THE INSURANCE POLICY: SIMPLIFIED!

INSURANCE CONTRACT: COMMERCIAL PROPERTY AND BUSINESS INCOME

The insurance policy is a contract and as such, is governed by its conditions, provisions, and exclusions. Most insurance buyers do not read their contract before a claim, and as a result, receive far less compensation than they expected. The purpose of the following outline is to identify the most common problem areas, as well as provide solutions for you to consider. As always, you should discuss your particular needs with your insurance professional.

Businesses need to carefully review their insurance policies because it is a contract and dictates how claims will be paid. This contract also directly impacts the calculations of the business income amount to be insured. You do not know how much financing you need unless you understand how the contract will respond. Otherwise, it is like asking a bank for a car loan without knowing how much the car actually costs.

Please pay special attention to the exclusions and deductibles in the policy you are reviewing as these reduce the payment and always surprise business owners at the time of loss.

BUSINESS OWNER'S POLICY (BOP)

One size fits all, with pre-set coverages (take it or leave it) and limited options, and best suited for small, "main street" businesses that do not want many customized coverages. The business income coverage is actual loss sustained, but might have limits, such as a maximum of $100,000, or 6 months, etc.

COMMERCIAL MULTI-PERIL INSURANCE POLICY

Has a menu of coverages, exclusions, and limit selections that allows the business owner to tailor the policy to their particular needs. **Make sure the property policy includes the following**:

PROPERTY COVERAGES

A. BUILDING

Consider replacement cost on the same or different site with inflation guard or margin clause; including ordinance and law protection, demolition, and debris removal.

Valuation: For example, a business owner with a five year old building; $8,000,000 on the balance sheet would usually insure for $8,000,000 @ 80%, for a total of $6,400,000 of coverage.

Actual replacement cost: (You are already a coinsurer with an 80% coinsurance clause.)	$12,000,000
Increased cost of construction/ordinance and law:	1,000,000
Demolition of undamaged property:	1,000,000

Debris removal:	750,000
Actual cost to replace:	**$14,750,000**

Do you have the extra $8,000,000?

NOTE: Almost every city/county in the United States has a building ordinance that states if the building sustains 51% or more damage, it is totally destroyed. The owner is then forced to demolish the undamaged portion and rebuild the entire facility. Business owners think they will never have more than 50% damage, so they do not insure for a total rebuild. This mistake costs them a lot of money and may even bankrupt the company.

Have a contractor give you an estimate of what it would actually cost to replace your building. Keep this figure current based on the real estate/building values in your area. By the way, what is your replacement strategy? Stay or relocate; same or different building plans; change operations? See **CONTINGENCY PLANNING** section of this website.

B. CONTENTS

Include leasehold interest if you are renting your facilities. This protects your lower than market lease payments. Watch the wording on this coverage as some policies use a different definition. What is your arrangement with your landlord? Will they find you other space temporarily? Permanently? How long are you obligated to pay rent after the disaster, even though you cannot use the facilities? The standard time period is 3 months.

Watch replacement cost of improvements and betterments. This is usually only the unamortized portion of the original cost and sometimes is the actual cash value for replacement. This is important for those organizations with expensive wallboard, bookcases, built-in shelves, lighting, flooring, etc.

NOTE: Where are the building plans for your I&B?

Furniture and fixtures are usually “expensed” by businesses and are not reflected on the balance sheet. Therefore, they are not factored into the insurance value for contents coverage and you are out of pocket for several hundred thousand dollars buying desks, chairs, cabinets, tables, etc. If your computer equipment is being upgraded, inform your agent, so if replacement becomes necessary, you will be able to acquire the same equipment. Review the EDP replacement cost because usually the replacement cost of electronic equipment is less than the original cost and is much better equipment.

C. INVENTORY

Replacement cost of inventory should be the actual cost to replace, not the carrying value on the balance sheet. Adjust the asset value for LIFO, obsolescence, volatility, and seasonality.

