ADJUSTING
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Adjusters International Disaster Recovery Consulting

EDITOR'S NOTE

Today, there are few things companies whose operations encompass multiple locations won't do to stay connected. Much attention is paid to items that support and underscore the affiliation and interdependence of each site on the other — and ultimately on the whole.

Unfortunately, that same priority is not always given the firm's insurance program, especially when it comes to understanding and addressing the coverage that recognizes that interdependency — and how a loss at one facility can have a dramatic, unforeseen impact on the overall income of the business even though each site seems to be properly insured.

Blanket business income insurance is that coverage, and it is the subject of our feature article in this issue of Adjusting Today.

Veteran public adjuster Randy Goodman takes an informative look at the matter, using examples to point out how and why this coverage is too frequently overlooked by even experienced insurance brokers, buyers and risk managers — and how it was a lifesaver to one business that had the right program in place.

Mr. Goodman's article also includes some sound, basic information and suggestions on business income insurance, and is accompanied by a short piece that can help project the levels of business income insurance a firm might need.

More than interesting, this issue is must reading for anyone involved in developing or maintaining an insurance program aimed at adequately protecting an organization with multiple operating sites.

Sheila E. Salvatore
Editor

Valuing Business Income Exposures:

A Case for Blanket Business Income Insurance

By Randy H. Goodman, SPPA

It is a well-known fact that a substantial number of businesses never fully recover after suffering a major property loss and interruption of their business operations. While there may be a reasonable recovery of the loss of physical property, there is all too frequently insufficient, if any, "time element" insurance in place to protect against the interruption to operations. So while many expenses continue during the interruption, there is inadequate, if any, insurance in place to pay these ongoing expenses and the lost profits when operations are suspended.

"Time element" is a term used to describe the group of coverages that, rather than covering direct physical damage to property, apply to loss of income, loss of profits, increased costs to sustain operations, loss of rental income, and similar losses, when premises are damaged by an insured cause of loss. Our concern within this article is with "business income" (formerly known as "business interruption" and before that as "use and occupancy") and "extra expense" insurance.

It is a fairly simple matter to arrange appropriate time element coverage for a typical small or medium-sized business, normally with one location — a store or factory, an office or perhaps a warehouse. As we shall see in a moment, however, that procedure becomes a bit more complex when comparable protection must be arranged for a firm operating multiple sites. But before we get to that, let's look at the fundamental valuation and coverage issues that should be taken into consideration in establishing a sound program at any level.

Coinsurance vs. Agreed Value

A frequent disappointment experienced by insureds following a business income loss is the imposition of a coinsurance penalty. The coinsurance clause requires the insured to carry an amount of business income insurance equivalent to a stipulated percentage (most commonly 50 percent – 80 percent with ordinary payroll excluded) of the insurable business income value for the policy year. For an expanding business, the insurable value may quickly outgrow the amount of insurance established as adequate at the start of the policy year. Unless the amount of insurance has been increased during the year, a loss later in the year will result in inadequate insurance. Even with a modest loss, a coinsurance penalty (i.e., reduction of the payment of the loss in proportion to the deficiency) would result.

> *"A frequent disappointment experienced by insureds following a business income loss is the imposition of a coinsurance penalty."*

Note also that in the gross earnings business interruption forms, which preceded the business income forms and are still used by some insurers, the basis for coinsurance is the value for the 12 months following start of the business income loss (as opposed to the 12 months of the policy year defined in the business income form). For a growing business, unless the values are reviewed throughout the year and adjusted as needed, an even greater coinsurance penalty can result than under the business income forms.

An alternative to insuring with a coinsurance clause is the agreed value option, which waives the coinsurance clause for one year if agreed statements of business income values are filed each year and the appropriate amount of insurance is carried, based on these values. In effect, this coverage option will avoid a coinsurance penalty, but not without its own potential drawbacks:

1) The insured must maintain the amount of insurance called for by the statement of values filed to waive coinsurance. Even if the insurable earnings fall during the policy year, the amount of insurance may not be reduced below the original amount required without incurring a penalty for the deficiency in event of a loss. In order to reduce the amount of insurance in such cases, a new statement of values extending

the agreed value option on the revised values is called for.

2) If the new statement of values is not filed on time, the coinsurance requirement applies until a new agreed value filing is made. Again, in a growth business, an insured can outgrow the current amount of coverage — and any loss after the expiration of the agreed value option will almost certainly result in a coinsurance penalty. When the agreed value option is used, great care should be taken to be sure that valuations are accurate and that subsequent filings are made at renewal or when otherwise required.

