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BUSINESS INTERRUPTION INSURANCE BASICS

Some say that climate change is responsible for recent catastrophic events such as Harvey in Houston, Irma in Florida, María in Puerto Rico and a devastating earthquake in Mexico City. Although humanity is responsible for climate change, there is no single entity or individual accountable for making whole all injured parties. However, these events have not only led to the loss of life, homes, and even mental health but also to economic damages, including financial devastation in businesses. While businesses have urgency to resume operations after catastrophic events, in reality they may not even be able to do so for quite some time. That leads lost business benefits; yes, sort of like the lost net income during the time period the business did not operate after the catastrophic event.

Businesses that only carry a property and casualty insurance policy will have to self-finance the expenses incurred while shut down and will probably never be able to recover the lost income. On the other hand, those businesses that carry business interruption (BI) insurance must file a claim with the insurer to recoup the losses. Insurers, however, are for profit businesses that focus on their bottom lines; thus, while they do add value to society as risk sharers, they will try to minimize the disbursements related to the payment of business interruption claims. As such, businesses that maintain BI policies must understand the elements of their claims and other factors in order to ascertain that they get a reasonable result after placing their claim.

BI FUNDAMENTALS

Business interruption damage calculations are one of the most complex and challenging tasks that professionals face and are burdensome tasks for in house executives and entrepreneurs to handle on their own. Typically, BI claims take a long time to resolve because the full extent of the loss is normally not realized for some period of time. The ultimate objective of a BI insurance claim is that the insurer pays for the policyholder's lost profits, direct expenses and continuing expenses so that, financially speaking, it will be as though the policyholder had not suffered a loss. There are certain restrictions to recoupment based on the insurance contract, including deductibles and co-insurance; these are technical aspects that you must understand prior to filing a claim and which I will address in other articles.

Despite the technical aspects of loss calculations, you must first identify which type of policy covers your BI. Generally, there are three types of coverage for business interruption insurance, namely:

- **BI Insurance:** the underlying coverage on this type of policy is intended to compensate the policyholder for the lost income and the direct losses incurred; the period covered is the time that it takes to repair the physical damages so that the insured can resume operations.

- **Extended BI Insurance:** as a general rule, this type of BI policy covers the income lost after the physical damages are repaired but before the income level reaches its pre-loss levels. For instance, once the business is fully operational, it may take some time before revenues and profitability reach the pre-event level, which implies that there are additional lost profits caused by the event.

- **Contingent BI Insurance:** this type covers the policyholder's loss of profits resulting from physical property damages suffered by its suppliers and/or customers.

PROVING THE LOSS

Most BI insurance contracts require that the insured file a detailed "proof of loss" within a short period after the loss takes place. Upon completion of a preliminary analysis, the insurer develops a loss estimate to establish a loss reserve. As a general rule, insurers will try to negate responsibility in excess of the reserve established after this process. This is precisely the reason why policyholders must document the losses and develop accurate and comprehensive estimates at the time the proof of loss is filed.

Estimating damages with a reasonable degree of accuracy in the early stages demonstrates to the carrier that the insured is acting in good faith and supports requests for advance payments. As such, quantifying continuing and non-continuing costs is a critical issue to address early on in the process as most business interruption policies compensate the insured only for the former. In other words, to calculate recoverable lost income, you take lost sales and then subtract non-continuing costs as those are not actually incurred in the loss period. As a simplistic example, consider a retailer that was not able to operate for 4 weeks after a hurricane that damaged its site and that projected revenues for that period, based on prior history, would have been $100,000. If the cost of goods sold in that retailer represents 70% of revenues, then starting point in the calculation would be $30,000 and not $100,000 as the cost of goods sold will typically be classified as a non-continuing expense.

For some businesses the process to estimate the lost profits will be a difficult one as they do not maintain adequate accounting records. Furthermore, businesses that report significantly lower profits in their tax returns may not be able to justify to the insurer its lost profits if the adjuster gets truly technical. As you can probably guess, any and all information that is relevant to your claim should be provided to the insurer or at least identified, copied and kept in a file to eventually use in the process. Documents to gather will range from historical production and sales records to annual budgets and forecasts. Some of the documents that businesses must gather to prove the losses may include:

- Monthly Profit and Loss Statements
- General ledger reports
- Audited Financial Statements (if available)
- Income Tax returns (seldom requested by insurer)
- Bank Statements
- List of employees, with their corresponding compensation and job descriptions
- Monthly and Daily Production Reports
- Monthly Inventory
- Monthly Cost Accounting Reports
- Invoices and Purchase Orders

Each industry or business is certainly unique. For manufacturing operations, it is important to provide the typical production days and actual production days, noting normal maintenance or downtime, whereas a retailer should keep documentation sufficient to estimate mark-ups and markdowns along with inventory turnover and inventory obsolescence.

One of the first steps in the calculation of lost profits is to estimate sales not generated due to the event. Having historical sales that are on an upward trend would provide excellent support for using a growth trend in your sales calculation. Also, having budgets or sales forecasts that are close to actual results is helpful. The key in developing a lost sales projection model is to present an analysis that is consistent with the anticipated business environment during the loss period.

INSURED BEWARE

Your insurer will have someone who specializes in BI claims and who is knowledgeable in both accounting and insurance basics. You should expect a high degree of audit skepticism coming from this individual. You should also expect that they would handle your claim within the general rules that govern auditing standards. This would include treating you and your claim with due professional care, technical proficiency, and effective communication while serving the interest of their client, the insurance company.

Since your insurer will have a professional adjuster and/or an experienced accountant on its corner, you should take steps to ascertain that you are treated fairly. As such, you may want to consider these suggestions:

- Hire your own professional and independent accountant to help you prepare the claim and anticipate questions from the insurer.

- Identify one key contact within your company to deal with the insurer's adjuster and the entire process.

- Ask for a written document request by the insurer's accountants to avoid confusion over what has or has not been requested.

- Ascertain that the insurer's adjuster or accountant understands your business so that he or she can better apply the methodologies to estimate lost profit.

- Maintain a log of information provided during the process to avoid re-sending information that has already been provided.

- Prepare a well-documented comprehensive claim, which includes source documents that are consistent and referenced. You may wish to hire a professional for this endeavor.

WRAP IT UP

Once you have compiled all necessary documents and prepared your claim, you submit it to the insurer. By this time, your claim should be a stand-alone or self-sufficient document with an audit trail, which means that it has references to source documents. Remember that the claim will be reviewed by the insurer, the adjuster, possibly an insurer accountant and even your insurance broker. Therefore, the claim should be self-explanatory. Finally, keep in mind that the ultimate user of the claim document may very well be a Court of Law.