

# The Adjuster's Case Book

We now want to look at how various commercial enterprises may be affected by a major flooding incident.

First of all I need to ask you whether you believe that in actual fact the local economy will benefit from an upturn as a result of the flood or whether the economy will suffer a downturn? (Without exception each of the Masterclass audiences were split between an upturn, a downturn and indeed a significant number of 'don't knows'). All three answers are potentially correct since it very much depends upon the nature of the individual businesses involved.

The purpose of this part of the presentation is to firstly identify the specific causes that give rise to the fluctuation in the level of business enjoyed by individual commercial enterprises, and secondly to decide how much of this insurers should be paying for under the terms of the various covers that may be available.

## **What are we dealing with when a flood occurs?**

The scenario needs to be differentiated from a major fire loss which impacts upon a single business. As the overhead shows when it is raining it is raining on the employees, the suppliers, the customers as well as the physical assets which may include the products of the business.

How will this impact upon the loss? Significant differences may well be:

- **Employees** – if they live locally their homes may have been flooded. In these circumstances, as opposed to a fire, they may want time away from work in order to deal with more pressing matters at home. Even if they live further afield will they actually be able to make it to their place of work or will the flooding prevent them?
- **Suppliers** – Our suppliers may also have suffered damage. Stock and Work in Progress for delivery to ourselves may have been damaged and will need to be reworked or even scrapped. Even if there is no damage to product destined for us the business may still be unable to produce due to the effects of the flood. Likewise they too, even if able to manufacture product, may not be able to deliver it to us due to the prevailing conditions.
- **Customers** – similar criteria apply to customers as to suppliers such that even if we are able to produce they may no longer require deliveries from us because they are out of production.

Equally they may not be able to receive deliveries because we are unable to get them there because of the prevailing conditions.

- **Products** – All of this means that the demand for our products may fall. However it is also possible that there could be a rise in demand if, for instance, stock at our customers' premises had been damaged and they required replacements.

The contrast with the fire situation can best be illustrated by considering making a telephone call to any one of these people under the disaster recovery plan for a fire situation. In the case of a flood the person we are speaking to may well respond in the first instance by saying “we have suffered a flood here, didn't you know that!”

### **Crisis Management**

Relating back to the concept of triage raised in the previous presentation, this very different scenario requires investigations which differ from a fire situation. As has previously been explained the nature of damage may not be as straightforward as it first appears and thus needs to be investigated further. Likewise cause should not be taken for granted and prospects for recovery need to be considered where damage is in excess of that which might otherwise have been anticipated.

In drawing up site recovery plans these may well differ from the standard business recovery plan and needs to take account of the factors that are unique to a flood both in the short term (non availability of employees/suppliers/customers/contractors) and in the long term if other businesses continue to be affected.

The gathering of business information may need to extend beyond our own business. Likewise the need for good communication is merely heightened by the circumstances. Overall consideration needs to be given to the management of the entire supplier chain.

Thus it remains the case that key decisions are likely to be site based for a major loss under these circumstances.

## Case Studies

There are some very significant issues that arise from the flood scenario and I now wish to illustrate these by reference to some simple case studies.

First of all let us consider two hotels in the centre of the town which has been engulfed by the flood. The first is a City Centre tourist hotel which has had to be evacuated because it has been heavily damaged by water and the repairs will take four months to complete. The second hotel is in the west of the City on slightly higher ground and thus did not actually suffer direct damage but was isolated by the flood water. In this latter case there is a claim for loss of revenue as access is prevented by the flood waters. They are also making a claim for 'branded' stock which had been acquired in anticipation of a major sporting event. Unfortunately the sporting event has had to be postponed due to the flooding and the branded stock bore the planned date of the event.

The attached graph at **figure 1** illustrates the income for the first of the two City Centre hotels. Prior to the incident turnover is relatively flat on a monthly basis with minor peaks and troughs that largely reflect the differentials in the prices that the hotel is able to charge due to the time of year. Thus it can be seen that in the year following the incident their anticipated turnover merely mirrors that of the prior year.

