BUSINESS interruption:

«A tailor-made» policy

Whilst, in general, it is important that any policy is adapted to the characteristics of the risk to be insured, this is fundamental in the field of consequential losses that arise after a material damage claim. No two companies are identical and there should not be two Business Interruption Policies that are the same: the policy should be «tailor-made».

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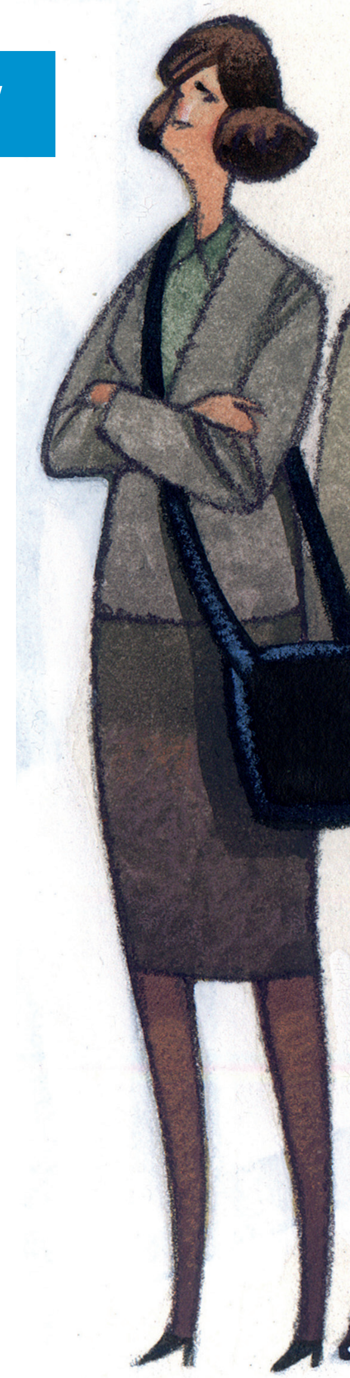

For this reason, it is essential to obtain the maximum information about the risk to be insured and this can be obtained from the company's web site, the company registry, from firms that specialise in providing financial-economic information... and the actual insured that should provide accurate and detailed answers to the questionnaire provided by the insurer or broker.

The Business Interruption, Loss of Profits or Consequential Loss Policy, which can be called in either of these three ways, provides cover in order that a claim does not affect the forecasted financial results of the company, i.e., the insurance tries to put the company in the same financial position that it would have been if the claim had not occurred.

Obviously, a stoppage of a week in the production process, for the equivalent of only 2% of annual production, will not affect all companies in the same way. For example, it will depend on whether the company manufacturers to order or by stock, whether their process is continuous

THE BUSINESS INTERRUPTION POLICY TRIES TO PUT THE COMPANY IN THE SAME FINANCIAL POSITION THAT IT WOULD HAVE BEEN IF THE CLAIM HAD NOT OCCURRED

(aluminium manufacturers, oil refineries...) or not, if there is stock available for days or weeks, if work is carried out 8 hours a day, 5 days a week or 24 hours for 7 days a week, if production capacity is greater than sales capacity or, vice versa, if sales capacity is greater than that of production…

The policy covers «the Loss of Turnover attributable to the claim during the indemnity period, the increased cost of working and Extraordinary Expenses incurred by the Insured in order to reduce or avoid the loss of sales», always with the limit of the gross margin loss they avoid; i.e., the extra costs and extraordinary expenses must be profitable.

For a claim to be indemnifiable under the policy, it has to have affected the financial results of the company:

INCOME – EXPENSES = PROFIT

In other words, it must affect income (produce a loss of sales) or expenses (produce increased costs) or both, which is what tends to happen in large claims.

For many business, it is also common that stoppages of a few days do not affect the financial result since their production capacity is greater than that of sales and this is usual in times, such as the present crisis, when stock equivalent to 1-2 months production may be held.

The three main parameters of a Business Interruption Policy, which can be very complex as it covers Loss of Profit due to Fire, Machinery Breakdown, claims at suppliers´ or clients´ premises, for failure of supply, impossibility of access..., are:

- The Sum Insured
- The Maximum Indemnity Period
- The Deductible

The Sum Insured is the company´s gross margin (GM) and can be calculated in two ways:

The addition method: GM = FC + NP
The difference method: GM = T/O - VS + Variation in Stocks

Where:
–FC: Fixed Costs or non-variable expenses (they are not proportional to production and usually continue after a claim).
–VE: Variable Expenses (they are proportional to production and are usually avoided after a claim).
–T/O: Turnover (the company´s normal annual income).
–NP: The Net Profit generated through the company´s insured business activity before the deduction of tax on profit.
–Variation in Stocks: Closing Stock less Opening Stock.

Gross Margin is also referred to as Gross Profit. We prefer to call it Gross Margin since accountants confuse Gross Profit with profit before tax.

It is not usually a problem to calculate the Gross Margin and we recommend using the addition method since, in this way, the fixed costs, and the insured percentage, are specified (semi-fixed or semi-variable expenses such as electricity, telephone...).

Whilst it is difficult to predict what the net profit will be for the coming year, in order to avoid under-insurance, an automatic increase clause of between 20% and 40% exists and enables the sum insured to be adjusted after the close of the financial year and once the annual accounts have been audited.

The policy must be designed to cover a large claim and, for that reason, it is advisable to analyse the worst possible claim and the time that would be needed to get the company business back to normal.

Since the UK Policy (Business Interruption) which is the form normally used in Europe, provides an indemnity period from the date of loss up to the time when sales levels return to normal (with the «Gross Earnings» form, it is only until production returns to normal), one should always consider the time for reconstructing buildings and replacing key machinery, plus 4 to 6 months necessary for removal of the debris of what has been destroyed, permits, projects, recovery of 100% production, replacement of back-up stock...

If the indemnity period that we fix is for 12 months or less, the sum insured must be the equivalent for 12 months and, if the maximum indemnity period is between 12 and 24 months, the sum insured must correspond to the latter period. Large claims with insufficient maximum indemnity periods are frequently encountered.

Lastly, another aspect to be established is the deductible. This will normally be a time deductible but it is often not properly defined and this causes problems in the adjustment of claims.

For example, for a 5 day deductible: Which 5 days are they? The first 5 calendar days? The first 5 production days? Are they 5 days proportional to the indemnity period? We would suggest that this is specified. For example: X number of production days with a minimum of Y € (the latter is to eliminate small claims that do not usually affect the company´s profit).

To summarise all of the above and if, with adequate information, we are able to determine the correct sum insured with the corresponding automatic increase cover, to fix a maximum indemnity period that will be sufficient even for the worst possible claim (the total destruction of the company) and a deductible which, in addition to providing a policy saving, enables us to take out those stoppages that are not going to affect the company´s annual results, normally the policy can guarantee that the claim will not affect the company´s financial position, i.e., its financial results will be the same regardless of the claim.

IF THE INDEMNITY PERIOD THAT WE FIX IS FOR 12 MONTHS OR LESS, THE SUM INSURED MUST BE EQUIVALENT FOR 12 MONTHS, AND IF THE MAXIMUM INDEMINTY PERIOD IS BETWEEN 12 AND 24 MONTHS, THE SUM INSURED MUST CORRESPOND TO THE LATTER PERIOD