LMI Group

Peter Brown & Associates
INSURANCE BROKERS

MANNINGS GUIDE TO

INTERRUPTION INSURANCE

Another slim little book that could save your business (& perhaps your home!)

Prof. Allan Manning
Steven A. Manning

Contents

To Helen and Chantelle
Without interruption, you are always in our hearts.

“Education is what you get from reading the small print;

Experience is what you get from not reading it.”

Anonymous.

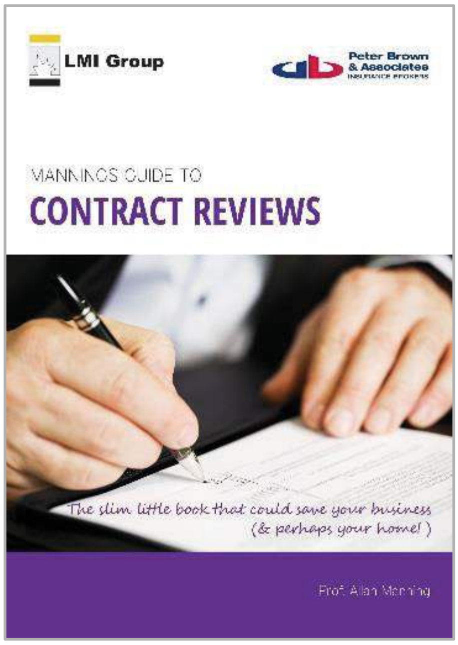
Other titles by Allan Manning

Business Interruption Insurance & Claims: A Practical Guide
Understanding the ISR Policy: A Comprehensive Guide
It Will Never Happen to Me! The Strategic Management of Crises in Business
It May Happen to Me! The Essential Guide to General Insurance
Fidelity, Theft & Money Insurance & Claims
The Closure of the Bougainville Copper Mine: Anatomy of a Major Claim
What’s Insurance? – Mr Owl explains how it protects your stuff
Mannings Six Principles of General Insurance
Mannings Guide to Contract Reviews

Preface

“No matter how busy you may think you are, you must find time for reading, or surrender yourself to self-chosen ignorance.”

Confucius



Following the great success of Allan’s eBook, “*Mannings Guide to Contract Reviews*” that has nearly reached a thousand downloads, I mentioned to him that the book’s tag line,: “*the slim little book that could save your business (and your home!*)”, could equally apply to a guide to Business Interruption insurance, to which he readily agreed. We now present you with this Business Interruption guide we have written together, with the tag line: “*Another slim little book that could save your business (and your home!*)”

But before we get to that, here is a little bit about me. I attended my first major insured loss when I was 13 years of age on work experience with my father. The business was a factory that had been ‘torched” by a disgruntled employee who had been dismissed on justifiable grounds the day before. I arrived with my Dad and the worry and stress that was written all over the owner’s face left a lasting impression on me. As I watched the process of developing and exercising a business recovery plan that was overseen by Allan and funded by a well prepared insurance program, this demonstrated to me the value of Business Interruption insurance. In that case, the business was saved despite the considerable damage.

I later joined my Dad in the insurance claims business soon after he started LMI Group in 1999. Since then, it continues to amaze me how many businesses do not have Business Interruption insurance or if they do, the percentage where cover turns out to be inadequate. This can lead to business failure and, if there is a bank or other finance institution in place, it could mean the foreclosure of a mortgage. This, of course, has life changing consequences for the owners and their families, the staff and other stakeholders in the business.

Realising that most business owners and managers are time poor, we have kept this Guide as slim as we dare but at the same time ensuring that we cover the most important areas in which Business Interruption insurance is needed and why so many businesses are underinsured.

I would also like to note that a work like this does not just happen. First, I want to acknowledge Allan for allowing me to work with him on this and in many ways, allowing me to take the lead. We were also helped by a great number of people and I want to express sincere thanks to many of our colleagues at the LMI Group who have offered invaluable comments based on their years of experience. Special thanks to Elle Cody and Paul Tilley who assisted with the proof reading. Allan and I also wish to record our personal thanks to Gloria Lu for her layout and graphic design work in both the eBook and printed versions of this Guide.

Valuable assistance was also provided by Victoria University and its College of Law and Justice in particular. For their help, we are most grateful.

Lastly, a warning: a Guide such as this should never be solely relied upon for advice. Matters differ according to their facts, while the law around insurance and the policies themselves undergo constant change. You should always seek specialist advice on your insurance needs from your insurance broker, Peter Brown & Associates and should you ever suffer a disruption, obtain the services of a claims preparer such as LMI Group.

Furthermore, Allan and I would be pleased to receive feedback regarding the relevance, ease of understanding and usefulness of the material contained in this Guide and any suggestions for improvement. You may reply via email to Steve.Manning@LMIGroup.com. It is through such feedback that our Guides continue to grow with each edition.

Steven Manning
Melbourne, 16 November 2013

Printed in Australia

Mannings Guide to Interruption Insurance

"Not all readers are leaders, but all leaders must be readers"
Harry S. Truman[1]

Introduction

Interruption Insurance, also known as Business Interruption Insurance or BI[2], is one of the most important forms of insurance any business can have. We at LMI have compiled a data base of risk, [**LMI Risk**Coach] for over 6,000 industries. Based on that research, we created a Hazard Rating Index that looks at how important 11 classes of general insurance are, based on frequency of losses and their severity. An analysis of this work found that Interruption Insurance came in as the first, second or third most important type of insurance in the vast majority of cases.

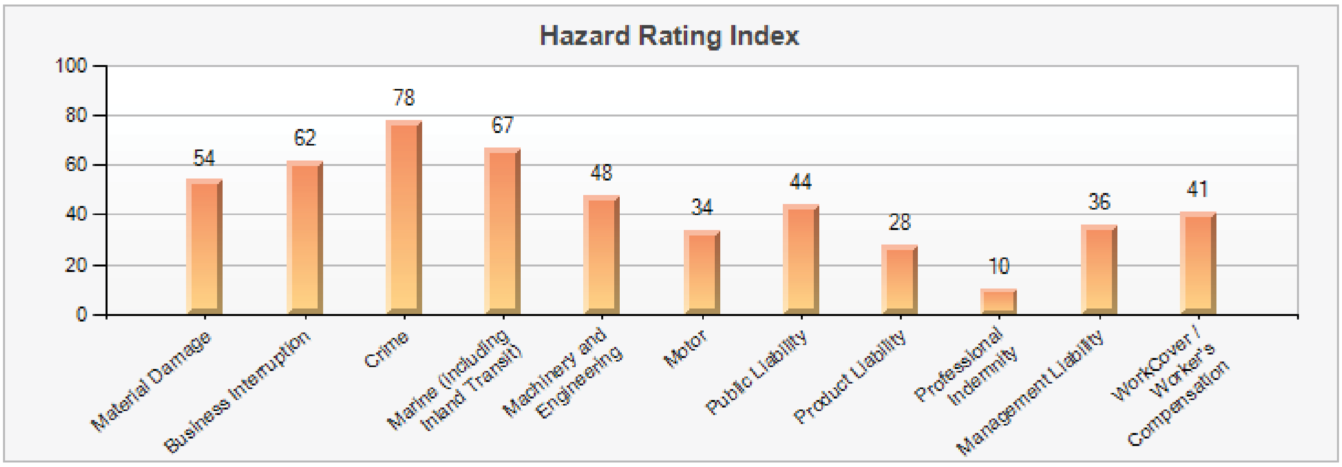


Figure 1: The LMI RiskCoach Hazard Rating Index Graph for a Clothing Retailer – RISC[3] Code 4251 0030

Therefore, it is disappointing to us that at the time of writing, less than half of the businesses in Australia and New Zealand have any form of Interruption Insurance. Of

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1 From a hand-written manuscript found in Truman's desk after he died, Post-Presidential Papers. The Post-Presidential Papers of Harry S. Truman consist of correspondence and other documents created or compiled by Mr Truman from the end of his Presidency in 1953 until his death in 1972.

