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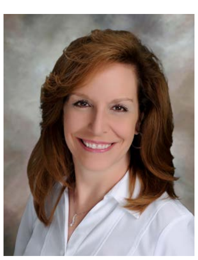
FROM THE EDITOR

Business income insurance — also known as business interruption coverage — can be critical not only to a company's prosperity, but to its very survival. It protects the business against loss of income due to a slowdown or temporary suspension of operations stemming from damage to physical property.

This complex coverage is also discussed in Adjusting Today *#3013, "A Case for Blanket Business Interruption Insurance" and #3048, "Business Interruption Coverage Times Three" (Prepare for Overlapping and Contrasting BI Provisions Under Property, Equipment Breakdown and Cyber Policies).*

This issue focuses on eight challenging questions that have been asked of our professionals. The answers combine the insight of two prominent insurance experts — the late Paul O. Dudey, CPCU, original author, and Joseph H. Harrington, CPCU, who has updated and expanded Mr. Dudey's responses.

The reply card enclosed with every issue of Adjusting Today *invites you to submit questions and suggest topics to be covered in the future. We look forward to hearing from you!*



Sheila E. Salvatore
Editor

SPECIAL ISSUE

Questions About Business Income Insurance

By Joseph S. Harrington, CPCU
Paul O. Dudey, CPCU

Q ***Would you please explain the difference between adjusting a retail claim on a selling-price basis versus using ordinary business interruption (business income) insurance?***

ANSWER: Under standard property and business income forms, without a selling price provision or endorsement, a loss to stock would be settled on an actual cash value or replacement cost basis. Any lost profit from lost sales would have to be recovered under business income coverage.

If you add a manufacturer's selling price endorsement (or incorporate an equivalent provision), the loss would be settled on that basis. In that case, any allowance in the selling price for an insured's profit would have to be *deducted* from business income payments.

Q: How does one adjust a business income claim when the insured business is losing money?

ANSWER: It's really no different than a claim settlement for a business that is turning a profit. It's just a matter of determining how much larger a deficit is than it would have been if there had been no insured loss.

The basic calculation is the same. A business income loss is determined by combining the normally expected profit or loss for the period of restoration with the continuing expenses for the period.

This simple table compares business income losses for two companies, one operating at a profit and the other at a loss:

	PROFITABLE BUSINESS	UNPROFITABLE BUSINESS
Normal sales	$10,000	$5,000
Normal expenses	$7,500	$7,500
Normal profit/loss	$2,500	-$2,500
Sales during suspension	$0	$0
Expenses during suspension	$7,500	$7,500
Profit/loss during suspension	-$7,500	-$7,500
Business income loss	= Normal profit + Continuing Expenses + $2,500 + $7,500 **= $10,000**	= Normal profit + Continuing Expenses -$2,500 + $7,500 ***= $5,000***
Effect on balance sheet	Still a $2,500 profit	Still a $2,500 loss

Businesses often operate at a loss, especially when they are new and during seasonal downturns for their products. In real life, coverage for these enterprises would be subject to coinsurance requirements, deductibles and limits.

Q: What about an otherwise profitable firm that has a new subsidiary faced with substantial start-up or R&D costs, so that the combined result is an operating loss for the firm?

ANSWER: In such a case, income coverage would depend on whether the firm and its subsidiary were insured as one entity or as separate entities.

If the firm and its subsidiary are insured jointly, any income loss by the start-up subsidiary would be recoverable for the overall firm, whose profits would be diminished by the loss to the subsidiary. Similarly, if the subsidiary were insured separately, its income loss would be recoverable, as its loss would be greater than anticipated.

In either case, the impact on the overall company's balance sheet should be the same.

> *... Contingent business income insurance does* not *apply to suppliers of utility services (electricity, water, steam, heat, communications, etc.).*

How can a business protect itself when a major supplier is shut down by fire or other peril, so that the business cannot obtain needed materials to operate? What about the shutdown of a major customer?

ANSWER: There is no automatic coverage for either of these cases under standard business income or extra expense coverages, unless the supplier or customer is an affiliate or subsidiary of the insured. (In that case, blanket business income coverage could apply.)