The actual turnover achieved by the hotel makes interesting reading. Following the four month repair period turnover starts to gather momentum but then never actually reaches the pre flood levels even though as the small peak in the graph suggests Santa still arrives at Christmas time but does not distribute as many presents as in the previous year. On the face of it it is tempting to conclude that the shortfall in turnover apparent between the budget and the actual figures should be paid for by Insurers under the standard policy wording for covering losses resulting from damage at the premises.



# Hotel - Flooded - Damage

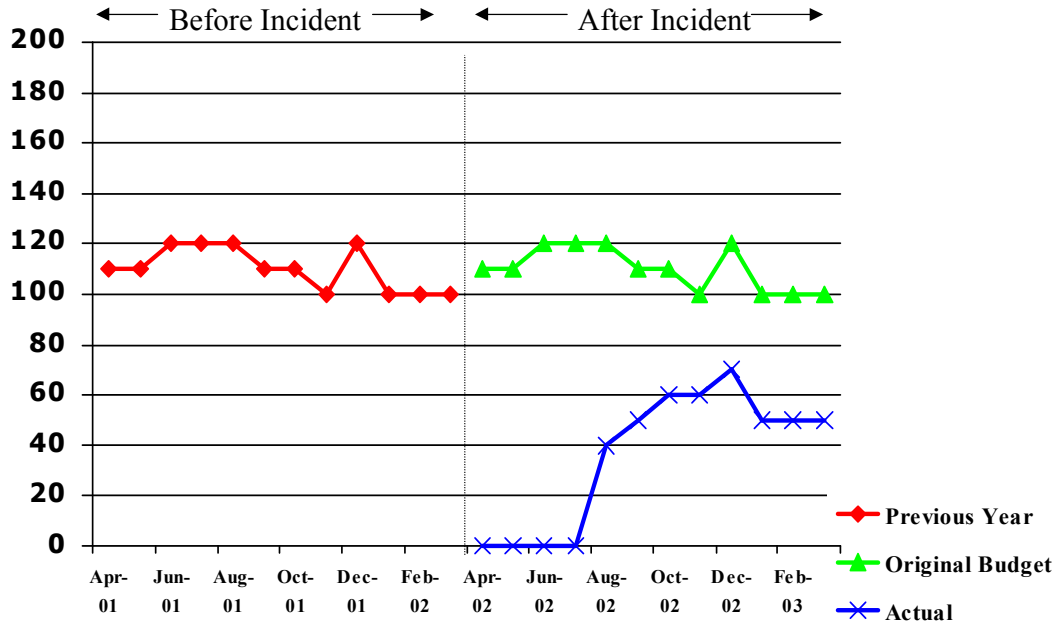


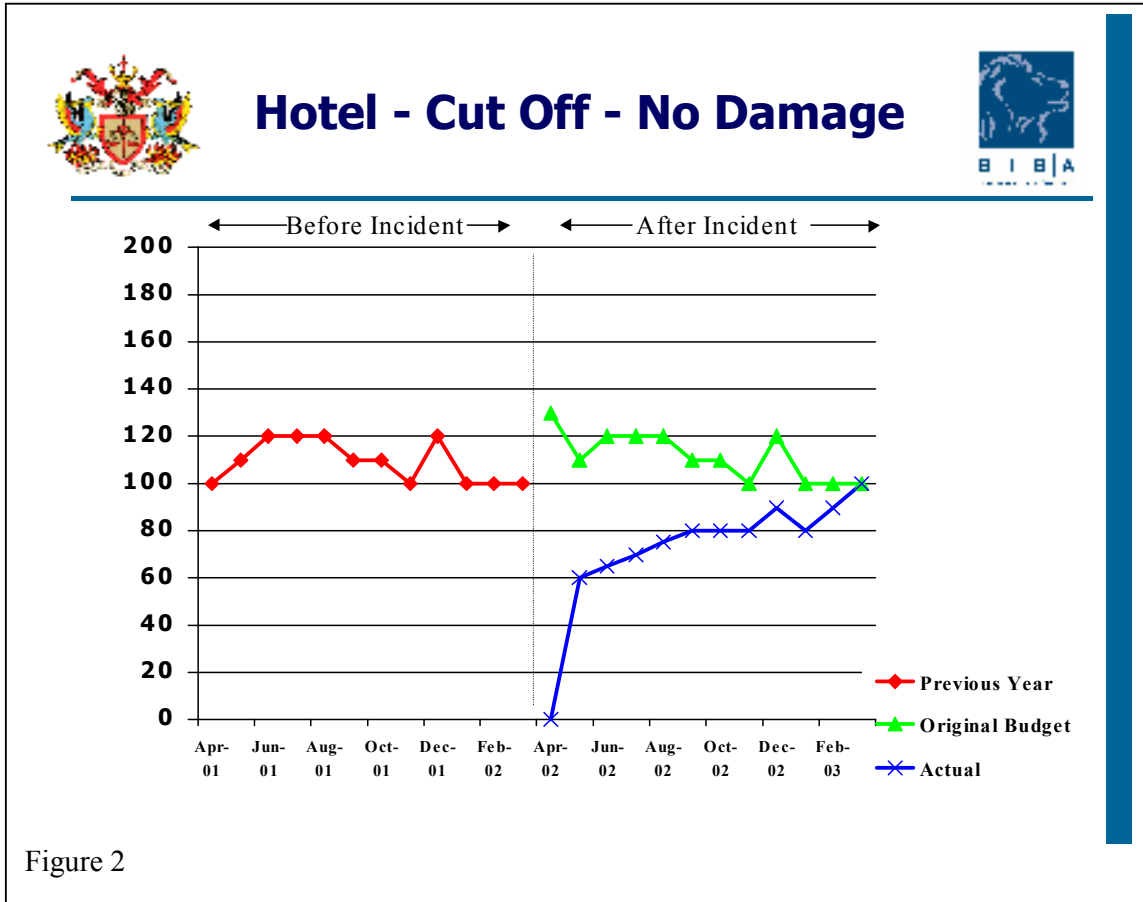
Figure 1

However, things may not be quite so straightforward. Please consider the same graphs presented with regard to the second hotel (**figure 2**). Again the budgeted turnover is far from dramatic mirroring very closely that of the prior year with the single exception of an increase in the month immediately following the flood when the sporting event to which I have already referred was likely to give rise to a small peak in income. Again turnover recovers, more rapidly on this occasion due to absence of damage to the hotel, but not until almost 12 months later does the turnover return to pre flood levels. In this instance what is the cause of the loss? Certainly it is not damage at the hotel because the hotel was on higher ground and suffered no direct flooding. It is thus the case that the remainder of the downturn must be associated either with Denial of Access or Loss of Attraction.

This second scenario demonstrates two important points;