2 For the sake of completeness other names for this class insurance include: Consequential Loss, Consequential Loss of Profits, Business Income Protection, Instant Profits Insurance, and Loss of Profits Insurance. There are no doubt other names where an insurer has sought to find a more appropriate name that explains the important protection offered by this class of insurance.

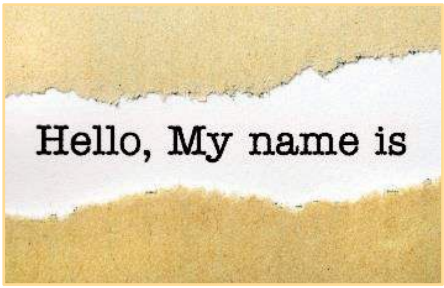
3 RISC stands for Risk Coach Industry Classification. An 8 digit code based on the 2003 ANZSIC but expanded to 8 numbers to provide sufficient granularity between industries within each category at the 4 digit level.

those businesses that do, most do not review their Sum Insured each year. Therefore, when a disruption does occur, they usually find that their coverage is no longer adequate enough to fully protect them.

The purpose of this Guide is to:

- explain why Business Interruption coverage is so important;
- provide a simple Check List that will help you determine if you should consider the coverage for your business;
- explain what this class of insurance covers;
- explain how to set the Sum Insured so that you are fully protected; and
- to answer the most frequently asked questions we receive about Interruption Insurance.

What is in a name?



Before we start, you will find that we refer to this class of insurance coverage as Interruption Insurance which is its modern name.

Part 1: Why is Interruption Insurance so important?

"Whenever you look back and say "if [only]" you know you're in trouble. There is no such thing as "if". The only thing that matters is what really happened."

D.J. MacHale[4]

The postie does not stop delivering bills after the fire brigade leaves after a fire or earthquake, or when a storm passes or flood water subside. How long can your business survive without revenue to pay your on-going expenses?

If you have Interruption Insurance, the financial risk and associated stress is taken away from the business, its owners/shareholders, managers and employees and has been transferred to an insurer. There is, of course, a cost to this, known as the insurance premium, but this is a very small price to pay for the peace of mind the coverage affords.

What so many business owners do not appreciate until a loss occurs (by which time it is often too late) is just how much they have invested in their business. For most business owners it is their:

- sole source of income – often for more than one person or several family members;
- major financial investment – many forgo their current lifestyle building an asset for the future;
- mortgage over their home - often with a personal guarantee;
- superannuation or a major part of it; and
- the purpose for getting out of bed in the morning – their role in the community.

Far too many times we have heard business owners say that if they suffered a major loss they would simply retire. This is all well and good until they pay out their staff's entitlements, the bank loans and overdraft by which time they usually discover they have

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4 2002, *The Merchant of Death,* Simon & Schuster, New York.

very little funds left to actually retire. Their life's work has literally gone up in smoke and they have nothing to show for it.

Understanding Risk

In simplest terms there are three types of risk.

1. Third Party Risk
2. Business Risk; and
3. Personal Risk

Third Party Risk is, as most business owners know, the risk a business and each owner owes to visitors, customers and the public in general. But it can be much more than this.

CASE STUDY # 1

THE MANUFACTURER

The day after a massive fire destroyed a factory, we were sitting with the owner and the firm's accountant. As we were going through the coverage summary Allan asked: why is there no Interruption Insurance in place? This was after finding that the building, contents and stock were all well under insured. The answer we got was all too common. We thought it was too expensive and "it would never happen to me!"

A week later, while alone with the accountant, a frustrated Allan asked: *"if I could wave a magic wand and send you back in time would you be prepared to pay 10 times as much to have full insurance on the assets and business interruption*?" The answer was: "Without a second's hesitation".

The moral of this case study and countless like it is that no one considers the price of insurance to be important after the event. It is then that they realise that what really matters is the coverage afforded by the policy, the financial strength rating of the insurer and the claims service of the insurer and their loss adjuster.

For Example

- A business owner is asked to sign a lease that includes an Indemnity Clause, which requires the tenant to reimburse the landlord for any injury or damage caused to anyone, anywhere in the building complex. While most businesses have Pubic Liability coverage for their own shop, factory or office, most Liability policies will not cover injury or damage arising in common areas. This additional Third Party Risk becomes a *personal risk* to the owners of the business.

- A supply agreement for a major client of your business provides an Indemnity to the customer, this contractual liability is unlikely to be covered by your standard Public Liability policy. As soon as it is not covered, the Third Party Risk becomes a *personal risk* to the owners of the business.

As these risks are real and not generally understood, we highly recommend you take a look at the related companion guide to this eBook: *Mannings Guide to Contract Review* which is available in both hard copy and as an eBook.

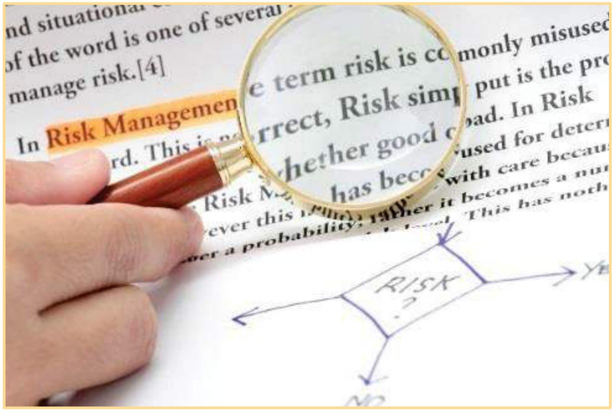
With **Business Risk**, if the assets of the business are not fully insured and if adequate Interruption Insurance is not in place, the question arises: who is going to get what is left? The bank and/or finance companies, or the owners of the business? In most cases it is the bank and this means that there is a large personal loss (risk) to the owners of the business. This is particularly so if there is a mortgage over the private home of the owners of the business. I will go into more detail about this point later on in this Guide.

Personal Risk is the risk that putting their home and other personal assets at risk.

At the end of the day, by transferring as much of the Third Party Risk, and as much of the Business Risk as possible to an insurer, the Personal Risk of the owners and other stake holders (e.g. employees, directors, financiers, creditors etc.) of the business is greatly reduced.