NOTE: For manufacturers, endorse functional replacement cost on the policy for old, out-of-date machinery and equipment. Or use the used market value if there is an abundance of quality used equipment available. Make certain the cost of transportation and installation is included. Also, if you have equipment under warranty, watch the repair requirement carefully or you will void the warranty.

Valuation:

Machinery & equipment: (original cost)		$5,000,000
Minus depreciation:		2,000,000
Insurance value:		$3,000,000
Actual replacement cost:	$7,000,000	
Transportation:	800,000	
Installation:	150,000	
	$7,950,000	

Do you have the extra $5 million available?

Endorse **selling price** for finished stock (manufacturers only). Do not use actual cash value on the policy.

Valuation:
Finished stock on the balance sheet at $1,000,000 (cost) times the mark-up (for example, 1.5 times) = $1,500,000 selling price. The larger the inventory value, the greater the difference.

NOTE: Be certain to add a significant amount of coverage ($50,000 to $100,000) for professional fees/claim expenses, so you are able to hire professionals to assist you with your claim and have their fees paid by the insurance company.

BUSINESS INCOME

The standard contract wording is: We will pay for the **actual** business income loss you incur **due to the actual impairment** of your operations and extra expenses you incur during the **period of restoration**, not to exceed the applicable limit of insurance caused by, or result from, **direct physical damage** by a peril **not otherwise excluded** to property at or within 1,000 feet of the premises **shown in the declarations**, unless otherwise stated.

In other words, there must be direct physical damage to the property which impairs your operations and causes you to lose income. The period of restoration is the claim payment period and stops when income reaches its expected level. However, some polices say that the period of restoration stops when you are able to resume operations (turn on your machines or pick up the telephone). This latter type of policy wording does not factor into the recovery period, the time it takes to recover sales. Make certain there is an **extended** period of indemnity endorsement added to the business income coverage to pay for the recovery of market share.

Business income coverage pays for **actual business income loss** (lost **FUTURE** sales), however many of the insurance company accountants deny there is ever lost future sales because they say you can always make it up. WRONG! Make certain you are able to document your lost future income such as sales forecasts with historical accuracy; specific lost contracts; expected sales; etc. They should be available to substantiate the loss. You have to be very careful to differentiate between **deferred sales** and **lost sales**. There is a clause in the policy that limits the amount of loss payable for contracts that are cancelled. Watch multi-year sales contracts, as many insurance policies only pay for the portion that was lost during the recovery period.

For example: You have a 3 year contract with Biggy & Co. who cancels it when they hear you had a fire. You recover and are 100% whole in 18 months. The business income coverage on this policy would only pay for 18 of the 36 months of lost sales.

The lost income calculation is supposed to be the amount of lost income that should have been earned **during the recovery period**, not the amount of income earned last year. Almost all the insurance accountants use last year's figures because most business owners cannot substantiate their sales growth. This results in the amount paid being less than what the business owner actually lost.

Premises description is very important when you are in a high rise building or multi-tenant location. You need to have the common areas (atrium, hallways, stairs, elevators, etc) defined as part of the building premises (the Insurance Services Office standard policy has this language). Otherwise there must be physical damage to your suite (#735) in order to trigger coverage. An example would be a fire on the third floor. You cannot get to your office on the seventh floor, but there was no direct physical damage to your office. What is your plan in this instance? .

Lost **sales value of production** is extremely important coverage for manufacturers. After a loss, they may be able to continue to sell from their warehouse while they are repairing their building, but they have lost their units of production. Here again, many insurance company accountants deny there is any **lost** production saying It can be made up. If possible, have the underwriter agree **in writing** what calculation will be used at the time of loss.

If the business has interdependent locations, discuss with your insurance professional how your policy will respond if there is no physical damage at a location that loses sales because another location was damaged.