- 1) Not all of the loss apparent at the first hotel can really be attributed to the damage occasioned at the premises themselves. Whilst the premises are still undergoing repair it is clear that the hotel would have suffered the loss in any event. Upon reopening, however, a question mark must exist over whether the continuing reduction in turnover is actually due to the damage or one of the other causes.
- 2) Both hotels would be in a far better position to recover their losses in their entirety if they had both Denial of Access and Loss of Attraction cover.

In this latter regard not only are questions likely to arise over what constitutes the vicinity with regard to Denial of Access, it is also the case that Attraction has not actually been defined and I believe this needs to be interpreted liberally so that for instance people unable to go to work, however much of an attraction they may or may not deem their work to be, would still qualify for the purposes of this particular extension.



At this point let me move on to another case study to demonstrate that it will not necessarily be the case that all claims will be reduced by the presence of flooding in the vicinity. Consider if you will a DIY / Builders Merchants based on an out-of-town shopping centre site. Following the flooding they have submitted a claim for Loss of Revenue which includes an additional sum in respect of additional dehumidifier hire which they would have enjoyed, due to the presence of flooding in the area, but which they were unable to service due to damage to their property. They have explained that the significant increase in demand for dehumidifiers could have been met by additional stocks supplied from the groups central store in Southern England. Incidentally they also wish to submit a stock claim for the full value of stock which had previously been written down prior to the flood but which now due to the effects of the flood will be in significant demand and could otherwise have been put back up to its original full selling price.