Of course, just buying any insurance does not necessarily help. This is where a competent reliable insurance broker, Peter Brown & Associates, comes into their own.

The True Cost of Risk



One of the common mistakes made by business owners and managers is to think of insurance only as a cost. They falsely see that insurance premiums are the Total Cost of Risk. **This is a false premise**.

Insurance Premiums are the cost of transferring risk from the owners of the business to an insurance company.

In simplistic terms, the Total Cost of Risk is made up of:

- insurance premiums;
- commissions and fees;
- costs of risk evaluation and analysis;
- risk control (things like fire and security protection);
- administration;
- uninsured or self-insured losses due to under insurance or lack of cover[5];
- the application of policy deductibles; and
- several other indirect costs that are outside the scope of this Guide.

A saving in premium is not a saving in the Cost of Risk, if the premium saving comes at the expense of insurance coverage. The problem for many buyers of insurance is that they do not fully appreciate the additional risk they are assuming through having inadequate cover or not understanding the insurance coverage they are actually purchasing. That is where your insurance broker is so important.

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5 It is this risk that the authors see destroy businesses far too often and what prompted this Guide and its sister.

The Most Important Contract

Insurance contracts are, in our opinion, some of the most important contracts you will enter into.

How would you feel if your asset was damaged or destroyed and you were in the position where you still owed the debt, but no longer had use of the asset? By having full insurance including Interruption Insurance, not only is the value of the asset protected, the loss of income caused by the damage can also reimbursed.

For example: let us say the building or a key piece of equipment is damaged and the cost of reinstatement is insured. While it is some comfort that the value of the asset is covered, it is equally important that the income stream to the business derived from the asset is also protected. Interruption Insurance will cover this loss of income. Additionally, Business Interruption can, in certain circumstances, provide loss of income where the machine is not directly damaged. Examples include protection for financial losses caused by disruption to public utilities supply, restriction of access, and closure by public authority caused by an insured event.

What happens to the business if a supplier or customer has a flood or fire, suffers storm damage or the like and cannot operate? With the right Business Interruption insurance in place your business is protected. Trade credit is another form of insurance that may protect the business from financial ruin if a customer defaults.

What it all comes down to is this one simple question: do the business owners/shareholders want to risk their investment, their life's work and on-going financial security? The mantra of all business owners should be to: "*hope for the best but to plan and insure for the worst*.

"Business Interruption Insurance in particular, should not be treated as a business cost (and by the way you do get a tax deduction for it so the tax man is funding some of it) but as PROTECTION.

Part 2: Do you need interruption insurance for your business or organisation?

"Simple Checklists help eliminate 'stupid' mistakes"
Atul Gawande[6]

The following is concise check list containing just 30 quick questions. The first 20 concentrate on business risks while the final 10 look at personal risk. Together they are designed to assist you to work out whether you need Interruption Insurance. For organisations that are not-for-profit making businesses, read 'organisation 'for 'business in this checklist.

DOWNLOAD PDF VERSION

Mannings Checklist on Enterprises that Need Interruption Insurance©

	Question	Yes	No
Business Risks			
1	Business owns commercial property?		
2	Business is a manufacturer?		
3	Business is a wholesaler?		
4	Business is a retailer?		
5	Business relies on key stock which is not able to be immediately replaced?		
6	Business relies on items of plant and/or equipment which are not able to be immediately replaced?		
7	Business relies on key supplier which is not able to be immediately replaced?		
8	Business relies on key customer which is not able to be immediately replaced?		
9	Business would continue to be liable for ongoing costs such as lease payments on building, vehicles, equipment, or the like even if the business was not able to trade?		
10	Business is financed by debt?		
11	Business would lose revenue if it were unable to operate from the existing building?		

6 2009, *The Checklist Manifesto,* Metropolitan Books, Henry Holt & Co, New York.

12	Business could keep operating after a loss but with significant increased costs?	☐	☐
13	It would be difficult to find alternative premises?	☐	☐
14	Staff are key to the business's future success?	☐	☐
15	Business does not have a business continuity plan?	☐	☐
16	Business is seasonal and cannot afford to lose one peak season?	☐	☐
17	Business relies on Utilities?	☐	☐
18	Business does not have sufficient cash reserves to finance a long term disruption?	☐	☐
19	Business would be liable for contractual fines and penalties if it were not able to supply or take delivery of stock?	☐	☐
20	Business is required to insure business interruption or loss of rent under a lease or other contract?	☐	☐

	Question	Yes	No
Personal Risks		☑	☒
21	My business is my sole or major source of income for me and/or my family?	☐	☐
22	My business is my major or sole investment?	☐	☐
23	My business is a major part of my superannuation?	☐	☐
24	My home is mortgaged to finance my business?	☐	☐
25	I would not be able to obtain finance to fund a business recovery plan in the event of a major disruption to my business?	☐	☐
26	My business provides/funds my car(s)?	☐	☐
27	I rely on my business to fund school / university fees?	☐	☐
28	My business is the reason I get up in the morning?	☐	☐
29	I would hate to have to start over from scratch with nothing?	☐	☐
30	I would hate to go back to working for a boss?	☐	☐

If you have ticked "**Yes**" to any of the boxes then our recommendation is that your business or organisation, even a not for profit one, should be protected by some form of Interruption Insurance.

Please discuss this further with your insurance broker, Peter Brown & Associates who should be able to recommend the right type and level of cover to meet your needs.

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Part 3: Understanding the basics of Interruption Insurance

"Most of the fundamental ideas of science are essentially simple and may, as a rule, be expressed in a language comprehensible to everyone."

Albert Einstein[7]

How does it work in practice?

If the business or organisation suffers a disruption caused by an insured peril, which affects its cash flow and/or profitability, then Interruption Insurance steps in and protects the organisation by continuing to pay the net profit, and all the on-going expenses. These expenses include but are not limited to:

- financing costs such as lease payments, hire purchase and mortgage repayments;
- pay-roll costs including on costs such as WorkCover, PAYE, payroll tax, and superannuation;
- rent and outgoings;
- insurance – key man, income protection, life insurance; and all the types of general insurance the business has;
- Utilities such as gas, electricity, communications and water charges; and
- all other expenses of the business that may continue during the period of disruption.

The Basic Principle of Interruption Insurance

The fundamental principle behind most Interruption Insurance policies, and non-life insurance in general for that matter, is to put the Insured, as near as money will allow in the same position as they would have enjoyed but for the loss or disruption[8]. An Interruption Insurance policy can only achieve this if it maintains the net profit of the business and meets

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7 Co-authored with Leopold Infeld (1898-1968)

8 This principle was confirmed in *Castellain v Preston* (1883) 11 QBD 380. To read more on this principle see Manning A, 2010, *Mannings Six Principles of General Insurance,* Mannings of Melbourne, Camberwell, Chapter 2.

the ongoing expenses of the business as well as any additional expenses that the organisation incurs as a direct result of the disruption.

So that the business is not over-indemnified, most policies also allow the insurer to deduct any savings in normal business expenses that cease or reduce as a result of the disruption.

