1740H Dell Range Blvd., #300 I Cheyenne, Wyoming 82009
PHONE: 307.433.8180 I FAX: 307.634.9497
EMAIL: info@bisimplified.com
www.bisimplified.com

ARTICLES: THE 411

Business Income Insurance Policy: End the Confusion

Guide to ISO Business Income and Extra Expense Coverage Form

By Robert M. Swift, CPCU, CIPA, CBCP

Since the Insurance Services Office (ISO) wording is the most widely used contract language, this article will discuss the various components of this type of insurance policy. As a rule, business owners do not read their policy until they have a claim and then it is too late. They are surprised to discover exclusions, missing coverages, and incorrect limits. Therefore, it is important for agents to emphasize that insurance buyers carefully read the entire insurance policy to determine their rights and duties, as well as what is and is not covered. The following areas of the insurance policy cause the most confusion.

RENTAL INCOME: May be included, excluded, or by itself. This coverage protects income from a third party who has an "arm's length" relationship with the insured. For example, the jewelry counter or shoe department in a department store is owned by another company and they lease space from the store and pay a percentage of their sales as rent. If the department store burns down, the store loses this rental income.

Rents are an area of confusion because quite a few organizations have separate entities for their operations and realty ownership. For example, the president owns the real estate and the operating company pays him rent through his realty company. This is simply two pockets of the same suit and not considered rent protection as long as both entities are named insureds on the policy. The business income policy pays the rental expense as a continuing expense of the operating company, so it does not have to be included as additional income.

about the author

Robert M. Swift, CPCU, CIPA, CBCP

is a business interruption specialist with more than thirty years' experience worldwide in the insurance and risk management field. Swift assists insurance professionals with providing market differentiation to their clients through business income consultations and appraisals. He also reviews insurance contracts for coverage gaps, traps, undervaluation, and missing protection and believes thorough preparation is essential. Through his company, Business Interruption Consultants, Inc., he has developed a unique, Web-based BI resource, **www.BISimplified.com** that includes a detailed analysis of the Commercial Property/Business Income insurance policy.

Mr. Swift is an accredited instructor for the Institute for Business Continuity Training and is in demand by numerous professional organizations as a frequent public speaker. He is a member of the CPCU Society, the Disaster Recovery Institute, the Risk and Insurance Management Society, the National Society of Insurance Premium Auditors, and a past member of the Insurance Institute of London.

BUSINESS INCOME: Defined in the policy to be net profit or loss, plus continuing normal operating expenses, including payroll.

For example: Sales minus cost of sales equals gross margin or gross profit for manufacturers, wholesalers, and retailers and is approximately the 100% B.I. amount.

Net sales:	$10,000,000	
Cost of sales:	- 7,000,000	
Gross profit:	$ 3,000,000	(approximate annual business income amount)

Service organizations do not have cost of sales, so their 100% BI amount is their annual revenues.

As a rule of thumb, combined BI and extra expenses should be approximately:

Manufacturers:	100% of their gross profit.
Wholesalers:	50% of their gross margin.
Retailers:	30% of their gross margin.
Service:	15% of their revenues.

Do not use the above chart to determine insurance limits, but it will help prioritize your accounts so you are able to spend time on those needing the most attention.

ORDINARY PAYROLL: This causes a lot of problems. Businesses think it is direct labor, cash labor, warehouse, or temporary help, so they exclude this coverage from their policy. However, it is defined in the policy to be everyone below the department manager level. When this is explained to the insured, their usual comment is that they cannot afford to lose these people and want them included.

At the same time, if they do lay off employees after a disaster, their unemployment tax rate could increase, there are less qualified people in the job pool when they recover, and they have lost their reputation in the community. Following Hurricane Katrina, business owners discovered after they had rebuilt their facilities and contacted their employees to come back to work, very few returned because they had found other jobs. Consequently, these businesses folded because they had no experienced employees to produce their product.

COMMON AREAS: If there is no physical damage to the premises, there is no business income coverage. There have been several high rise office buildings damaged by fire, hurricanes, tornadoes, etc., but because a specific suite was not damaged, their claim was denied even though there was no access. The ISO policy includes common areas as part of the premises definition, but many policies currently on the market do not. It should be part of the premises description on the actual policy so that a tenant's premises include all internal access routes (hallways, stairs, elevators, etc.).

LAW AND ORDER: Remember to endorse **"building ordinance"** and **"increased cost of construction"** because while waiting for the property to be repaired, you could be losing a significant amount of sales.

DEDUCTIBLE: Most business income policies have a twenty-four to seventy-two hour deductible for lost income with no deductible for extra expenses. Some policies define it to be "normal business hours" which means a company working nine to five with a seventy-two hour deductible would subtract nine days from their claim.

EXTRA EXPENSES: Do not confuse expediting expenses with extra expenses even though some policies mistakenly call expediting expenses "extra expenses." The difference is extra expenses pay ALL the expenses above normal operating expenses incurred to recover from a disaster. However, expediting expenses only pay the expenses that directly reduce lost income.