The graph at **figure 3** illustrates the pre incident turnover and the budget for the original business, which includes an element of growth, as well as the actual turnover of the business following the flood. The point to note in the post flood turnover is that in actual fact once the damage at the site clears and access is again more readily available turnover exceeds budgeted levels due to the increased level of building work within the flood area.

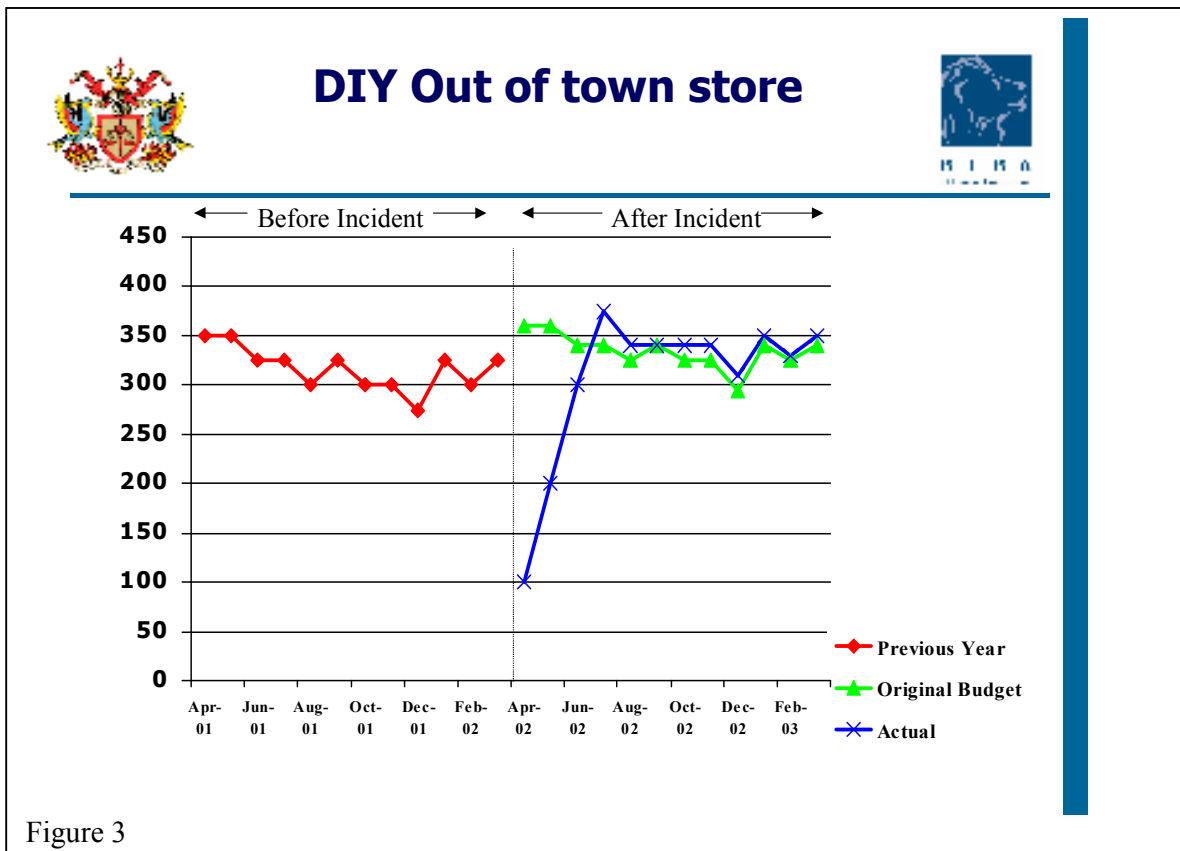
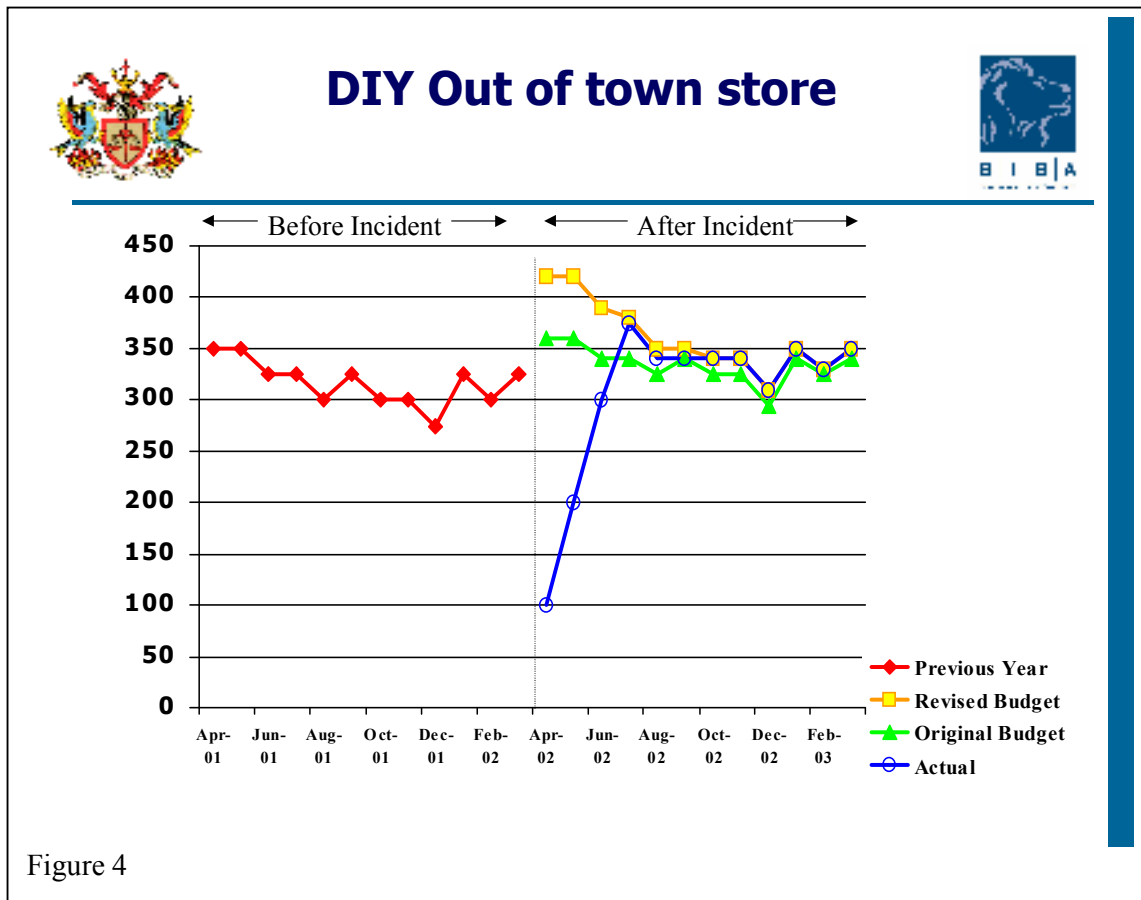


