



The Insurance Institute of  
**London**



RESEARCH STUDY GROUP 265

# Business Interruption Policy Wordings – Challenges Highlighted by Claims Experience



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Published by  
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Institute of Loss Adjusters

The contents of this report are not intended to be a full and authoritative statement of the law or practice relating to any of the issues covered; readers are recommended to take appropriate professional advice upon any issue which may affect them.

Statements and opinions in this report represent the majority view of the Study Group and are not necessarily in accordance with those of its individual members, their employers or the Institutes.

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The Insurance Institute of London  
20 Aldermanbury, London EC2V 7HY  
Telephone 020 7600 1343  
E-mail iil.london@cii.co.uk  
Web Page www.iilonon.co.uk

The Chartered Institute of Loss Adjusters  
51-55 Gresham Street, London EC2V 7HQ  
Telephone 020 7216 7580  
E-mail info@cila.co.uk  
Web Page www.cila.co.uk

## The Chartered Institute of Loss Adjusters

The Great Fire of London in 1666 heralded the beginnings of the loss adjusting profession, but it wasn't until 1941 that the term 'loss adjuster' was used when the Association of Fire Adjusters was founded. The Chartered Institute of Loss Adjusters (CILA) received its royal charter in 1961 and in 1979 the CILA received a Grant of Arms with the motto "Truth and Equity" which remain the key principles and ethos of the profession. CILA provides strict guidance to its world-wide membership on conflict of interest, business ethics and confidentiality.

The CILA's commitment to setting standards, examinations and professional conduct enables it to support all members across the industry. Members must comply with standards and are actively encouraged to achieve advanced levels of technical and professional competence.

## The Insurance Institute of London

The objectives of the Insurance Institute of London are:

**"To raise the levels of professional knowledge of those working in insurance in London, to assist members in their career development and to support and reinforce the role and work of the CII."**

The Institute achieves its objectives through its lecture and visits programmes, its journal and its research studies scheme. With its 17,800 members, London is by far the largest institute amongst the Chartered Insurance Institute's 67 local and associated institutes.

The Insurance Institute of London was established on 18 June 1907 following the initiative of the president of the Federation of Insurance Institutes of Great Britain and Ireland, who was also general manager of the Commercial Union.

In 1912 a Royal Charter was granted and the Chartered Insurance Institute came into being. Over the subsequent years the Insurance Institute of London handed over its library, museum, insurance courses and membership administration responsibilities to the CII and, in 1934, moved to the Insurance Hall, 20 Aldermanbury, which was specially built for their combined purposes.

## Preface

We all know what ‘contract certainty’ means technically – that there needs to be a policy in existence at the start of the insurance. But when it comes to business interruption (BI), we think it would be a good idea to take the concept of contract certainty a little further.

Our concern is that there has been a lack of clarity for a long time now – for insurers, adjusters and customers – over certain aspects of BI policies. For example, there is often a big difference between the technical meanings for words in a policy and the way those words are used in everyday business. The way indemnity periods are worked out can be confusing and there are parts of standard BI policies that even the professionals have never agreed about. In these circumstances, it's hardly fair to expect customers to have the right answers.

Because of the different schools of thought, the advice to Chartered Loss Adjusters from their Institute has been to take instruction from their principals. But this doesn't change the fact that similar claims can end up with different outcomes, depending on the insurer's interpretation of the policy. At best, this leaves us in the same fog we are in now – still confused, still uncertain. At worst, it can leave customers feeling like they've been treated unfairly, putting all our reputations at risk.

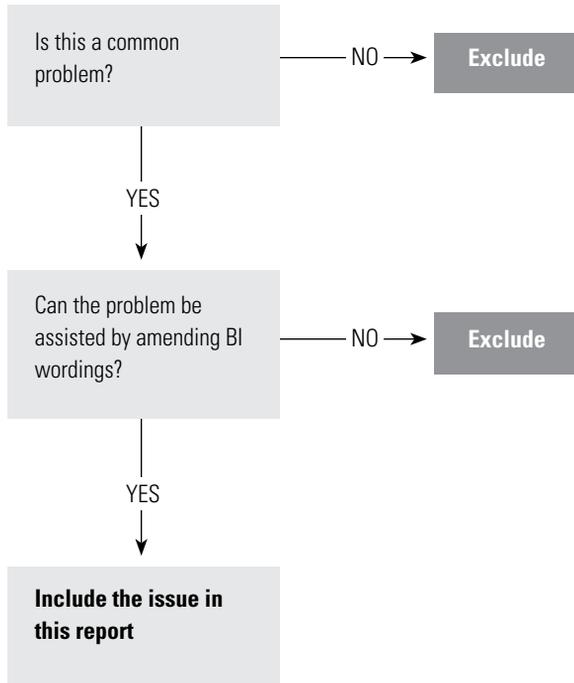
With this in mind, wouldn't it just be easier – and perhaps less risky – if we were all more certain about what the words in the contract actually mean? We think so.