Accounting Gross Profit does not Equal Insurable Gross Profit

One of the problems with Interruption Insurance is that the accounting terms such as Gross Profit and Gross Income used in insurance policies do not necessarily have the same meaning that accountants or business people use. The important differences are not usually taught at university and so clearly there is potential for misunderstanding. Sadly this is a common mistake which is often not realised until a claim is made, often with disastrous results for the policyholder.

The difference in definition between Accounting Gross Profit and Insurable Gross Profit occurs most often in manufacturing risks, but it can occur in any industry. The cost accountant is trying to determine the exact cost of goods sold. All the costs of manufacture such as direct materials, direct labour, and factory overheads are captured and deducted from sales turnover to arrive at Accounting Gross Profit.

When it comes to Insurable Gross Profit under an Interruption Policy, it is only those expenses that vary in direct proportion to sales that ought to be deducted from turnover to arrive at the Insurable Gross Profit. Any and all fixed or semi variable expense should be insured, whether it be above or below the Accounting Gross Profit line. **LMI BI**calculator will help you get the right answer. Ask your broker, Peter Brown & Associates for a link to the calculator for the policy you are insured under and the 'smart form' calculator will do the rest.

Part 4: Setting the Correct Sum Insured

"If you don't have time to do it right, when will you have time to do it over?"

John Wooden[9]

There are many different types of Interruption Insurance coverage available, which can require a different method of calculating the Sum Insured. The one that is best for your business or organisation will generally depend on your business/occupation. The 3 main types of cover provided in broad terms are:

1) ***Gross Revenue Basis***

The money paid or payable to the Insured for services rendered (and goods, if any, sold) in the course of the Business at the Premises.

For businesses which have very few *variable* expenses and do not produce or sell goods, the cover should be provided on a Gross Revenue Basis. This type of cover is usually suitable for service industries and professional practices such as doctors' surgeries, solicitors and office based businesses.

The way to calculate the correct sum insured is to simply take the turnover for the last financial year and add the expected growth in the revenue for the next 2 to 3 years. Refer to Part 6 on 'How Long Should I Insure For?'. Factoring in an adequate growth rate is important so that you can be paid at the correct revenue level you are likely to have achieved in the future, rather than at a historical rate that is no longer relevant.

2) ***Gross Rentals Basis***

Usually applies to property owners or landlords and can be defined as:

'*The money paid or payable by Tenants in respect of rental of the premises and for services rendered* by *you or on your behalf'.*

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9 Co-author Don Yaeger, 2009 *A Game Plan for Life*, Bloomsbury, New York

3) *Insurable Gross Profit - Difference Method*

The policy formula for Gross Profit is defined as *"The sum of Turnover and Closing Stock, less the* sum *of Specified Working Expenses and Opening Stock".* This is suitable for all other business, including manufacturers; retailers; trades people; hospitality; wholesalers; importers and distributors etc.

Insuring Loss of Rent (Gross Rentals)

As a landlord, you need to insure not only the net rent that you receive, but also all the outgoings paid by the tenants that would be payable by you, should they suspend, terminate or default on the lease.

It should be noted that special care is required where the Landlord and Tenant are related companies.

Furthermore, an insurer can meet two claims for the one group of companies when one entity is a tenant and another is the landlord should the building become unlettable due to an insured loss. To achieve this cover, both entities need to have rent insured.

The tenant, as one legal entity, needs to insure Loss of Rent so that in the event, the tenant can rent an alternate accommodation while repairs to the damaged building are undertaken. This can be achieved by not deducting rent as an Uninsured Working Expense.

The landlord, however, also needs to insure the rent so that this legal entity continues to receive the equivalent of rental income, as well as the monies needed to fund any outgoings (rent, land tax and the like). These may continue even though the building is damaged to the extent that it cannot be let. Rent, therefore, needs to be insured as a separate item.

Insurable Gross Profit - Difference Method

The first thing to understand is that this is not difficult, even if you do not like working with numbers. The methodology is simple, especially if you utilise the ‘smart form’ we have available, which we will provide further information on at the end of this Part.

The Difference Method, used to calculate an organisations’ Insurable Gross Profit for claims and setting the Sum Insured/Declared Value, is carried out by starting with the turnover of a business/organisation then deducting expenses that **vary in direct proportion** to turnover, regardless of the length or severity of any disruption.

The Difference Method was introduced in the United Kingdom in the late 1960’s. It is much easier and has less chance for error than the original Additions Method, where you started with Net Profit and then added the expenses that you wanted to insure. For these reasons, the Difference Method is used in most parts of the world. We only mention this method as we occasionally see a broker or insured calculate the Insurable Gross Profit using the Additions Method on a Policy that only allows the Difference Method. The end result is a disaster, as the Insured entity ends up with little or no pay-out!

Arguably the best way to do this (and reduce the risk of being underinsured) is to take the turnover of the business; add the closing stock and then deduct the value of the opening stock and purchases during the last financial year. This means that every other expense of the business, other than purchases, are insured. The stock itself is insured under your fire or property insurance policy.

Some policies allow other expenses of the business, which vary in direct proportion of sales, to also be deducted. This could include packaging and freight outwards (where it is a truly variable cost).

Once you have made the calculation using the figures obtained from the last financial year’s accounting records, it is then necessary to make upwards adjustments to ensure that you have enough coverage to allow for growth in the business over at least the next 2 years. Longer if the start of your Policy period is not close to the end of the financial reporting period you have used for the turnover and Uninsured Working Expenses. For example, if your business is growing by 10% per annum, you should add at least 21%[10] to your Historic Insurable Gross Profit.

The easiest way to do the calculation is to speak with your insurance broker, Peter Brown & Associates, and ask them to send you a link to the ‘smart form’ calculator on **LMI BI**calculator for the Interruption Insurance Policy that you have in place, or which they are recommending. We have designed the form to be a simple step by step process where each step is explained and you are guided as to how long you should insure for and to consider the optional covers available. The service is completely free, but only available through your insurance broker, Peter Brown & Associates, as there are so many calculators, one for each policy and they need to link you to the correct one.

The good news is there are no calculations for you to do, you do not need a calculator and the process is completed in a maximum of 6 simple steps.

10 21% as the growth is cumulative year on year and 1% is 10% of the first year’s growth.

Part 5 Understanding the True Penalty for Being Under Insured

Together we have been handling insurance claims for over 50 years at the time of writing this Guide. We both believe that the most common reasons businesses fail after an insurable loss are either being uninsured or being underinsured - particularly when it comes to Interruption Insurance. It is for this reason we collaborated to write this Guide.

Many business owners believe that they can pick any sum insured and they will not be penalised in any way unless their loss exceeds the sum insured. This is simply **not** correct.

Even with a partial loss, if you are under insured, under most insurance policies covering the assets or an interruption, you will be bearing part of the loss yourself.

It is important in the extreme that you understand this, as being under insured can mean business failure or, at best, financial stress. The reality is that Business Interruption policies have one of the worst, if not the very highest, incidence of underinsurance of all the classes of general insurance. It is estimated that over 70% of Business Interruption policies have some form of underinsurance. This estimate is conservative in our opinion.