Figure 3

At **figure 4** they introduce an extra element to their claim (the revised budget) representing the additional turnover that they believe they would have enjoyed as a result of the flooding but which they were unable to capture because their premises were damaged. The question arises as to whether this additional turnover constitutes a valid head of claim under the policy.

On first considering this problem it is tempting to suggest that the policyholder is pushing their luck somewhat. To seek to recover a sum which will provide them with a profit in excess of that which they would have enjoyed had the flood not occurred, because they have suffered flood damage seems to be adding insult to injury for the insurer.

Perhaps the best way to consider this is to look at a similar business on the immediate periphery of the flood area. Such a business will not have suffered damage but clearly in the aftermath of the flood a DIY store in such a position could fully expect to enjoy an increased level of turnover once repairs to properties within the flood area get underway. The question then becomes is the flood damaged DIY store equally entitled to claim for this loss? I am led to believe that in the United States insurers are reluctant to pay for this and it is not an uncommon scenario for a hurricane to cause damage to a clearly defined area leaving businesses that are just outside the path of the hurricane to enjoy significantly larger turnover. When faced with matters of this complexity it is perhaps time to resort to reading the policy.



### Policy Cover

The policy states that the amount payable as indemnity shall be the sum produced by applying the Rate of Gross Profit to the Turnover shortfall in consequence of the Incident. Incident is defined within the policy generally as *loss destruction or damage to property in use by the insured at the premises*. Thus without either Denial of Access, Loss of Attraction or Customers/Suppliers Extensions the policy requires that there be Damage at the premises. Even under the extensions the vast majority of policy wordings will require there to have been Damage. The significant point to draw from this is that in actual fact one is not insured against flood, rather policies cover policyholders against Damage caused by flooding.

A number of items within the standard BI cover are bracketed so they can be adjusted for trend. This includes the Turnover anticipated in the period following any incident and the adjustment for trend allows for variations in or other circumstances affecting the Business either before or after the date of the incident which but for the incident would have been obtained. The significant points to note are that allowance in terms of trend can be made to figures both before and after the date of the

incident and the term incident relates to loss destruction or damage to property not the incident in its general form. You are all probably quite content in, say, a standard fire scenario that if a competitor had opened up in the post fire period then you would adjust for that in your overall settlement of a claim because that would have affected a business in any event.

From the above it would seem to be the case that the DIY store is indeed entitled to claim for the additional turnover which it would have enjoyed but for the damage it has suffered.

This may seem a bitter pill for insurers to swallow but the situation can often be seen in reverse. The attached article published shortly after the terrorism incident of September 11 highlights a reason why insurers should not, and indeed are probably unable to, fund some of the downturn suffered by those businesses following that tragedy. The reason for this is that the downturn in the US economy was suffered generally across the country and not merely by those who had suffered damage.

## **Summary**

It has been demonstrated by the show of hands at the first 6 masterclasses that there was a divergence of view as to the extent of loss that insurers should be meeting in these scenarios. In the same way that the insurance industry as a whole has learnt from previous incidents and planned for future ones, it seems strange that this particular issue has not been explored and a generally accepted practice developed.

There are very significant differences between the flood scenario and the fire scenario. This necessitates an alternative disaster recovery plan and, from an insurance point of view, it clearly demonstrates the need for Denial of Access, Loss of Attraction, Suppliers and Customers extensions and even possibly Suppliers of Suppliers, Customers of Customers and Suppliers of Customers and Customers of Suppliers, i.e. the whole supply chain.

Returning to the case studies it is as well to be aware of the potential effects on the economy of the area, and its constituent businesses, and to be comfortable with the different scenarios in terms of the loss which is attributable to the damage. As a rule of thumb the easiest way to consider what insurers should potentially be paying is to consider a business on the immediate periphery of the flood damaged area and how it might contrast its turnover with those that have suffered damage.

The case studies highlight once again one of the unique features of Business Interruption losses, namely that the strict doctrine of proximate cause does not apply to events following the initial incident. Whilst the initial incident and its cause may be determined by the doctrine of proximate cause events thereafter need to be considered in a different light. The key words are there in the policy where they refer to putting the business back in the position it would have been but for the damage. Various events may occur following an incident, which would not affect a business other than a business that had suffered damage. Thus whilst these events may not be proximately caused by the initial damage nevertheless their effect on a business may well fall to be considered under the policy.

### **Footnote**

In the two case studies mention was also made to stock losses. This was done in order to contrast the position under the Material Damage with that under Business Interruption.

The hotel had had a stock of items for a forthcoming sporting event. Whilst they were rendered worthless by the cancellation of the event nevertheless at the time that the damage occurred they had significant value and therefore one would expect to meet the normal level of claim that might have occurred say had a fire occurred.

Likewise at the DIY store it is also the case that at the moment the damage occurred the stock had been written down to reflect that it was slow moving. That was its value at the time of the flood and the subsequent increase in its value by virtue of the effects of the flood should not be taken into account.

This scenario should be contrasted with Business Interruption which does take into account events which occur after the date of the loss. In fact Business Interruption can be summed up in the phrase 'Day one no loss.....'