In June 2009, the Chartered Institute of Loss Adjusters (CILA) convened a seminar, involving a wide range of industry professionals, to highlight recurring and significant BI issues encountered in practice that would benefit from clarification in policy wordings. The group gave the CILA's Business Interruption Special Interest Group (BI SIG) a mandate to identify problem areas within the existing BI wording and make recommendations about how to fix them.

May 2010 saw the issue of a first report and many of the observations made at that time are included here. That report was issued primarily to show that some interim progress was being made and it was entitled *BI Wording Review Initial Report*. In fact, this project is not an exhaustive review of BI wordings. It is an attempt to focus on recurring problems that are capable of being resolved by changes in policy wordings. There may be issues in the wordings that might be clarified but which rarely, if ever, cause a practical

difficulty. Likewise, there are common problems with BI claims that cannot be resolved merely by a change in policy wordings. None of these issues therefore fall within the remit of this Report.

The following diagram summarises the approach we have taken.



The initial report was not exhaustive and more complex issues needed some deeper study. So with the support of the Insurance Institute of London, an ambitious project to identify and comment upon the more complex issues was commenced. A cross-industry team was formed to progress this and thanks go to everyone who gave of their time so generously.

This Report marks the culmination of three year’s work and addresses topics identified by the BI community and the CILA. We do not propose prescriptive new wordings. Nor do we want to throw the baby out with the bathwater. In fact, we believe that most of the existing BI wording works, most of the time. As a result, this publication highlights those areas where we think some clarification would help customers, insurers and adjusters and with contributors from across the industry we explore some fundamental procedural change where it is agreed it would be helpful to all.

Throughout, the objective has remained unaltered – to avoid similar claims giving rise to different outcomes depending on a particular interpretation of a policy wording. Clarity and contract certainty, where consistency in the claims response can be seen, is what we have tried to achieve.

While we have attempted to identify the issues that we believe would benefit from some level of change in as concise a manner as possible, we have tried to balance this with the need for a degree of discussion so that the need for clarity is clearly appreciated and justified.

We are aware of several wording changes, some of which were underway within insurance companies irrespective of this initiative, which have drawn from this work. We hope that this Report will assist consideration of further change.

This is not a finite undertaking. New circumstances and the changing face of the economy, both locally and globally, will demand an ongoing review process. New risks, which existing wordings may struggle to easily accommodate, will undoubtedly present themselves. This is something that has been clear over the last few years, and it is likely to continue. Even in the absence of significant new exposures, clarification is an ongoing process.

This Report does not claim to be exhaustive; it does, however, aim to deal with the most commonly encountered difficulties. There are many issues that remain problematic, for specific market sectors for example.

In scoping this work, we have been mindful of the need to avoid being unduly prescriptive; we are not seeking to produce new wordings, but rather to identify issues benefiting from clarification, and have offered potential solutions as opposed to any specific recommendations. Contributors have been mindful of the need to avoid any anti-competiveness and we believe that this is a balanced and objective assessment of the issues we all face on a day-to-day basis.

We hope this is a useful and thought provoking document that will influence policy wordings in the future. Whether we have succeeded will be objectively tested by answering one question – will BI wordings change as a result of this (or the earlier initial) Report?

Damian Glynn  
Harry Roberts

## **Contributors and Members of Study Group**

### *Joint Chair*

Harry Roberts (Cunningham Lindsey)  
Damian Glynn (vrs Vericclaim)

### *Core Team*

Mike Dean (Dialog Consulting)  
Andrew King (Aon Risk Solutions)  
Gerald Williams (Fitzgerald Consulting)

### *Contributors*

David Henderson (FM Global)  
Graham Herridge (Zurich)  
Vivienne Hexter (Aon Ltd)  
John Holland (Crawford & Company)  
Diane Jenkins (Aon Ltd)  
Flemming Jensen (Matson Driscoll Damico)  
Heather Lees (Marsh)  
Tony Levitt (RGL Forensics)  
Heather Parkinson (Parkinson Consulting)  
Geoff Piggot (Gen Re)  
Richard Popple (Crawford & Company)  
Harry Rule (Allianz)  
Jonathan Samuelson (Harris Balcombe)  
Victoria Sherratt (Barlow Lyde & Gilbert,  
now with Reynolds Porter Chamberlain)  
Martin Singleton (Aviva)  
John Thompson (Hilton Thompson)  
Tim Thompson (Crawford & Company)  
Neil Warden  
Sue Willmott (GAB Robins)

### *Other Contributors*

David Abbott (Barlow Lyde & Gilbert)  
Colin Alderson (Zurich)  
John Bartlett (Allianz)

Peter Clark (Zurich)

Paul Jenkin (Groupama)

Steve Manville (Chartis)

William May

Ian Shelley (Aviva)

Steve Sodeau (Guy Carpenter)

Dr Tony Sowter

Malcolm Stewart

Phil Thorpe (NW Brown Insurance Brokers)

David Watkins (Allianz)

David Way (Lockton)

*Editorial consultant:* Roger Jordan

*Designer:* Barry Kemp

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**1****Gross Profit**

Reference is made to the following illustrative profit and loss account in some of the sections.