With many policies there is a 20% tolerance built in, however with some policies in the market there is no tolerance at all for being under insured on Business Interruption cover.

To show the impact of underinsurance, we include the following example. The formula on a policy with 80% co-insurance/average is:

$$\textit{Amount payable by Insurer} = \left(\frac{\text{Sum Insured}}{\text{80\% of Value at Risk}} \times \text{Loss Amount} \right) - \text{Policy Excess}$$

Amount borne by Insured = Gross Loss - Insurer's Pay-out + Policy Excess

If you selected $1,000,000 as the Sum Insured under your Interruption Insurance Policy, but the value at risk (that is what you should have insured for to be fully protected) was say $2,000,000 with a business interruption loss of $250,000, the claim would be adjusted as follows.

CLAIM CALCULATION - INSURER

Formula with claim figures:

$$\frac{\$1{,}000{,}000}{80\% \text{ of } \$2{,}000{,}000} \times \$250{,}000$$

$$\text{i.e. } \frac{\$1{,}000{,}000}{\$1{,}600{,}000} \times \$250{,}000$$

i.e. 62.5% x $250,000

Amount payable by insurer **= $147,059 *less* any policy excess**

CLAIM CALCULATION - INSURED

Formula with claim figures: $250,000 - $147,059 + Policy Excess

*Amount borne by **(YOU)** the Insured* = **$102,941** ***plus*** any Policy Excess

When you consider the premium saving, even on a Sum Insured of $1,000,000, would be somewhere in the region of $1,250 (depending on the occupation of the business), the loss of over 82 times ($102,941 ÷ 1,250) that figure on this moderate loss, shows the complete folly of risking underinsurance. You only need to have a moderate loss anytime in the next 82 years to be much worse off.

It would be understandable if the business had the uninsured portion of their insurance $102,941[11] available in funds to meet the uninsured portion of the loss and were happy to fund the shortfall. Unfortunately, the harsh reality is that most businesses cannot afford to sustain such a financial loss, without ultimately affecting the bottom line and/or stopping the business from achieving its strategic objectives. In far too many cases it leads to business failure.

Any business that is not fully insured for business interruption is risking the very survival of your business. When you consider that one in 500 businesses suffer a loss every year, a prudent business person would never risk it.

Under insuring the Insurable Gross Profit is just one form of under insurance. Others, include not having a sufficient Indemnity Period, which we will look at next.

CASE STUDY # 2

THE PRINTER

At the request of an insurance broker, Allan visited a second generation business and set up a comprehensive insurance program that included full Interruption insurance with a 2 year Indemnity Period so that the business would be fully protected once the Founder's son took over.

The son ran into some difficulties with the business and brought in a business adviser, who only looked at insurance as a cost. The business adviser subsequently halved the sum insured for Interruption Insurance and reduced the Indemnity Period for the sake of a few thousand dollars on a business that was turning over many millions of dollars.

During a storm, the Insured's roof lifted, allowing water to leak into the main switch board, which in turn caused a short circuit culminating in a massive fire.

The business failed within a month of the fire, solely due to under insuring the Interruption insurance. A lifetime's work for the father was lost in an effort to theoretically save money'. Insurance should not be considered a cost, but rather PROTECTION.

[11] If the loss was to be larger: then the amount the amount that would be borne by the Insured would of course be proportionately larger.

In summary, Business Interruption Insurance is not a first loss cover. If you under-declare your Sum Insured (in some policies the Declared Value) then you are deemed to be your own insurer for the proportion of any loss no matter how small or large[12].

In reality, the cost of insurance is not high, particularly when you consider the level of protection it can bring in the event of even a short disruption. The premium is tax deductible and unless your business has significant cash resources and/or you have the ability and are prepared to fund the recovery program yourself, you need to be fully insured.

If you own a smart phone and would like to down load an App or use a website that is smart phone compatible and allows you do an under insurance calculation to see how much being under insured would affect you or your clients, please go to http://www.lmigroup.com/content.aspx?catId=199. There is no charge for this.

[12] To be technically correct, some policies do not apply the under insurance test on losses under 5% or 10% of the Sum Insured or Declared Value.

Part 6: How Long Should I Insure For?

"Time is money."

Benjamin Franklin[13]

Setting the Indemnity Period

The Indemnity Period is the maximum period that you can claim from your insurer for a disruption to your business. The clock starts ticking the moment the damage that gives rise to the disruption occurs. It is typically shown in weeks or months on the Policy Schedule.

The most common period selected is 12 months, but this often proves inadequate following a major loss or a loss arising from a natural disaster such as bush fires, cyclone, earthquake, major hail storm or flood.

The important point to bear in mind is the period chosen should not just be for the period that you, or the building you operate from, takes to repair nor how long it would take to replace your contents. It needs to be based on the entire length of time that your business could be affected by the disruption. For example, if you were to lose clients due to your inability to trade or supply your goods or services, how long would it take to replace them and get your business back to where it would have been but for the disruption.

CASE STUDY # 3

LESSONS FROM CHRISTCHURCH

Following the second major earthquake, many buildings in and around Christchurch were damaged.

As there were insufficient undamaged buildings for businesses to utilise and a shortage of trades people, combined with delays in granting approval to repair, many businesses continued to operate from their damaged building.

In many instances, it was not until well after the Indemnity Period that they were finally ordered to vacate the building so that repairs could be completed. Far too often this meant that the Indemnity Period had run out and the financial loss, due to the disruption to the business during the repair period, had to be met by the business owners.

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[13] 1748, *Advice to a Young Tradesmen Written by an Old One,* The New-Printing-Office, Philadelphia.

Whether it be 18 months, 2 years or 5 years, this is what you should insure for.
If you are a landlord then the issue again is not how long it would take to rebuild, but how long it would take to re-let the premises with tenants paying the same level of rent they would have but for the damage.

If you are a tenant, one important thing to consider is that under many lease agreements, the tenant is bound by the lease to maintain and start paying the rent as soon as the building is fit for habitation again. There are often provisions that the landlord must fulfil, such as repairs being started within three months of the damage and completed within a specified time period, which could be anything from 6 months up to 24 months. Clearly, there is no use having a short indemnity period if

a) you have to incur the costs of moving back into the finished building after the indemnity period has expired or;

b) you have to pay the lease out because you have to move into another building, which required you signing another long term lease just to save your business and/or your brand reputation.

Other things to consider when determining how long to select for the Indemnity Period are:

Acceptance of the Property Claim

How long will it take the insurance company to accept your claim in respect of the loss of assets? In the case of a fire claim, this entails a thorough investigation into the cause and if it is a major loss, this process typically takes between 6 and 13 weeks.

Management of the Claim

Getting the claim accepted is just part of the process. How proactive the loss adjuster; consultants; engineers; builders and the claims department themselves are in progressing the claim and making important progress payments etc. needs to be considered. Business owners ought to give this much more consideration when they take out insurance than they tend to. Good quality insurers actively work to assist their clients, whereas others move the Insured from "customer" to "cost centre" the moment the claim happens. Having a longer Indemnity Period can act as a second form of insurance as, realising that delays are really going to hurt them, it can force otherwise slow insurers/loss adjusters to keep things moving.

