the reduction in turnover because that will automatically reduce any net profit earned by the turnover maintained and may not only cancel it out but be sufficient to create a net trading loss.

It will be appreciated that in this way a heavy loss due to the increased incidence of standing charges for even a limited period of two or three months could offset the whole of a year's net profit or possibly result in a trading deficit. The following simplified illustration of the effects of a fire shows how this might arise.

Accounts for last financial year preceding a fire

	£		£
Purchases	36,000	Sales	100,000
Productive wages etc	40,000		
Overheads	16,000 } rate of gross		
Net profit	8,000 } profit 24%		
	100,000		100,000

Accounts for 12 months during which a 50 per cent. reduction in sales has resulted from the fire

	£		£
Purchases	18,000	Sales	50,000
Productive wages etc	20,000	Consequential loss insurance claim: rate of gross profit (24%) applied to the reduction in turnover (£50,000)	12,000
Overheads	16,000		
Net profit	8,000		
	62,000		62,000

On an annual turnover of £200,000 the variable charges are £140,000 (70 per cent.), the standing charges are £50,000 (25 per cent.) and the net profit is £10,000 (5 per cent.). Fire causes an interruption of business during six months of the year resulting in a loss of turnover amounting to £72,000. The actual loss due to this is, therefore, 30 per cent. (non-variable charges 25 per cent. and net profit 5 per cent.) on the shortage in turnover (£72,000), namely £21,600, more than twice the normal annual net profit.

For a more detailed illustration of such effects of a fire, see the claim illustration set out in Appendix V, para. 504 which shows how a 50 per cent. reduction in turnover in twelve months can wipe out the net profit which it would take more than three years of normal trading to earn.

This potential loss due to an increased incidence of standing charges after a fire makes it essential to have the protection of a consequential loss or business interruption policy even during a time of adverse trading. Some businessmen are apt to think that such an insurance can be dispensed with when trading conditions are difficult and economies in overheads are necessary or that such a policy must be valueless when a business is running at a loss. Accountants in particular will understand the fallacy of such a line of thought and also that the effect of a small trading loss resulting from a fire, which would be relatively unimportant when good profits are being made and act as a cushion, can be most serious during a difficult trading period when no profit is being earned.

7. Compensation for additional expenditure

Interruption of trading which follows damage by fire or other perils generally involves additional expenditure of one kind or another with the object of minimising the loss of turnover and restoring normal conditions as quickly as possible. Any insurance which is intended to give an indemnity for loss consequent upon such damage must therefore provide compensation for additional expenditure undertaken to reduce the prospective loss of turnover during a period of interruption.

Without provision being made for the additional expenditure insurers would benefit through their insured's action whilst the latter would suffer the loss of the amount incurred. In practice such additional expenditure is generally of considerable amount and because of its effectiveness frequently exceeds the loss arising from reduction in turnover.

Consequently provision is made in the policy as explained in para. 39 for the payment of increase in cost of working. This rounds off the indemnity provided for loss of gross profit and the broad lines of the traditional U.K. consequential loss insurance may be summarised as giving compensation for:

(i) loss of net profit due to shortage in turnover;

(ii) loss due to the increased ratio of continuing charges to a reduced amount of turnover;

(iii) loss due to additional expenditure incurred with the object of minimising the effects of the damage on turnover.

The alternative way of stating this for an insurance where the definition of gross profit is on the modern difference basis would be compensation for:

(i) loss of net turnover *i.e.*, turnover less purchases and other variable charges;

(ii) loss due to additional expenditure incurred with the object of minimising the effects of the damage on turnover.

As mentioned in para. 3 a U.S. business interruption coverage contracts to indemnify for the "actual loss sustained." Under an Expenses to Reduce Loss clause it "also covers such expenses as are necessarily incurred for the purpose of reducing loss under the policy" (para. 96) on the same principle as the foregoing U.K. provision.

8. "Loss of profits," "consequential loss" or "business interruption" insurance?

The foregoing paragraphs give point to the term "consequential loss insurance" which over the years has superseded the use in the U.K. of the original nomenclature of "loss of profits insurance." The latter tended to direct thought too exclusively towards net profit and although protection of this may be the fundamental purpose of policies they are directly concerned with other matters such as directors' remuneration, salaries and wages, standing charges and additional expenditure which are generally of much greater amount and are of vital importance in arriving at net profit. There are also many additional items and extensions of cover available today which in