XYZ Ltd, accounts for the year ended 31 December 2010

	£m	£m
Turnover		125
Opening stock	20	
Raw materials	45	
Subcontracting	10	
Direct labour	23	
Closing stock	<u>(18)</u>	
Cost of sales		(80)
Gross profit		<b>45</b>
Administrative costs		15
Distribution expenses		10
Interest		<u>5</u>
Profit before tax		<b><u>15</u></b>

## **1.1 Gross Profit – Definition**

### **1.1.1 Current position**

Many business interruption (BI) policies are written on a Gross Profit basis, whether these are declaration-linked or not. The policy usually allows the insured to select the costs (variously described as Specified Working Expenses, Variable Costs, or Uninsured Working Expenses) to be deducted from turnover (or Revenue, Takings, or Sales) in defining Gross Profit. This is intended as a benefit rather than a complication, because it means that the purchaser of the insurance (who has the best understanding of their own business) can decide on what will make the cover most meaningful to them.

The majority of general combined commercial policies define Gross Profit as the difference between the sum of turnover plus closing stock and work in progress, and the sum of opening stock/work in progress plus Specified Working Expenses, Uninsured Working Expenses, Uninsured Variable Charges, or some similar term. Some explicitly use the word 'Purchases', which may

or may not be denoted with a capital 'P', and similarly may or may not be defined. In many wordings the costs to be uninsured are not listed within the policy wording itself, but reference is made to the Schedule in which they should be set out.

Package policies often offer a definition rather than referring to a specific list of Uninsured or Specified Working Expenses. In some cases, definitions of Gross Profit refer to lists of costs set out in the Schedule, but the Schedule does not always include such a list.

## 1.1.2

### What is the problem?

Gross profit is a term in everyday use in the business community, and is one that has no particular definition. It is not defined in statute. It is not defined in any accounting standard. In stark contrast, insurance policies explicitly include a definition, which typically may be stated as turnover less purchases (adjusted for stock) less bad debts and carriage out.

Confusion over an everyday commercial term arises.

With reference to the example profit and loss account above, the gross profit for accountancy purposes amounts to £45 million. However, based on an insurance definition only deducting purchases of raw materials, and allowing for the movement between opening and closing stock, the insurance gross profit would be £78 million:

	£m	£m
Turnover		125
Opening stock	20	
Raw materials	45	
Closing stock	(18)	
Cost of sales		(47)
Gross profit		<u><u>78</u></u>

In some cases, the policy refers to the Schedule to ascertain the list of uninsured costs. However, some Schedules do not contain any list, which effectively means that Gross Profit, for policy purposes, is not accurately defined pre-incident.

In other cases, insurers pre define Gross Profit, resulting in the policies not being tailored to the needs of policyholders, and lacking the flexibility otherwise available (albeit this may be an unavoidable necessity for a small and medium enterprises (SME) 'package' product).

Where the term ‘purchases’ is used, the BI texts, including *Riley on Business Interruption Insurance*<sup>1</sup> and *Honour and Hickmott’s Principles and Practice of Interruption Insurance*,<sup>2</sup> both take the view that ‘Purchases’ represent physical raw material purchases. Costs closely associated with Purchases, such as subcontracting expenses, are not always explicitly dealt with. Even where policies do contain a tight definition of purchases, it may be that that term does not appear in the books of account of the insuring business. There can therefore be a disjoint between terminology used in the policy and terminology used in the books of account. Even where the policy acquiesces to use terms in the books of account (accounts designation clause), it is not usually stated whether such books of account represent management accounts, statutory accounts, or some other underlying books maintained by the business.

As with gross profit, the term ‘purchases’ is in everyday use, and is not necessarily restricted to raw materials. For example, the term ‘purchases’ appears as a box on a standard VAT return, and, in that context, includes all types of purchase and expense, including utilities and even replacement of capital plant.

It is commonly the case that, when buying BI cover, the policyholder tends to envisage an incident of major proportions such that, say, their entire premises are destroyed. In such cases, many overheads may well cease, or abate, and thus there would have been no need for these to have been insured. This approach is flawed in that it fails to recognise those circumstances where partial damage can, for example, leave a production line operational but far less efficient. This is just one illustration of how costs that are apparently variable prove, under certain circumstances, to be fixed.

### 1.1.3 **What are the consequences?**

Differences in terminology or lack of clarity between the policy and the business community cause confusion.