Using a firm specialising in Claims Preparation, such as LMI Group, will assist in mitigating the disruption to your business by assisting in having the claim accepted, quantifying the loss and generally guiding you through the insurance maze. To learn more on this, visit the LMI Group website or email expert@LMIGroup.com.

Alternative Premises

Let us assume you cannot occupy the building you usually do. There has been a fire, or perhaps an outbreak of disease. What alternative premises are available to you? We find in many areas, such as shopping centres, retail shopping strips and country towns that there is a shortage of alternative accommodation available. This is particularly relevant in cases where your business has particular needs. Approval from the Health Department for food handling and particular requirements for electricity, gas, lifting, delivery and storage facilities are just a few examples.

The Connection of Services

The connection or reconnection of electricity, gas, and or telecommunications, to the Insured's original premises, or to the premises where the Insured had to relocate, either temporarily or permanently, can be problematic and time consuming, particularly in newer areas.

Removal of Debris

How long do you think it will take, allowing for the Environmental Protection Authority and Work Safe rules and regulations to clear the damaged property ready for replacement? Additionally, where there is asbestos present or dangerous residue after a fire, this will tend to increase the cost of removing the debris (this is a Fire or Property Damage Policy/Section issue, not an Interruption Policy one[14]) but it can also slow down the process.

Another point to consider is, in the case of a landlord, just how many of the tenants are insured adequately, if at all. Under insurance or, worse still, no insurance can certainly

[14] It can become one if the Insured does not have enough insurance to cover the full cost of removing the debris.

delay the rebuilding process, particularly if the tenants abandon their lease and or debris to the landlord.

Local Authority Requirements

The time frame to obtain council permission to rebuild to current standards, which sometimes requires a new planning permit, can take several months. This is why most commercial leases now allow the landlord a minimum of 3 months in which if they start repairs, and complete the repairs within a stated time period the lease cannot be terminated. Please check your own lease as part of your risk assessment process.

Environmental Issues

This is certainly becoming an issue in more and more cases and should be carefully considered when setting the Indemnity Period. Examples that we have confronted include: finding underground storage tanks that the Insured did not know existed before the damage to the building; and, objections that a high hazard process is no longer allowed at the Insured's location.

Tender Phase

There is the tender phase of obtaining quotations for the reinstatement of the building, machinery and plant etc. It takes time to prepare an adequate Scope of Works and then evaluate the tenders that are received.

From our experience, Insurers are increasingly less inclined to go down the 'cost plus' methodology today. This can be frustrating as this method has proved to be so much quicker in the past. It is faster as the builder can immediately commence the work with all the costs being audited as part of the verification process, with the overhead and profit margin agreed in advance. While we cannot see why this method is not used where appropriate, it must be understood that the process is predominantly controlled by the Insurer, their loss adjuster and their builder.

In any event, the tender phase does add considerable time to the process and needs to be factored in to the Indemnity Period.

Lead Times on Replacement Equipment

If your business relies on product or machinery that is imported or not readily available, then you need to factor this into your calculations. Typically, the more complex and expensive the machinery, the longer the lead time.

Fit Out, Testing, and Commissioning

It is one thing to rebuild a building, but then it has to be fitted out. Partitions may have to be built, telephone cables laid, computer networks installed, the list goes on. For some risks this

CASE STUDY # 4

THE MECHANIC

Allan visited a mechanical workshop specialising in the servicing of generators at the request of a broker, who could not convince the owner not reduce his Indemnity Period to 6 months. Allan fared no better, even though he recommended that rather than being reduced, it should be extended to at least 18 months.

A few months later there was a fire that damaged the building as well as all the customers' generators that were at the workshop being serviced.

The damage was such that the Insured was able to repair the customer's generators. So, for the duration of the 6 month Indemnity Period there was no Business Interruption loss payable, as there was no drop in sales.

At around the 6 month mark, all this work was completed but no new work was coming in. This was caused by 2 factors. The clients who had their machines damaged by the fire were upset with the Insured, as they blamed him for the damage and the disruption to their business caused by the extended repair period for their generator(s). The other regular clients of the Insured were upset because he was unable to do their work while he was madly fixing the machines that were damaged by the fire. Consequently, the disgruntled clients sought out better service elsewhere.

Ultimately, the broker had been proved correct. If the Insured's Indemnity Period had not been reduced and was instead extended, as Allan had suggested, this would have resulted in a very different post-loss outcome.

can mean many weeks of work. Similarly, any new equipment needs to be installed, tested and commissioned. What reasonable time is required for your business?

The Time to Relocate back into Your Premises

If your business has temporarily relocated after say a fire, you will need to return to your original premises. This can be a time consuming, costly and disruptive period.

Winning Back Customers

This is a major point that most, or many people overlook. Even when all your property is reinstated you are entitled to continue to claim under a quality Interruption Policy until your turnover and expense rate has returned to normal. As anyone who has tried it knows, it is hard to turn around lost customers.

Add More for Catastrophe Situations

If your business is located in an area where a catastrophe such as bushfires, flood, hail storms, cyclones or earthquakes occur, then, at minimum, increase your Indemnity Period by at least 25% to 33%. In our experience we know that, in the vast majority of cases, the reestablishment process will take longer after a large catastrophe.

Following Victoria's "Black Saturday" Bushfires and Christchurch's earthquakes, a minimum of three (3) years was necessary for many SME businesses to be fully protected.

Final Points to Consider

We find that the vast majority of business owners underestimate how long it will take to recover from a major disruption. Regardless of the type of insurance, when determining the level of Indemnity Period required, the estimated time it will take to win back your customers should be carefully considered and added to whatever time you estimate it will take to reinstate the assets that were lost or destroyed.

As a bare minimum, we recommend that you establish an Indemnity Period of 12 months. The saving in premium for a shorter period is minimal and simply not worth the risk. For example, should you elect to insure with, say, a 3 month Indemnity Period, you do not set your Sum Insured or Declared Value at 25% of the 12 month figure. You still have to set the Sum Insured for 12 months.

The reason for this is the frequency of short disruptions compared to longer ones. For instance, 75% of all business interruption losses have a period of disruption of less than 3 months. An Insurer is not going to allow their customers to pay 25% of the premium, but still pick up 75% of all claims. We are not suggesting you should insure for a short period as it is still possible that a major loss will cause disruption for a much longer period. What Insurers require is for Indemnity Periods of less than 12 months, that the Insured declare, and pay premium on, 12 months Gross Rentals or Insurable Gross Profit. They do provide you a modest discount in return, typically around 10% for a reduction of 6 months of the Indemnity Period.

When you want more than a 12 months Indemnity Period, you have to extrapolate the 12 months figure so that the Sum Insured or Declared Value represents the amount for the entire period.

Again, we cannot stress enough that you should take a longer Indemnity Period if you feel that 12 months is even the slightest bit “skinny”. Twelve months may sound a long time, but from our experience, it goes far too fast and many a business has not completed their recovery within this time.

Finally, selecting too short an Indemnity Period is yet another form of underinsurance. It creates financial hardship, which can lead to business failure.