To establish coverage for income losses due to shutdowns at non-owned locations, carriers add "dependent properties" or "contingent income" coverage based on two endorsements developed by the Insurance Services Office (ISO) or proprietary equivalents:

- The CP 15 08 Broad Form, which extends the firm's own business income insurance to include one or more of the supplier's or customer's properties, with the same limits of insurance as at the firm's location; and
- The CP 15 09 Limited Form, which provides separate limits of income insurance when an insured does not have its own coverage or is using a different insurer to cover the dependent location.

Contingent income coverage can be extended to four types of dependent properties:

1. A ***contributing*** location, a supplier to the insured;
2. A ***recipient*** location, a major buyer or user of the insured's output;
3. A ***manufacturing*** location used by an agent of the manufacturer; and
4. A ***"leader"*** location that attracts patrons to other businesses, such as an "anchor store" in a shopping mall.

Dependent locations coverage contributed to unprecedented levels of business income insurance losses in the wake of the September 11th attacks on the World Trade Center. For enterprises that did not have the coverage, the disruption was even greater.

A final note: Contingent business income insurance does *not* apply to suppliers of utility services (electricity, water, steam, heat, communications, etc.). Coverage for off-premises interruption of services typically requires addition of an off-premises service time element endorsement, and the type of service to be covered must be specified.

Q Considering the impact of inflation, how can a business anticipate the proper amount of business income insurance to guarantee adequate coverage for the worst possible loss that might occur?

ANSWER: While inflation has been creeping rather than galloping for some time now, it is still good to anticipate changes in rates of inflation, especially in different sectors of the economy. Apart from careful and continued analysis of its business plans and economic prospects, there are three insurance methods a firm can select among to ensure adequate coverage for a future income loss.

First, an insured can select an ***agreed value approach*** to income coverage.

Under an agreed value endorsement to a business income coverage part, the insured is typically required to prepare an annual income statement for the previous 12 months, plus estimates of changes in income over the coming year. An agreed value limit is established on the basis of the reported values, eliminating the coinsurance requirement typically found in other methods of settling income losses.

A word of caution: When the agreed value approach is used, new values must be reported within a reporting period specified in the endorsement. If a report is not filed on time, coinsurance automatically applies until a new report is filed. (Even though business income and extra expense are covered under one limit, extra expense coverage is not subject to coinsurance.)

Other options include endorsements providing income coverage for:

- A maximum period of indemnity (typically 120 days after an interruption); or

- A monthly limit of coverage for the restoration period.

In either case, the insured has greater certainty regarding recovery, but assumes the risk of being underinsured for a loss.

Q Regarding coverage under the civil authority clause of business income policies: (1) Is the length of time given for the coverage long enough? (2) Are there potentially severe exposures not covered by this clause? If so, how can they be insured?

ANSWER: Just about everyone learned in 2020 that the civil authority provision of business income insurance does not apply to public lockdowns with no direct connection to physical damage by insured perils.

The COVID-19 pandemic revealed that, indeed, there are very severe exposures not covered under the civil authority clause. In the case of infectious diseases, it's not at all likely that their effects can be covered under property insurance policies since insureds and their carriers have almost no control over how diseases spread.

In general, a civil authority clause cannot create a new insured peril but only extend coverage for physical damage by perils already insured under a policy. For the most part, property insurance addresses perils that are generally short in duration — fires, windstorms, riots, etc. — and whose damage can be addressed immediately after an event. Perils whose impacts can last indefinitely — floods, earthquakes, war, etc. — are generally excluded from coverage. Income coverage for civil authority follows this logic.

Given that logic, it's not surprising that standard business income coverage is limited to three consecutive weeks beginning 72 hours after a loss occurs.

The three-week standard is actually an extension over the two weeks previously covered and the trigger of coverage is no longer limited to damage at property "adjacent to" an insured location. Current civil authority clauses generally apply to loss or damage "other than at the described premises," although proprietary policies may limit the application of civil authority coverage to within a defined radius of the insured location.

Business income underwriting rules generally do not provide for extending the time limit beyond the standard three weeks. This suggests that carriers seek to avoid open-ended exposure for public decisions they cannot control during prolonged

> ***"While inflation has been creeping rather than galloping for some time now, it is still good to anticipate changes in rates of inflation, especially in different sectors of the economy."***

catastrophes. Underwriters might be prevailed upon to extend the time limit, although requests for extensions might be viewed as "adverse selection" and a substantial added premium required.