Many businesses, particularly manufacturing businesses, also deduct items such as wages and power in defining gross profit in the statutory accounts, and there is frequently a failure to appreciate that the definition of the term gross profit used in either the annual statutory or the monthly management accounts is likely to differ from the more specific definition of Gross Profit in an insurance policy.

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1 Harry Roberts, *Riley on Business Interruption Insurance* (9th edn, London: Sweet & Maxwell Ltd, 2012).

2 W B Honour and G J R Hickmott, *Honour and Hickmott’s Principles and Practice of Interruption Insurance* (4th edn, London: Butterworths, 1970).

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Businesses purchasing insurance can fail to appreciate the significance of this point even after their insurer or broker brings it to their attention, such that any misunderstanding crystallises in a potential shortfall in coverage when an incident occurs.

If items such as wages and power are deducted in addition to purchases (adjusted for stock), the resultant gross profit that is insured will be lower than that defined in the policy. In the event of a claim, the insured may receive less than the full loss due to the application of underinsurance, policy limits, or potential voiding of the policy where a significant under-declaration of Estimated Gross Profit has been made. While the policyholder may suffer a one-off and very unwelcome and untimely shortfall, insurers would have been receiving less premium income, over the lifetime of being on cover, than if the correct level of cover had been chosen. In other words, both parties potentially suffer.

In the example above, the Estimated Gross Profit of £45 million would be 42% inadequate compared to the insurable amount of £78 million.

The claims presentation community, in discussion with clients post-incident, frequently highlights for the first time that the policy defines Gross Profit in a manner other than that used within the accounts. This can give rise to a major expectation difficulty, frequently leading to significant shortfalls in indemnity.

The difference in terminology was highlighted in the case of *Arbory Group Ltd v West Craven Insurance Services*.<sup>3</sup> In that instance, a calculation of gross profit using an accountancy/business definition as opposed to that in the policy gave rise to a significant shortfall in the settlement and a subsequent claim for negligence against the broker.

Where the definition is not sufficiently clear, the level of under-recovery can be significant. On one occasion, financial information supplied after a fire was fundamentally irreconcilable to the level of declarations made in recent years. The business interruption loss was in the region of £5 million. The declarations were completed annually, showing turnover, purchases and opening and closing stock. It transpired that the finance director regularly summarised, over three pages of A4 paper, a significant list of costs (that represented things the business purchased) but entered only the total of that list against the term 'purchases' to reduce the amount of paper involved in the process. The existence of the list was unknown to the broker or insurer. The fact that purchases might be construed as relating to raw materials only did not occur to the finance director. If the definition used by the insured for

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3 *Arbory Group Ltd v West Craven Insurance Services* [2007] Lloyd's Rep IR 491; [2007] PNLR 23.

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declaration purposes had been adopted, under-recovery of 25% of the actual loss would have been achieved.

#### 1.1.4 **Potential solutions**

Given that the core difficulty here is an (erroneous) assumption on the part of the policyholder that Gross Profit in an insurance policy is likely to mean the same thing as it does in their accounts (which in some cases it will), it may be advantageous to introduce a new term that will require the business person to explore the relevant definition and necessary calculation when selecting the level of cover required.

The term 'Gross Profit' could be replaced with 'Insurance Profit', 'Insurance Gross Profit', 'Insurable Profit' or any similar term. By way of example, one leading insurer has already decided to adopt the term 'Insured Profit' in future policy wordings.

It has been suggested that the term 'Gross Margin' might replace 'Gross Profit', but it is unlikely that this would help, because gross margin is another technical accounting term in common usage; and, therefore, it is thought that it could prove equally confusing.

With regard to the specific use of the term 'purchases', this could be more specifically defined as 'purchases of stock, raw materials and components (and/or consumables)'. Some policies already do this, and this brings clarity, albeit there is still the potential risk of the term 'purchases', including other things in the accounts. Subcontracted manufacturing processes are the most likely area of difficulty given that the owner of a business may view those costs as purchases in the same way as raw materials. The definition of 'purchases' could be extended to include subcontract manufacturing processes.

Given the significant number of businesses that do not use the term 'purchases' in their accounts at all, there may be merit in having a slightly wider and more flexible wording to include 'purchases of stock, raw materials and components (and/or consumables) and other third party subcontracting costs'.

## 1.2 **Gross Profit – Uninsured Standing Charges Clause**

### 1.2.1 **Current position**

Many policies include an uninsured standing charges clause. This will state that if an insured business fails to insure fixed costs, and thereby takes on the risk of part of the gross profit of the business, the policy will only pay a proportion of increased costs incurred to mitigate loss.

Some policies omit (deliberately or otherwise) the uninsured standing charges clause.