For example, extra expenses are all the necessary money spent to avoid or minimize the suspension of business. $750,000 reduces the loss of $500,000, but it pays all $750,000. Expediting expenses are the monies spent that actually reduce the loss. $750,000 spent reduces the loss $500,000, so it only pays the $500,000, a very big difference.

CIVIL AUTHORITY: Access to premises denied by civil authority due to adjacent property damage, commonly has a twenty-four to seventy-two hour deductible with coverage lasting three weeks. There is no coverage for evacuation prior to the event, only for denied access after the disaster strikes because it is the physical damage that triggers the coverage.

For example, three days prior to a hurricane, the city is evacuated. Three days after the hurricane makes landfall, the access denial is lifted. However, your landlord denies you accessibility while they check the building for damage. Three days later they say there is no damage and allows entrance to your premises. What is the civil authority period of claim? The three days from hurricane landfall to access denial lifted by the city, not the landlord. This causes a tremendous amount of confusion for the insured and is even more reason for them to have a Contingency Plan that includes conversations with the landlord about how quickly they will open the building or find other space for them.

EXTENDED PERIOD OF INDEMNITY: Pays for lost sales after the business resumes operations. There is an automatic extended period of indemnity of thirty days in most policies, but this may not be enough to allow the business to reach their projected sales once they have resumed operations. The business usually needs at least 90, 180, or even 360 days if there is seasonality to the business. Once again, the Contingency Plan identifies this need for the business.

LOSS CONDITIONS: The area of the policy that explains the rights and responsibilities of the insured regarding claim payment. To eliminate confusion, these conditions need to be reviewed to make certain the business has the proper endorsements and they will be in compliance with all the requirements at the time of a loss. Several of the most important ones are:

- **Loss Settlement Fees:** If not already included, businesses should endorse their policy with "claim preparation" or "loss settlement fees" wording and probably need at least $25,000 to $100,000 to pay for an experienced consultant to help calculate the loss.

- **Duties in the Event of Loss:** Educates the insured so they know what to expect and what their responsibilities are including how to submit their claim. A business owner stated he lost $10 million because of the disaster, but when pressed he was just submitting his policy limit.

- **Loss Determination:** Excludes community-wide disaster impact. For example, a hotel could have a 125% occupancy rate following an event because most of the hotels in the city were destroyed, but their historical occupancy was 85%. Their claim would be based upon the 85% number, not the 125%. They cannot make money from the disaster.

- **Loss Payment Clause:** This is very frustrating because the insureds misread this statement. It states the insurance company will pay thirty days after reaching an **agreement on the amount of loss**, NOT thirty days **after claim submission**. Since even minor business income claims take a long time to come to agreement, it is imperative that the insured have alternative financing available to supplement their cash flow while they are working on their claim amount.

COINSURANCE: This really causes problems at the time of the claim and states that if the insured's business income limit is mathematically incorrect at the time of loss, then the insured will pay that error percentage of the claim.

For example, the policy states there is a $1 million limit with a 50% coinsurance clause. This means the 100% amount would be $2 million. If, at the time of loss, the 100% amount was $3 million, then the limit should be $1.5 million (which is 50% of the $3 million). Therefore the insured would be penalized 33% of their claim, and paid $1million versus $1.5 million.

One client was penalized 85% of their $750,000 loss because they had not revised their insurance limits or coinsurance amounts in several years. The coinsurance penalty is responsible for a lot of lawsuits and unpaid claims. If possible, endorse "agreed amount" on the policy and eliminate this problem. However, to do so requires a signed BI worksheet in file showing future projections of income. No worksheet, then coinsurance would apply.

Since most ISO companies have only filed rates to go down to fifty percent of the annual amount or a six month coverage, there are two other options available for businesses that want less than six month's protection.

1. **Maximum Period of Indemnity:** Covers actual loss sustained for 120 days. No coinsurance applies, but this pre-settles the loss period and will not pay for a partial loss that exceeds 120 days.

2. **Monthly Limit of Indemnity:** A commonly used endorsement that provides a chosen monthly percentage of the limit. 33% provides one third of the limit for three months, 25% gives one fourth of the limit each month for four months, etc. No coinsurance, but the problem is this endorsement also limits the loss period and the amounts are not additive. In other words, use it or lose it.

   For example, a $100,000 limit with a 33% monthly limit would be:

Month 1, lost	$45,000	Policy pays	$33,000
Month 2, lost	$27,000		$27,000
Month 3, lost	$38,000		$33,000
Total lost	$110,000	Total paid	$93,000

During a BI consultation, when I pointed out policy language that stated actual cash value for property damage, the president of a large, multi-national company explained that the underwriter told him not to worry; the insurance company would pay replacement cost. The executive was betting tens of millions of dollars against the policy language. In summary, it does not matter what someone says, it is the insurance contract language that dictates how the claim will be paid. Businesses get into trouble with their claims because they have not read their insurance policies and are not aware of their rights and duties, as well as what is and is not covered. The time for clarification is before a disaster. End the confusion: Be prepared and be protected.

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