Blanket Coverage — the Answer for Complex Businesses

When a business is more complex, involving two or more "fire divisions" (separate but adjoining structures, each with its own property insurance rate) or locations, the problem of arranging adequate business income insurance also becomes more complex, requiring that the agent, broker or insurance consultant have a full understanding and appreciation of the insured's business operations.

"...blanket insurance responds as if the entire company, regardless of the number of locations, were under one roof."

The most basic method of insuring such an operation is to have a separate item of coverage — each with its own limit of insurance — for each separately rated fire division or location. This works well when there is no overlap or interdependency among any of the locations. However, where interdependency exists, problems can arise. These problems can best be resolved though the use of "blanket" insurance: a single limit of insurance covering the combined business income exposure of all locations.

The blanket method of insuring the business income exposure for organizations with more than one location should always be contemplated and often recommended by the insurance consultant — especially when the various locations of the business operations are interdependent upon one another. Failure to recognize and identify this interdependency can severely reduce the insurance recovery.

A good example of this potential exposure would be a retail business with five separate and distinct locations from which retail sales are made. All five locations are constantly supplied with inventory that is stored by the business initially in a warehouse at a sixth location at which no retail sales are generated. If the business should sustain a property damage loss at the warehouse — reducing or eliminating the company's ability to provide inventory to their retail outlets — sales would be drastically reduced at the five retail locations. If specific insurance were provided at each location, the insured might not collect for their business interruption losses at the retail locations resulting from the physical damage at the warehouse — particularly if the warehouse operates as the parent company, with the retail stores as subsidiaries not named as additional insureds on the parent's insurance policy. This is a common scenario.

If instead, a blanket business interruption insurance policy was purchased, indemnification for the retail locations would be provided because blanket insurance responds as if the entire company, regardless of the number of locations, was under one roof. The physical damage sustained at the warehouse would be the trigger for the insured to make claim for business interruption/ extra expense losses sustained at all five retail locations. Again, this assumes commonality of insurable interest between the stores and the warehouse.

"Caution must be taken in establishing the blanket limit of liability. The limit should be established by computing the total values for the entire operation at all locations, not by using the highest value at any one location."

It is sometimes incorrectly assumed that the warehouse need not be named as one of the blanket locations since sales are not generated directly from the warehouse. I have seen instances where coverage was provided on a blanket basis for the five retail locations, without including the warehouse location. This mistake can be as costly as not providing any blanket coverage at all.

There are additional benefits available to the insured if blanket coverage is in its place. The entire blanket limit of liability becomes available to the insured for a loss at any single location, thereby providing additional coverage for both property and time element losses that would otherwise be unavailable if specific amounts of insurance were written instead. If the values for any listed specific location are less than what is actually required for that location — but the values for the aggregate locations are adequate — then the coverage from the other locations can help eliminate an underinsurance problem at that specific location.

Caution must be taken in establishing the blanket limit of liability. The limit should be established by computing the total values for the entire operation at all locations, not by using the highest value at any one location. The coinsurance requirement will be applied based on the insured's overall values at all locations and not just at the specific location that sustained the physical damage. The use of an agreed amount endorsement will significantly simplify any loss adjustment, since operating results at all locations are not taken into account.

It is ironic at times how some insurers approach loss adjustments for businesses with multiple locations which they have not insured under a blanket policy. If the business sustained a loss at one location, many insurers believe that the business would be entitled only to make claim for business interruption losses sustained at that location, and that it would not be entitled to make claim for a falloff of net profit at the undamaged locations which were insured separately.

Nevertheless, the insurers often want credit for any additional sales that may be generated from the undamaged location or locations, even though they maintain that the insured would not be entitled to a claim for lost sales at any undamaged location. This problem is, of course, eliminated with the use of a blanket limit of liability policy.

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A Case Study

As professional loss consultants, we represented a major railroad freight company that experienced both property and time element losses arising out of the Midwest Flood of 1993. Their case serves as a striking example of both the importance and necessity of blanket coverage.

Because this specific railroad transports freight throughout the United States through its integrated railroad network, disruption in any one area can ultimately affect all links of their highly interconnective system. Following the flood of 1993, congestion and delays were experienced by this railroad — not only over physically damaged lines in the Midwest — but also throughout their entire system.

The railroad's risk manager, in conjunction with their insurance broker, designed and had in place an insurance program that incorporated blanket property and business interruption/extra expense coverage for all locations. It became apparent during the adjustment process that this good wisdom and foresight in the development of the blanket insurance program was

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critical to the successful resolution of the claim.

Initially, the adjusters and forensic accountants representing the insurers approached the measurement of the business interruption/extra expense claim by requesting that the railroad identify only those costs associated with the detouring of trains around rail lines physically damaged in the flood. It was their belief that if you could identify the costs associated with moving trains from point A to point B following the flood, and subtract those costs that would have been incurred by moving trains from point A to point B had no flood occurred, you would have measured the full extra expense loss.