### 1.2.2 **What is the problem?**

The term ‘standing charges’ is not one in everyday commercial use, and the application of the uninsured standing charges clause may not be clear at first reading. To make matters worse, there is seldom, if ever, a definition of the term ‘standing charges’. This also begs the question as to whether there is any relationship between ‘standing charges’ and ‘working expenses’ used in the definition of Gross Profit.

### 1.2.3 **What are the consequences?**

Difficulties with the term ‘standing charges’ are likely to arise as a consequence of the difficulty in establishing what is variable and what is not. Over the course of a microsecond all costs are fixed (you couldn’t stop spending any money that quickly even if you wanted to); over the course of 100 years, all costs are variable.

It seems almost inevitable that applying the uninsured standing charges clause will prove problematic. The process of debating which costs have been shown to be fixed (although these were assumed to be variable when the sum insured was declared) will inevitably take time. Any lack of clarity over the meaning of ‘standing charges’ will be seized upon when a policyholder, having incurred additional expenditure in good faith to mitigate a loss, finds it will only be partially covered.

### 1.2.4 **Potential solutions**

The term ‘standing charges’ should be abandoned, because it is not a term in general use and thus has no generally accepted meaning. The issue that the current clause seeks to address is that of working expenses that have specifically been uninsured but which are not truly variable costs.

A previously-circulated proposal suggested referring to ‘the proportion that the insured working expenses bear to all of the working expenses that have not reduced in direct proportion to turnover’.

## **1.3 Material Damage/Business Interruption Overlap**

### 1.3.1 **Current position**

Business interruption policies typically define Gross Profit as turnover less

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raw material purchases adjusted for stock movement (with minor variations relating to carriage, bad debts and other costs likely to vary in direct proportion to turnover). As a consequence, all overheads and wage costs are insured as part of the Gross Profit.

This gives rise to two issues.

First, there is the issue of stock. Manufacturers especially, but not exclusively, add overheads and wages to the basic raw material costs in valuing their stock. This is to comply with the terms of the Statement of Standard Accounting Practice 9 (SSAP9), issued by the Institute of Chartered Accountants, in which it is acknowledged that an increasing proportion of fixed overheads should properly be regarded as part of the value of stock while it is in the course of manufacture.

If the stock is destroyed and this also gives rise to a reduction in turnover, there is the potential for the insured to be indemnified twice, in respect of both the overheads and wages, because these are insured under both covers.

This may occur where the stock (inventory) policy provides cover for the cost of raw materials, together with labour and overhead expenditure incurred to create either 'finished' or partly finished product (i.e., work in progress) and the related BI policy provides cover for the turnover value of the damaged product, reduced only by the cost of the raw materials.

It may also arise where the stock (inventory) policy provides for finished goods at their sales value and the related BI policy allows only deduction of the raw material costs when calculating the Rate of Gross Profit.

In the profit and loss example above, adopting the insurance definition of Gross Profit would result in the subcontracting and direct labour costs (along with all other overheads and net profit) being insured as part of the business interruption cover. These are the type of costs that would be included in any stock valuation for manufacturers in particular. Were that to be the case, there may need to be a deduction of these amounts at the point of settlement to avoid an over indemnity.

The mere fact that there is both a BI and stock claim running in parallel does not of itself mean that there is definitely an overlap to be dealt with. If damaged stock is not re-manufactured until after the end of the Maximum Indemnity Period, the overheads incurred as part of the stock re-creation process will be those of the subsequent period and no overlap will present itself.

The fact that a stock loss has occurred does not inevitably mean that there will be a BI loss arising for it to overlap with.

Second, the insured's overheads and wages might be paid as part of the cost of the repair and reinstatement process under the material damage cover, while also being an element of the BI claim in the event of a loss of turnover. For example, the insured's staff might be paid to carry out cleaning work post incident. If the insured presents a valid claim for their own labour/overhead costs incurred as part of the material damage recovery costs and simultaneously presents a claim for the same labour and overhead costs under the related BI policy (by virtue of the definition of specified working expenses applicable within the BI policy), there is a risk of the policyholder receiving more than a full indemnity.

### 1.3.2 **What is the problem?**

Whenever these scenarios arise, policyholders may potentially benefit because elements of their costs are covered by both policies, or by both sections of a combined policy.

Policyholders often argue that they have paid appropriate premiums for both elements of cover and, therefore, they should be entitled to receive the benefit of any duplication in the cover.

There is no clear means under either policy by which any duplicated amounts may be deducted from the settlement, thereby restricting the overall 'global' figure to a strict indemnity.

### 1.3.3 **What are the consequences?**

Policyholders may be seen to be claiming a double indemnity for costs incurred, contrary to the principle of indemnity.

If the insured mitigates its losses by using its own labour (often at considerable saving to insurers), it might recover the costs incurred from its material damage insurers. If the labour costs paid are then deducted from the BI claim in order to avoid this so called 'double indemnity', the policyholder may feel that it is penalised unjustifiably.