Q Can an insured claim a business income loss if the event causing the loss contributed to greater profits overall?

ANSWER: This question arises from time to time. In 2011, for example, oil companies had to suspend drilling operations in the Gulf of Mexico after incurring storm damage to drilling platforms, but soon profited from the rise in oil prices that followed from the disruptions. Insurers disputed whether income coverage should be applied in the wake of an event that ultimately benefitted insureds.

One could imagine such an occurrence on a smaller scale, such as a home improvement store that is forced to close for a week because of storm damage, but realizes greater-than-anticipated sales upon reopening due to a surge in demand for building materials.

In this, as in all cases, policy provisions prevail. If an enterprise with business income coverage must suspend operations due to damage by an insured peril, it is entitled to coverage for loss of income, subject to coinsurance requirements, time element and/or dollar deductibles, and applicable limits.

In light of this possibility, many property policies, particularly on hotels, now have provisions limiting income coverage in cases where surges in demand following a shutdown result from the same event causing the shutdown. Even with such a provision, a business that suffered a fire loss at the same time that its community was shut down by a hurricane might still be able to collect its full business income recovery while benefitting from the demand surge following a hurricane cleanup.

Furthermore, the impact of a post-event windfall may be reflected in the time period selected for calculating an income loss. Still, barring any explicit provision preventing or modifying recovery on the basis of subsequent earnings, an insured is entitled to the full amount of recovery established in the policy contract.

Q After 2020, can business interruption coverage be written and priced to extend to orders by civil authorities closing off access due to a pandemic?

ANSWER: "Never say never," but don't count on it. Several things stand in the way of insurers ever accepting much risk (at least voluntarily) for business interruptions caused by a pandemic.

Given what we experienced in 2020, we can reasonably expect that public health authorities may be quick to impose restrictions of lesser scope and severity to contain outbreaks of disease. In light of that, business and property owners will understandably ask whether "civil authority" BI coverage could be extended to orders arising from a pandemic.

Civil authority coverage is already triggered for a business that has suffered no damage, provided the order arises from damage by a covered peril at some location. What's the difference with an order arising from a pandemic? A lot, it turns out — and it mostly has to do with underwriting and loss control.

Now, some commercial insurers may start to offer some limited coverage for pandemic closures, both as an enticement to buyers and as a means to make sure that any future pandemic claims are clearly routed away from the overall BI limit and toward a (presumably lower) pandemic limit.

Beyond that, insurers and policyholders have very little, if any, ability to assess the risk of a pandemic and control its consequences. Viruses circulate freely around the globe and one rarely knows for certain where an individual has contracted a virus.

The existence of a public order doesn't really change things.

Insurers can provide civil authority BI coverage for undamaged businesses due to damage at other locations because the insurers have often underwritten those other locations, at least indirectly. When an insurer writes property coverage for one enterprise it acquires knowledge of hazards, public protection, and ingress/egress affecting neighboring enterprises. It also does so with extensive historical experience of business recoveries from disasters.

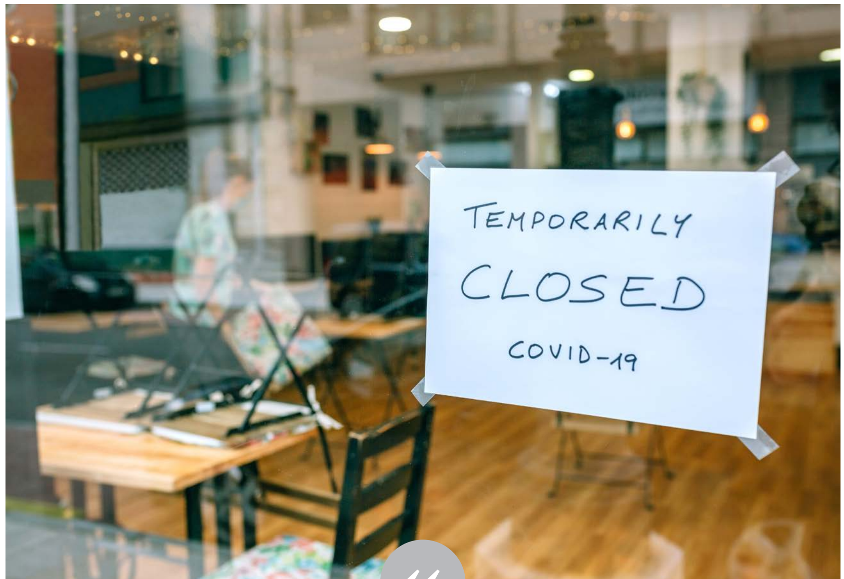
Standard BI coverage is also written with the presumption that, for the most part, the event causing the loss will be limited to one area for a relatively short time. A pandemic, which circulates worldwide and comes and goes in different regions, is another thing entirely — an exposure of indefinite extent in time and space.