This approach to the loss would certainly have measured a portion of the extra expense losses experienced by the railroad, but it would have failed to capture all of the extra expense losses experienced as a direct result of the physical damage caused by the flood. A full understanding of the insured's business and an appreciation for the global effects of the disruption concluded that the financial impact of the flood's physical damage went far beyond the costs exclusively related to detours and re-routes around the damaged rail lines.

It was necessary to provide the insurers with a full explanation of what caused a line to become congested and, as such, what expenses were triggered relative to the delays.

Consider a single-track railroad between two points with a given number of sidings (bypass points for meeting and passing trains). In normal operations, scheduled trains could move over the rail line with minimum delay when meeting and passing each other. With increased train movements over this line, as was the case following the flood, delays began to mount, as sidings became blocked by trains awaiting a route, a crew, or a locomotive. It became impossible to maintain a train's scheduled route because of the reduced number of available points to meet or to pass other trains.

The result was severe service deterioration for all trains moving on the route, including the local trains that were assigned to do work for the customers along the route.

When extending this single-route congestion over the entire interconnected rail system, the additional costs began to escalate. Delays experienced in the Midwest caused delays throughout the entire system. This phenomenon led to a substantially increased cost for fuel, personnel, locomotive hire and many other expenses throughout the entire system.

"If proper care is taken in the analysis of time element coverage, a majority of unrecoverable losses can be avoided."

Fortunately, the blanket time element provisions of the railroad's insurance policy included coverage for extra expenses. This coverage allowed the insured to recover "the excess of the total cost during the period of restoration of the damaged property chargeable to the operation of the assured's business, over and above the total cost that would normally have been incurred to conduct the business during the same period, had no loss or damage occurred."

With consideration for this extra expense definition — and the blanket coverage — we believed that to appropriately analyze the claim, a projection needed to be made for what the railroad would have achieved financially had the flood never occurred. By so doing we identified not only the lost net profit but also all aggregate costs that exceeded those that would have been experienced by the operation in the absence of the flood.

An added benefit for the insurers was derived by analyzing the claim in this manner. It not only allowed the insured to identify those line item expenses that exceeded the projected normal expense during the period of restoration, it also assured that saved expenses, in alternative categories, were identified and considered.

The insurer could be confident that the level of indemnification which was established was in line with the terms and conditions of the blanket policy of insurance. This global approach to the claim calculation was eventually adopted and accepted by the insurers in their claim analysis.

It is imperative when developing insurance programs to understand the business being insured so that appropriate coverages are in place when they are needed. The development and implementation of the blanket insurance policy for this insured was the most important factor in allowing them to be fully indemnified for the losses they incurred. The blanket coverage allowed the insured to measure the financial impact of the flood throughout its entire operation. In the absence of blanket coverage, this railroad company could not have been indemnified for the majority of

"It is imperative when developing insurance programs to understand the business being insured so that appropriate coverages are in place when they are needed."

the losses that it experienced as a result of the flood.

If proper care is taken in the analysis of time element coverage, a majority of unrecoverable losses can be avoided. This case is an excellent example of how proper care in analyzing the insured's exposures and coverage needs — and then making sure the right coverages were in place — avoided a serious problem.

If similar care were taken in designing every company's insurance program, unrecoverable losses could be avoided. More active promotion and explanation of such valuable coverage as blanket business income would also raise confidence in the insurance community's ability to respond to the needs of the insuring public.

Determining Insurable Business Income Values:

Establishing Potential Exposures — Do a Worst-Case Scenario

Under actual loss conditions, many unforeseen problems can arise. Remember that there seems often to be a "Murphy's Law" at work; that losses tend to occur at the worst possible time and under the worst possible circumstances, so the worst-case scenarios should be considered (it is better to be a little pessimistic than unduly optimistic). Among the many factors that should be considered are:

- In the worst scenario, how long will it be before the premises can be rebuilt and reoccupied?
- Could alternate premises be found and used either temporarily or as a permanent replacement? How quickly?
- How quickly can replacement equipment be located and installed?
- Are there seasonal variations either in production or sales volume, or in the time needed to restore occupancy, or both?
- If seasonal stock is lost at a critical time, can replacement stock be found to get back into operation quickly?
- If rapid replacement of equipment would be difficult, can temporary alternative equipment be substituted? Will there be a loss in efficiency, with a higher operating cost?
- Can operations be resumed quickly at another site? At what probable cost?
- How long after operations are restored will it be before the flow of business is restored to its former level? What are the added costs, if any, of advertising, special incentives, etc.?