There is no facility for making any adjustments (to reflect the duplicated amounts) within either the material damage or the BI policy. Such adjustments are generally applied to the BI settlement, but these do not fall within any of the clearly-defined elements of the standard UK BI policy wording. Consequently, they are often treated incorrectly as 'savings' even though they do not fall within the definition of costs/expenses saved in consequence of the incident, giving rise to the claim.

Notwithstanding this, where one or other element of the cover (MD/BI) is underinsured and average conditions are incorporated, policyholders may be entitled to ‘cherry pick’ the sections of the policy against which the costs that are covered under both sections are allocated.

### 1.3.4 **Potential solutions**

There are several possible solutions to this issue.

If it is the intention to avoid any double indemnity, a provision could be made in either the material damage or BI policy to make an appropriate deduction. Current practice would seem to be that any adjustment be made under the BI policy, but this could act to the detriment of the insured if the material damage settlement had already been limited by the application of average.

It is possible to amend the wording of the BI policy to enable such costs that have already been paid (after application of average) within the material damage policy or section to be taken into account in the BI settlement. This could be achieved by, for example, including the following clause:

Due account will be taken of any payment already made in respect of insured costs under a related Property Damage policy or section of this policy.

Alternatively, it may be insurers’ intention to pay both the BI and material damage claims on the basis that the insured has paid the full premium for both covers.

The US approach is to exclude BI losses relating to finished stock, which reduces the significance of the overlap in relation to stock but does not address the circumstance where the insured’s own labour undertakes material damage repairs to buildings, plant, etc.

## 1.4 **Material Damage Proviso**

### 1.4.1 **Current position**

The material damage proviso is fused with the operative clause in some policies, and set out separately in others. Regardless, it is invariably not identified in policy wordings as ‘the material damage proviso’ (MDP) – this term is used within the industry to refer to a form of words seen in most policies.

A typical material damage proviso might read:

[The Operative clause will trigger] provided that at the time of the happening of the damage there shall be in force an insurance covering the interest of the insured in the property at the premises against such damage and that payment shall have been made or liability admitted therefore under such insurance.

The main purpose of the material damage proviso stated in *Riley*<sup>4</sup> has been to ensure that sufficient funds are available to facilitate reinstatement, which in turn will mitigate the BI loss. A subsidiary objective is to obviate the need for the business interruption adjuster to duplicate the work of the material damage adjuster in investigating cause and considering the application of any clauses precedent to liability.

#### 1.4.2

### **What is the problem?**

It seems to be widely accepted that when it comes to the availability of sufficient funds to effect reinstatement, the material damage proviso fails. There is no requirement for the property insurance to be adequate, or for that matter that it be on a reinstatement basis. The proviso is either satisfied or it is not; an all-or-nothing position is established, irrespective of the underlying commercial sufficiency of the cover.

The need to anticipate separate material damage and business interruption investigations into causation is anachronistic, particularly in respect of commercial combined policies.

The material damage proviso was conceived when the various covers were purchased as separate policies. Not only have commercial combined covers become the norm, but also the breadth and availability of BI extensions have increased. The extent to which the traditional material damage proviso wording can be applied to these extensions varies between wordings.

This issue was tested in the courts in the case of *Glengate-KG Properties Ltd v Norwich Union Fire Insurance Society Ltd and Others*.<sup>5</sup> Glengate bought an old department store building on Oxford Street to redevelop. It took out two policies with Norwich Union, one for material damage and one for business interruption. It had a temporary site office in the building, which was used by the construction professionals, including the architects. There was a fire that destroyed the site office, and, with it, a large number of drawings on

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4 As note 1 above.

5 *Glengate-KG Properties Ltd v Norwich Union Fire Insurance Society Ltd, Scottish Union & National Insurance Co and Lowndes Lambert UK Ltd* [1996] 2 All ER 487; [1996] 1 Lloyd's Rep 614.

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which the the architects were working. Importantly, the drawings were very clearly the architects' property. They retained the copyright and ownership and the drawings were in their possession. Once completed, Glengate was to have a license to use the drawings.

The architects had not insured the drawings. There was an extension in the material damage policy that included temporary offices and plans, but only if these were the, 'property of the insured or for which they are responsible'. Norwich Union argued that the material damage proviso in the business interruption policy was not satisfied because there was no cover in force for the drawings. The two majority judgments rejected this argument. These drew a distinction between the type of interest covered by the business interruption policy and the insurable interest necessary to insure property under a material damage policy. It was held that the former was broader and focused on the fact that the business interruption cover clause only required the property to be used by the insured for the purposes of the business at the premises. It did not spell out a need to have a proprietary interest (e.g., ownership). In contrast, they found that the material damage cover required an insurable interest in a more narrow sense, namely a proprietary or contractual interest in the property.