Finally, the current trigger for civil authority coverage, physical damage by a peril insured against, is easy for all concerned to recognize objectively. In contrast, public health officials are usually the only ones with the ability to discern the presence of an impending pandemic. The existence of private insurance for business interruption could tempt public health officials to issue lockdown orders more readily, perceiving them as a precaution with no immediate costs, except to insurers.

There's considerable discussion today in Washington about federal support for some means of insuring for pandemic-related business interruption. Whatever emerges will almost certainly be substantially different from the federal terrorism reinsurance program, however.

The federal backstop for terrorism losses, including business interruption, serves to keep property insurers from excluding coverage for perils they already cover, particularly fire and explosion, when these are caused by terrorist acts. Insurer participation in a federal pandemic insurance program would mean covering an entirely new cause of loss for private insurers.

It's hard to envision what role private insurers can play in such a program other than being a pass-through



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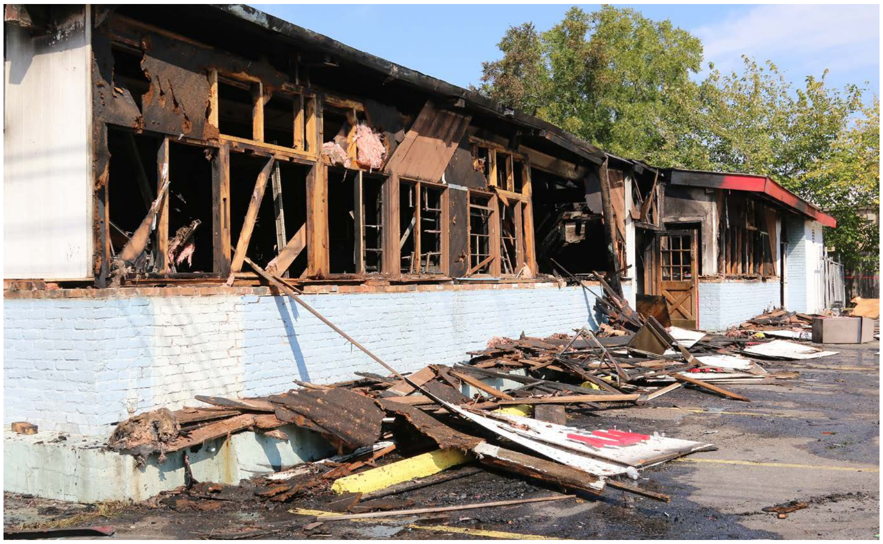
source of coverage for a public program underwritten by those with knowledge and authority in public health.

Prioritize Your Risk

The variety of business income losses described in the answers to these questions indicates that your greatest source of income risk may not be the most obvious or the most traditional. If you learned during the recent pandemic that you can operate remotely when your central location is closed off, you may want to direct your premium dollars toward contingent exposures that could truly halt your operations.

On the other hand, if your supply and distribution chains are sufficiently robust to preclude interruptions from contingent locations, there will always be other types of risk requiring capital and active management. There is no "one size fits all" approach to addressing the risk of business interruption.



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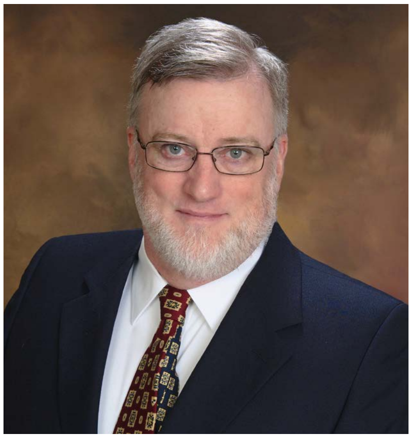

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