Time Element Coverage: Some Choices

With the results of such a study, the various impacts can be quantified and costs projected to determine the appropriate amount of coverage to purchase. The type of coverage should also be carefully evaluated to be sure that optimum coverage is provided. Following are the typical choices of time element coverages:

1. In the worst-case scenario, if operations can be fully restored and back to normal within a four-month period (which is rarely the case), consider the Maximum Period of Indemnity option of the Business Income form.
2. For operations that might take longer than four months to restore, use business income insurance with coinsurance or the agreed value option.
3. If operations are to be maintained with little or no interruption, but at a higher cost, consider extra expense insurance. Along with this, have a "worst-loss" disaster plan laid out that can be implemented

immediately after the loss to maintain and restore operations quickly.

4. If, in the worst case, interruption of operations cannot be avoided but can be resumed earlier by expending extraordinary costs — possibly more than any business income loss that would be experienced — combined business income with extra expense coverage should be the choice.

5. If it would take more than an additional 30 days after restoration of the damaged property to return the business to the operational condition that existed prior to the loss, consider purchasing an extended period of indemnity longer than the 30-day basic extended period incorporated in the business income coverage.

Other Considerations

Whenever a coinsurance or agreed value clause is used on business income insurance (generally a requirement with blanket coverage), determining the correct insurable business income values is critical. Moreover, there are some significant differences between general accounting practices and terminology, and those applying to business income valuations, especially for manufacturing firms.

With either coinsurance or agreed value policies, a statement of business income values must be filed periodically (annually with agreed value). This form must be carefully completed. With coinsurance policies, underreporting of values can lead to severe underinsuring. The result — a coinsurance penalty on the business income loss if enough insurance is not carried — will be even greater if business income values increase after the effective or anniversary date of the policy and before a loss occurs.

With the agreed value policy the statement of values becomes a part of the business income policy. This statement sets forth the business income values to be insured, which are agreed to in advance by both the insured and insurer, thereby eliminating the coinsurance clause. (Note that a new statement of values must be filed annually by the required date in the agreed value clause. If the statement is late or not refiled, the coinsurance clause will apply until a new statement is filed, extending the agreed value clause for another year.)

For manufacturing firms, business income is based not on annual sales but on annual "sales value of production;" a concept not commonly used in

> ***"For manufacturing firms, business income is based not on annual sales but on annual 'sales value of production;' a concept not commonly used in normal accounting."***

normal accounting. Sales value of production is the value of goods produced in the year, rather than the amount sold, and is computed by adding the beginning of the year's consumable inventory to annual sales and subtracting end-of-year consumable inventory.

Note that this method of insuring business income for manufacturers leaves the profit from sales of destroyed finished inventory uninsured. To compensate for this shortfall, a manufacturer's selling price (or finished goods) clause should be included covering the business personal property. Also, the property insurance limits should be adjusted to value the goods at selling price, less any customary discounts and unincurred costs (packing and shipping costs, etc.).

When a manufacturer's insurance program incorporates both sales-value of-production business income coverage and a selling-price endorsement for finished stock, the insurance company may seek to reduce the business income loss by applying a credit to the measured sales value of production loss for the "margin" attained through the payment of the selling price claim for the finished stock. This "duplication of coverage" issue occurs when a loss simultaneously affects both finished stock and the ability to manufacture, but would not come into play if only one of those components was affected in a loss.

"With either coinsurance or agreed value policies, a statement of business income values must be filed periodically (annually with agreed value)."

Another variation from normal accounting methods found in business income claim calculations is the treatment of "cost of goods sold"— the deduction taken from sales to arrive at the insurable business income values. For business income values, only costs for materials, raw stock or purchased inventory, and supplies consumed in the manufacturing process are deducted. For manufacturing risks, the manufacturers and their accountants frequently include as part of the "cost of goods sold," the labor costs incurred in converting raw materials to finished goods, for unpacking and shelving goods, etc. These significant direct labor expenses (as well as utilities, depreciation and others) should be removed by insurance consultants from "cost of goods sold" and viewed as operating expenses in determining insurable business income values. Failure to do this can result in an understatement of business income values, effectively creating coinsurance penalties for an insured.

> **"With blanket coverage, the parent and all subsidiaries can be included together and their combined values insured without duplication."**

One of the great advantages of blanket business income insurance is the avoidance of the duplication of values when there is interdependency among separate locations. This is particularly true with a parent company that has subsidiaries. With specific coverage at each location, the total value generated at each location — including spill-over value at other dependent locations either "upstream" or "downstream" from the location — must be included at each location. With blanket coverage, the parent and all subsidiaries can be included together and their combined values insured without duplication. A common method used to project all interests on the policy is to insure "SES Corporation [parent] and all subsidiary or affiliated companies [and/or partnerships], as interests may appear."

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