For example: One building dyes cloth, the next building sews pants. If the sewing operation is shutdown, the dying operation loses production value. The standard approach is to only value lost pants sales and not calculate the loss of dying production. Keep in mind, the business will not be paid twice for the same loss, so the accounting methodology needs to be discussed.

Finally, the lost income calculation obviously needs to factor in such things as seasonality and economic cycles which will impact the amount of the loss if the period of recovery is less than a year.

ADDITIONAL COVERAGES

Off premises utilities provides coverage if the utility company cannot provide service due to damage to **their** property (excluding transmission lines or pipes). This coverage should be for at least 21 days (30 is better) with no more than a 12 clock-hour (not business hours) deductible. Therefore, the lost income for this period is covered. If you have perishables, you need spoilage coverage on the property section. Obviously you would want to have back-up power available. .

For example: Utilities (not just power) coverage is for 14 days, minus 3 day deductible = 11 days.

Civil Authority is another very misunderstood coverage and it has cost numerous business owners some serious money. The coverage works this way. There must be physical damage first (the hurricane actually has to hit land and cause damage), then the time period starts for the civil authority period of restoration. The pre-hurricane evacuation is not part of the civil authority period. The civil authority period ends when the authorities say it is okay to go back into your property. If your landlord turns you away while he checks the structural integrity of the building, that is NOT civil authority and this additional waiting period is not covered. Of course, none of this applies if there is physical damage to your building which triggers the basic coverage. The standard coverage is fourteen days, but most businesses should ask for thirty days of coverage.

Contingent business income must be purchased separately from most insurance companies. This pays for lost income because a supplier, subcontractor, or customer is damaged and cannot complete its transaction with your business, causing you to lose sales. The other premises are underwritten based upon its building construction, but this coverage may not be available in some situations.

For example: Our single source supplier burns down, so we cannot sell our product for 3 months. While we find another supplier, Contingent Business Income pays for our lost income.

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EXTRA EXPENSES

First of all, watch the definitions because some policies say they pay extra expenses and then define extra expenses to be loss reduction expenses (expediting expenses).

Extra Expenses vs. Expediting Expenses:
Extra expenses pay **all** the **extra** expenses incurred to recover from physical damage, while expediting expenses only pay for the amount of money spent that actually reduces the loss and then only to the extent of the reduction.

For example: If you spend ten dollars and reduce your loss by five dollars, extra expenses will pay you ten dollars. However, expediting expenses will only pay five dollars.

Extra expenses pay for such things as increased rent; personnel travel, meals and lodging; increased subcontract costs; emergency operations center; transportation; temporary facilities; IT ‘hot” site; etc.

EXCLUSIONS

This refers to the perils that are not insured against, and include flood, earthquake, pollution, and nuclear explosion, to name a few. For the business income calculation, discontinuing expenses and interest income are excluded.

DEDUCTIBLES

For property, this is a dollar amount and should be on an **occurrence basis, not location basis**. Named storms (hurricanes) have a separate and larger deductible. Business income has a time deductible, such as 24 hours. Watch this definition to make sure it is not business hours.

Coinsurance is also used as a “deductible”. This provision requires the business owner to insure a certain percentage of the replacement cost of property and a certain percentage of the 100% (annual) business income.

For example: 80% coinsurance for a building would be replacement cost of $10,000,000, times 80%, or $8,000,000.

Business income 50% coinsurance would be 6 months protection and as long as the proper amount was purchased, there would be no penalty.

For example: 12 months, 100% BI (gross profit) of $10,000,000, times 50% = $5,000,000 required insurance. At the time of loss, the coinsurance is recalculated. This is always a problem as the actual sales and expenses are different from the originally estimated amounts, so business owners end up severely penalized.

Ask for agreed amount! Do not have coinsurance on your business income policy! Be aware that you need to complete a worksheet to get agreed amount.

It should now be obvious how very important it is to be an educated consumer. What you do not know CAN hurt you. Make certain you are buying the right coverages for the correct amount and discuss your needs with your insurance professional.

Be prepared. Be protected. ™