By this reasoning, the Court of Appeal found that there was sufficient insurable interest to allow the claim under the business interruption section but no insurable interest for the purposes of the material damage section, meaning that there was no breach of the material damage proviso. The broader interest required by BI did not need to be insured by Glengate and the claim was paid.

### 1.4.3 **What are the consequences?**

The material damage proviso is ineffective in terms of the main objective stated in *Riley*.<sup>6</sup> In the event of significant underinsurance giving rise to delay in the reinstatement process, insurers have to employ other arguments to avoid their liability being increased by virtue of a potentially extended indemnity period.

If the current wordings can produce unfairness to insurers, there can also be disproportionate difficulty for the policyholder. In *Glengate*, there was a suggestion that any failure to satisfy the material damage proviso might invalidate all of the BI cover, which may have produced an unfair resolution in the mind of the policyholder. If funds are made available, so that any failure to adequately insure all elements of the business at risk has no impact on the reinstatement period or BI loss, it may be inequitable for

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6 As note 1 above.

a technical breach of the material damage proviso to invalidate significant elements of claim.

Potential breaches of the material damage proviso may be more likely now than in the past, as recent wordings have required the material damage proviso to be applied to property (used by the policyholder) that others insure also, notably buildings insured by landlords, in addition to property owned by the policyholder.

Duplication of cause investigation work etc. is not relevant for combined policies, where the adjuster investigation relates to all sub-sections of cover; in cases of BI loss only (extensions), there is an underlying policy requirement to prove any loss subject to the terms and conditions of the policy, irrespective of the material damage proviso.

Historically, before policies became combined, the material damage proviso could be satisfied by any one of several separate covers, potentially underwritten by different insurers being triggered, for example: stock, engineering, computers, contents, buildings. Some recent wordings relate the proviso to a specific section of the combined policy only thereby producing a restriction in the way that the material damage proviso can be satisfied and reducing the breadth of the BI cover.

#### 1.4.4

### **Potential solutions**

United States' policy forms relate the indemnity period to a notional reinstatement period, which excludes additional/exacerbation of loss due to a lack of funds (irrespective of whether that arises due to inadequate insurance or any other cause). This could be adopted within UK-style policies.

The above suggestion is considered equitable if reinstatement is within the insured's control. However, there is a difficulty when the reinstatement is under the control of a third party. For example, a third party may fail to carry out the reinstatement expeditiously, as a result of which the policyholder suffers extended business interruption losses. This could be addressed by including an explicit statement within the policy wordings concerning whether the exacerbation of loss caused by third parties is covered or not.

It seems appropriate to observe that adequate insurance does not guarantee timely reinstatement, and inadequate insurance does not lead directly to delay, if alternative funds are drawn upon to drive mitigation.

With regard to the issue of the duplication of investigation, the BI insurers could specify that they will rely on the investigations carried out by the material damage insurer to determine liability under the material damage claim. The findings of these investigations could then be accepted as prima facie evidence in relation to causation. The BI insurers would thus have the option to follow the material damage insurers' decision to accept or deny liability, provided there were no other grounds on which liability might be disputed, such as a breach of a condition of the BI policy.

If the material damage proviso were altered, there would be a need to alter the wordings for BI extensions. Those extending the definition of Perils at the Premises (such as notifiable diseases, murder, etc.) present no particular difficulty, but those that extend the definition of Premises (such as customers, suppliers, utilities, etc.) require fundamental refreshment.

## **1.5 Rent**

### **1.5.1 Overview**

There is sometimes confusion as to the scope of cover for Rent that is required. Where there is cover on a schedule, it can be unclear whether this is intended to relate to Rent Receivable or Rent Payable. For the purposes of the discussion that follows it is considered helpful to provide clarity as to the meaning of the following terms.

#### **1.5.1.1 Rent**

The money paid by a lessee to the landlord for the benefit of occupying a building or part of it. The rent is usually expressed as an annual figure but is paid quarterly.

#### **1.5.1.2 Rent review**

An agreement in the lease whereby the rent payable is reviewed at specified intervals. Many leases are written on the basis that the rent can never go down regardless of market conditions and many on the basis that the rent can only go up. Sometimes the increase is capped so that it cannot exceed a certain percentage. Rent reviews usually take place at five-year intervals although more frequent reviews could be agreed if it suits both parties.

#### **1.5.1.3 Service charges**

This is the amount payable by a tenant for services provided by the landlord, for example, cleaning or security.

#### 1.5.1.4 **Rent cessation clauses**

This is the clause in a lease that enables the lessee to cease paying rent, or an equitable part of it, should the premises be damaged by defined risks to the point where the lessees' business is affected. The risks will be defined elsewhere in the lease but usually correspond to defined risks under an all risks policy. There is a maximum period, specified in the lease (usually three years), during which the rent ceases to be payable.