With an adequate Indemnity Period, your Insurer will continue to fund your business until it has returned to the position it would have enjoyed but for the loss. This will certainly improve the chances of your business and you personally being a survivor.

Part 7: Extensions of Coverage

"Please Sir, can I have some more"

Oliver Twist[15]

Depending on the Policy selected by you (with the advice and assistance your insurance broker, Peter Brown & Associates), there are different extensions of coverage to the standard Business Interruption policy available. Two that are considered very important are:

Additional Increase in Cost of Working

This cover allows the business to claim the increased costs that maintain the business or service, but which do not necessarily reduce or avoid a Loss of Turnover during the Indemnity Period. For example, say a business needed to employ additional accounting staff to ensure debt collection is maintained at the normal rate, then this would now be covered under the Policy.

Further, the Additional Increase in Cost of Working cover is not subject to the standard policy's Economic Limit Test. This can be a great advantage, particularly if the expenditure ensures the retention of customers well after the expiration of the Indemnity Period. The costs, however, must be reasonable and incurred in consequence of the damage.

An example of this would be a business that had a machine destroyed that was only available from overseas and the property insurer would only sea-freight a replacement machine. To reduce the impact on the business, the business owner pays extra to air-freight the replacement machine and this cover would pay the extra charge incurred.

From experience we find this to be a very valuable cover. It allows an insured to make quicker decisions as they do not have to justify expenditure before incurring it. If it is prudent and reasonable then it should be covered by the Policy.

[15] Dickens, Charles, 1837, *Oliver Twist,* Richard Bentley, London

One final benefit is that the Additional Increased Cost of Working is a first loss limit which means that any claim under this section is not subject to any adjustment for underinsurance. However, it is important that the cover is adequate to allow the businessperson to take all reasonable steps to protect their business during the period of the crisis.

Besides air freighting, Additional Increased Cost of Working has been used to fund:

- Additional rent for temporary premises
- Outsourcing of manufacture to a competitor or contract manufacturer
- An advertising campaign to win back lost or disgruntled customers
- The hire of temporary plant and/or equipment
- Overtime payment to staff
- The temporary employment of additional staff

This is just a short list that immediately comes to mind. It is really an invaluable cover that every business should have.

For a small business, you should consider $50,000 and more for larger businesses. As you complete your Business Continuity Management Plan, you should consider preparing a budget for your business recovery and then use this figure, with a minimum 20% contingency factor as your Sub-Limit for Additional Increase in Cost of Working.

If you wish to develop a Business Continuity Management Plan consider using **LMI Continuity**Coach as an inexpensive way and yet be fully compliant with Risk Management Standards.

Claims Preparation Services

Insurance is one of the most complex products and for a business owner their focus after an event should be on getting their business back to normal as quickly as possible.

The insurance company will engage a loss adjuster who is there to protect the insurance company's interest and it is therefore comforting to know that there are insurance claims experts, (that can utilise their experience gained from handling thousands of claims in the past), are available to you, the Insured, to ensure you understand and receive all your rights and benefits.

The best thing is that this invaluable service to you is insured by the Policy if the additional cover is selected. For a small business, we recommend $25,000 over and above any basic cover that may be provided. For larger, more complex businesses this figure should be increased.

The LMI Group have a specialist Claims Service Division that employs experts in insurance, forensic accountants, lawyers and engineers to assist you through a claim minimising stress and speeding up the recovery process. Having this coverage means you can engage LMI and the costs will be covered by the Interruption Insurance Policy.

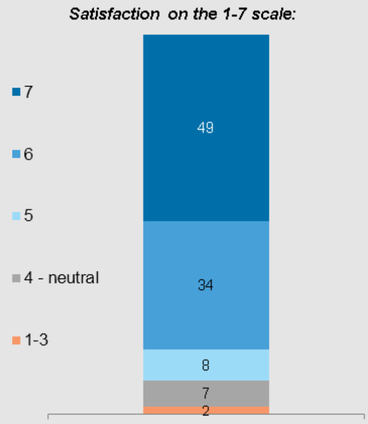
To obtain our specialist assistance in the event that you have a claim, please phone one of the phone numbers listed below or, alternatively, you can email your nearest office using claim@LMIGroup.com

Australia:
1300 LMI GROUP
(1300 5644 7687)

New Zealand:
0800 001 964

Recently we had the independent brand survey company, Brand Matters, survey insurance brokers around Australia as to what they thought of our claims service. The results speak for themselves, with 49% of brokers giving a 7 out 7 ranking.
The main reasons given for appointing LMI to a claim were:

43. What are the main triggers for you to use a claims preparation service?



Q41. You've indicated that you have used LMI for claims preparation services. How do you rate your overall satisfaction with LMI claims preparation services?

Base: Current users of LMI claims preparation services

Other Optional Covers

There are a raft of other covers that may need to be added to the base coverage, but on the other hand, the risks may automatically be included in the Policy depending on the wording you have. Covers to discuss with your broker, Peter Brown & Associates, should include, among others: public utilities cover; prevention of access; suppliers and customers premises; murder & suicide and any others that they identify during their risk review.

Part 8: Getting Expert Help

"When a person really desires something,
all the universe conspires to help that person to realize his dream."

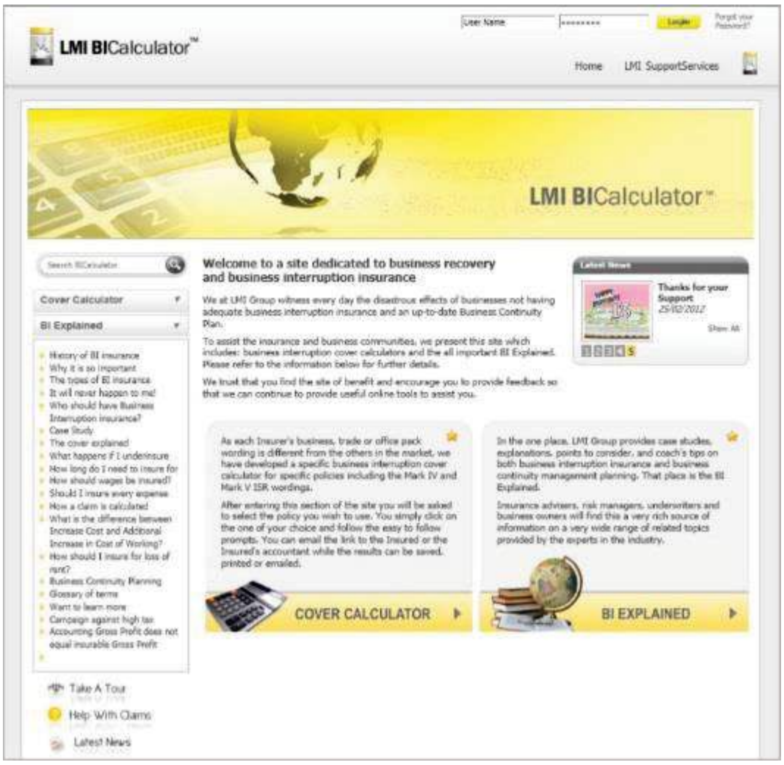
Paulo Coelho[16]

As we have explained many times throughout this Guide, getting advice is highly recommended. This comes in three separate and important forms when it comes to business interruption insurance.

