



## **Technical Briefing Note**

### **Payments Made Beyond Maximum Indemnity Period**

#### **1. Introduction**

One of the requirements for “Increases in Cost of Working” to be payable as an alternative to a loss of Gross Profit, is that the additional expenditure be incurred for the sole purpose of avoiding or diminishing a reduction in turnover during the Maximum Indemnity Period. The question arises as to whether payments made following expiry of the Maximum Indemnity Period can rank for consideration as ICWs.

#### **2. Policy Interruption**

The standard policy wording could be interpreted as meaning that either:

- a) the expenditure needs to be incurred during the M.I.P, or
- b) the turnover protected by the additional expenditure needs to be generated within the M.I.P.

Any such debate is, to all intents and purposes, purely academic. However, the critical factors are how the word “incurred” should be interpreted, coupled with the requirements that i) the policyholder has a duty to mitigate their loss and ii) all ICW’s have also to be economic in terms of Gross Profit loss thereby avoided.

#### **3. When is Expenditure Incurred?**

Working backwards this could be deemed to be:

- When payment is due.
- When an invoice is raised.
- When the goods or services were delivered.
- When the order for the goods or services was accepted by the supplier.
- When the order for goods or services was placed.



It could be argued that until the order has been accepted by the supplier, there is no contract and thus the policyholder is not committed to an expenditure, and even after that it might be possible to cancel the contract.

On the other hand the business may be committed to incurring expenditure even before an order is placed. Once a mitigating course of action is decided upon, and the first steps have been taken, then there is a commitment to meet all the ensuing costs that result from the decision to go ahead.

This is perhaps best illustrated by a decision made to occupy alternative premises pending reinstatement of damage at the risk address. Once a lease has been signed the business is effectively committed to a variety of costs, beyond the rent itself, such as removal costs, alterations, set up costs, rates, additional travelling, insurance, energy. More significantly there is a commitment to meet the cost of moving back to the original premises and possibly dilapidations. Since all these costs are linked, and relate to a single decision to occupy alternative premises, they are, in effect, incurred at the point that the decision to occupy the alternative premises becomes irrevocable.

Incidentally, this is the same basis on which the economics of any ICW should be assessed, i.e. all the expenditure related to the specific mitigating action should be added together, and then compared with the Gross Profit loss thereby avoided.

#### **4. Goods or Services Delivered Outside the Maximum Indemnity Period**

The attached example (Appendix A) illustrates the above principle in relation to rental of alternative premises which although only required for six months are only available on a minimum 18 month lease. This concludes that all costs associated with the alternative premises constitute a valid ICW since they are also economic within the M.I.P.

The situation may, however, not be quite so straightforward. In particular, what if the M.I.P proves to be inadequate and reinstatement at the risk address is not completed until three months after expiry of the M.I.P?

It is a generally accepted principle that if, for example, a second hand item of plant is purchased to temporarily maintain production, then when it is no longer required the original cost should be offset by the proceeds of sale (or residual value) to provide a net ICW. If the Insured chooses to retain the item (e.g. as a spare) then a notional residual value will be agreed.



It is recommended that a similar approach be adopted in the case of leased alternative premises. If the Insured need to occupy the premises beyond the M.I.P. then, in equity, they should contribute proportionately to the total cost in the ratio of the period occupied within the MIP to the period occupied outside the M.I.P. This is illustrated at Appendix B in calculation (e). **It is also the case that the need to occupy the premises beyond the expiry of the MIP merely serves to highlight that the chosen M.I.P. is inadequate and thus the Insured should bear their share of the loss.** Reluctance on the part of the Insured to this approach could, in principle, although unlikely in practice, be countered by Insurers suggesting that the property be sub- let once the M.I.P. had expired.

An alternative interpretation might be that the Insured should only contribute to the time related charges and not to the initial costs (e.g. legal fees, alterations) or those involved in moving back (e.g. removals or dilapidations) because these would be incurred anyway. See calculation (f) at Appendix B. However this approach does not overcome the need for the non-rental elements to have been incurred for the sole purpose of avoiding or diminishing a reduction in turnover within the MIP. **In this context, consideration also needs to be given to the anticipated use at the time the decision to occupy alternative premises is taken. If occupancy beyond the M.I.P is not anticipated then the expenditure will satisfy the sole purpose criteria.**



## Appendix A

### Declared Estimated Gross Profit £1m (12 months MIP)

01.03.09 -Fire damages building rendering it unoccupiable. Repairs are estimated to take eight months. Search for suitable alternative premises proves difficult. The search, the legal formalities, and the need to replace damaged stock meant that the Insured would be unable to take up occupation until 01.05.09. Even then the only premises available are on an 18 month sub-let (coinciding with expiry of head lease on 31.10.10) at £120,000 per annum.

In the six month period that the temporary premises will be occupied it is estimated that £360,000 Gross Profit will be generated.

The alternative rental cost claimed is £180,000. Ignoring other costs of occupation which are estimated to be less than £20,000, what contribution should be payable under the ICW item of the BI cover:

|    |   |          |
|----|---|----------|
| a) | Rental accruing during the period of occupation | £ 60,000 |
| b) | Rental accruing during the MIP                  | £100,000 |
| c) | Rent for 12 months – based on MIP               | £120,000 |
| d) | Rent accruing over the lifetime of the lease    | £180,000 |

Any of the above would be economic. The Insured is under a duty to mitigate their loss. At the time they sign the lease they incur 18 months of rental (albeit that during the latter 12 months the premises will be unoccupied). The alternative that they do not occupy the premises and continue to search for a shorter term let would, if unsuccessful, lead to a claimable GP loss of £360,000.



## Appendix B

The circumstances are as in Appendix A, except the repair period for the risk address is likely to be 15 months. The initial costs (£15,000) and those involved in moving back (£10,000) will total £25,000.

Possible contributions:

|    |  |                   |          |
|----|--|-------------------|----------|
| a) | Costs including rental accruing during the period of occupation  | £130,000          |          |
|    |  | £ 25,000          | £155,000 |
| b) | Costs incurred plus rental accruing during the remainder of the MIP                                    | £100,000          |          |
|    |  | £ 15,000          | £115,000 |
| c) | Costs including rental for 12 months representing the length of the MIP                                | £120,000          |          |
|    |  | £ 25,000          | £145,000 |
| d) | Costs including rent accruing over the lifetime of the lease   | £180,000          |          |
|    |  | £ 25,000          | £205,000 |
| e) | Period of occupation within MIP  | = 10 months       |          |
|    | Period of occupation after expiry of MIP   | = <u>3</u> months |          |
|    |  | <u>13</u> months  |          |
|    | Insurer's contribution $10/13 \times 205,000$  | £157,692          |          |
| f) | Costs including rent accruing over the lifetime of the lease less Insured's use outside MIP (3 months) | £150,000          |          |
|    |  | £ 25,000          | £175,000 |

It could once again be argued that if insurers do not agree to meet the full cost, which would be more than economic, then the Insured could refuse to take up occupation. However, under these circumstances the Insured would also suffer an uninsured GP loss (in months 13 – 15 inclusive).