First, your insurance broker, Peter Brown & Associates. They should be regarded as a trusted adviser. We believe they are as important to you and your business as your lawyer and accountant. Ideally, everything you tell your lawyer and accountant should be told to your insurance broker, Peter Brown & Associates before you commit.

Secondly, if you would like to read more on this topic, please visit the **BI**calculator website. Here you will find over 200 pages of information in bite size chunks under heading such as:

- History of BI insurance
- Why it is so important
- The types of BI insurance
- It will never happen to me!
- Who should have Business Interruption insurance?
- Case Study
- The cover explained
- What happens if I underinsure



16 2011, *Aleph*, Harper Collins, New York.

- How long do I need to insure for
- How should wages be insured?
- Should I insure every expense
- How a claim is calculated
- What is the difference between Increase Cost and Additional Increase in Cost of Working?
- How should I insure for loss of rent?
- Business Continuity Planning
- Glossary of terms
- Want to learn more
- Accounting Gross Profit does not equal insurable Gross Profit

Note: to gain access to the Cover Calculator section, you do need to speak with your insurance broker, Peter Brown & Associates who will send you a link to the 'smart form' calculator for the particular Policy that they feel offers you the most appropriate protection for your business.

Finally, the experts at LMI Group. Not all accountants are highly experienced in general insurance, particularly Interruption Insurance. LMI Group has both pre and post loss expertise in business interruption and all other classes of general insurance including experts in calculating the correct sum insured, tailoring the policy wording, insurance claims and specialist forensic accounting and legal divisions.

Contact can be made via email expert@LMIGroup.com.

Part 9: Frequently Asked Questions and Conclusion

"Don't make assumptions. Find the courage to ask questions and to express what you really want. With just this one agreement, you can completely transform your life.

Miguel Angel Ruiz[17]

Frequently asked questions

***Question 1**:*
What types of disruptions are not covered by Business Interruption Insurance?

Steve Answers: Disruptions that are inherent in doing business. Examples of these risks include losses due to labour strikes, a customer going out of business, road works, and changes in government policy or legislation.

***Question 2**:*
Is Business Interruption caused by flood covered?

Allan Answers: You do need to have the peril of flood insured under your fire/property insurance policy for disruption from flood to be covered. This is important to understand as it may not be your premises that is flooded, but your customers or suppliers. Their inability to trade could disrupt your business and without flood coverage your Business Interruption Policy will not respond.

***Question 3**:*
Can I protect against disruption caused by overseas Customers and Suppliers?

Steve Answers: Under most standard Business Interruption policies this is not covered automatically. It can be elected as an extension of coverage but as with any Business Interruption cover, the disruption must be caused by an insured event such as fire. Full coverage may not be available for very high risk perils, such as a hurricane in Taiwan or an earthquake in Japan. Your broker, Peter Brown & Associates can provide advice of what is available and where.

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17 1997 *The Four Agreements: A Practical Guide to Personal Wisdom,* (A Toltec Wisdom Book), Amber-Allen Publishing, New York

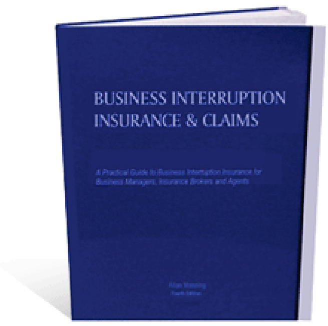
Conclusion

The take away points about Business Interruption Insurance that this Guide has covered are:

- Interruption Insurance is one of the most important classes of general insurance and yet less than half of all businesses have the protection the coverage provides;
- There are different types of coverage depending on the type of occupation;
- Some risks may be able to be insured, but others are uninsurable;
- How to set the Sum Insured / Declared Value to ensure your organisation is fully insured;
- The penalty for being underinsured or uninsured could be the end of your business, not only creating a business risk, but a personal risk for the directors and staff of the organisation;
- Your insurance broker, Peter Brown & Associates is trained to provide trusted advice on Interruption Insurance and other classes of general insurance to protect your business;
- Insurance Premiums are not the total cost of risk, premiums are the price of transferring risk to an insurer; and
- Should a claim occur, get expert help in preparing your claim and get that advice early.

We end with our own business mantra which we quoted earlier: *Hope for the best, but plan and insure for the worst!* We have seen too many businesses fail simply relying on hope alone. We sincerely trust that this Guide helps you in your business and allows you to keep your hopes and dreams alive.

Additional reading



Manning A, *BUSINESS INTERRUPTION INSURANCE & CLAIMS - A Practical Guide to Business Interruption Insurance for Business Managers, Insurance Brokers and Advisers, Underwriters, Claims Officers, Loss Adjusters and Risk Managers,* 5th Edition, Mannings of Melbourne, Camberwell. Order at http://www.lmigroup.com/content.aspx?artId=62&catId=26.

Details of the full range LMI Group's consultative services and eServices are available via the website

www.LMIGroup.com

Your FEEDBACK is appreciated…

Any comments or suggestions for improvement to this Guide are most welcome and we invite you to contact the publisher.

Email	publisher@mom.com.au
Postal	PO Box 2103, Camberwell, Victoria, 3124, Australia
Telephone	+61 3 9835 9990
Facsimile	+61 3 9885 6996

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or an order form downloaded from the website.

The Authors

Professor Allan Manning, is the Managing Director of LMI Group (www.LMIGroup.com) and a non-practicing Director of and consultant to LMI Legal (www.LMILegal.com). He is one of Australia's leading experts in insurance. He holds the post of Adjunct Professor in Victoria University's College of Law & Justice. Allan has delivered over 1,000 lectures on insurance and risk management and is the author of 10 books on insurance including It May Happen to Me! – the essential guide to general insurance.

Allan has over 40 years practical experience managing and preparing claims. He is the brain child behind many of the online research tools such as **LMI Policy**Comparison.com, **LMI** ClaimsComparison.com, **LMI BI**calculator.com, **LMI Risk**Coach, **LMI Policy**Coach and **LMI** ContinuityCoach.com used by the insurance and business communities.

Steven A Manning has concentrated on business interruption insurance since commencing his career in the insurance industry in 2000. He was soon regarded as an expert in his own right. He is the product manager of **LMI BI**Calculator, which provides knowledge on business interruption cover together with an online sum insured calculator for a wide range of business interruption policies from around the world.

In addition to managing **LMI BI**Calculator (www.BIcalculator.com), Steve also heads up **LMI** Media, (www.LMIMedia.com) which writes, produces, films and edits the training videos and podcasts used throughout the LMI Group suite of research and comparison websites.

He has delivered dozens of papers and training on business interruption locally and internationally.

Address	LMI Group House, 428 Burke Road, Camberwell PO Box 2116, Camberwell Victoria 3124
Telephone	+61 3 9835 9900
Facsimile	+61 3 9835 9966
Website	www.LMIGroup.com

Melbourne / Sydney / Brisbane / Canberra / Adelaide / Perth / NZ / UK / Ireland / Singapore / China