#### 1.5.2 **Rent Receivable**

##### 1.5.2.1 **Current position**

Businesses for which rent is the main revenue for their business, that is, property owners, will usually have specific Gross Rental policies.

However, many businesses earn rent as an incidental part of their business; from owned buildings no longer needed by the business, from subletting of larger leased premises or as part of an investment portfolio. It is, therefore, desirable for Rent Receivable to be insured under a Gross Profit or Gross Revenue policy, as part of the income of the business.

Alternatively, Rent Receivable is sometimes insured under the material damage cover rather than BI cover, particularly in the case of landlords. It should be noted that this form of cover is not as extensive as that provided under a BI wording, because the Indemnity Period automatically ceases when the repairs are complete. If rent is insured under the material damage section, the cover ceases at reinstatement. However, if rent is covered within a gross profit item often the Indemnity Period is not aligned to the rent cessation clause; the cover will continue until the Premises are reoccupied by a tenant as opposed to being reoccupiable.

Leases commonly contain cessation clauses. In some cases, the lease will also specify a minimum period, of up to three years, after the cessation commences in respect of which landlords should insure the rental income under the lease.

Leases are subject to review at fixed intervals, at which times the rent may increase by significant amounts. In the event of a loss, unlike most Gross Profit claims, a reduction in Rent Receivable is not ameliorated by significant commensurate savings.

##### 1.5.2.2 **What is the problem?**

Although not an integral part of their business, many companies will receive rent payments. It is vital to include all of the constituent parts of an insured's

business that might be affected by an interruption in the policy business description. If the particular activity is not identified within the definition, the policy cannot respond to the losses incurred by that part of the business.

Consider, for example, the case of an office block owned and partially occupied by the insured for its business, with a portion sublet to a third party tenant. In the event of an interruption, unless 'property owning' has been defined as part of the business description, the policy would not respond to any loss of rent receivable from the tenant.

Even if the policy has been extended to cover rental income, the overall rate of gross profit is likely to be substantially less than that attaching to the rental income, which may well be 100%.

In the absence of a rent cessation clause, this is not an issue from the landlord's perspective. However, if the lease does contain a rent cessation clause (common in modern leases), the potential for an uninsured loss of rent may exist. The reduction in Rent would only be payable if the business activity specified in the schedule has been expanded appropriately. This applies equally to freeholders and tenants who sublet.

If the landlord insures Rent Receivable, this may raise the question as to the need for the tenant to effect insurance for Rent Payable, ostensibly insuring the same income stream twice.

There is frequently a mismatch between the basis of the insurance of Rent Receivable and the underlying lease.

The term 'Rent' as defined above may be insufficiently wide to address losses presenting themselves. Related income streams such as service charges, advance rent and ancillary charges may all be at risk and should potentially be brought within the ambit of the cover.

Where there is a minimum period stipulated by the lease, this may well exceed the Maximum Indemnity Period provided under the businesses' BI policy. It would be costly to increase an indemnity period solely to cater for Rent Receivable when it is incidental to the main business.

Rent losses are more likely than Gross Profit losses to exceed the limit of 133.33%. This is because significant step increases in Rent Receivable may accrue within the Maximum Indemnity Period, compounded with the absence of significant savings to deduct from the income loss.

### 1.5.2.3

#### **What are the consequences?**

If the description of the business has not been appropriately expanded to

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include the receipt of rent and related income streams, a reduction thereof after an incident will not be payable.

Rent may be insured more than once; if the lease contains a rent cessation clause it is usual for the landlord to arrange loss of rent cover (and re-charge the premium to the tenant as part of the rent). If the tenant is funding the landlord's rent premium by way of a re-charge, and is additionally insuring it as a constituent element of his Gross Profit, they are in effect paying twice for the same thing.

Where there is a mismatch between the insurance cover and the underlying lease, an under-recovery might arise.

In one case, a large retail chain discovered that it was insuring Rent three times. The landlord was insuring Rent (with a rent cessation clause in the leases) and charging the retailer its cost; Rent was not deducted from the Gross Profit calculation and so was included within the sum insured for the full three-year indemnity period; and, further, there was a separate Rent Payable sum insured on the business interruption policy. It was discovered that approximately £20,000 was being spent on unnecessary rent cover each year.

#### 1.5.2.4 **Potential solutions**

Rent Receivable may be insured if the description of the business is appropriately framed.

For the avoidance of doubt, a departmental clause should be incorporated to provide a true indemnity if different parts of the business likely to be affected by a loss earn differential rates of profit or revenue.

Where the period that the lease requires Rent to be insured following the operation of a cessation clause runs beyond the Maximum Indemnity Period, it may be preferable to show Rent Receivable as a separate item on the policy carrying its own indemnity period. This indemnity period should match the period stipulated in the lease.

The definition of Rent Receivable should be broad enough to include service charges but these are often overlooked when sums insured are calculated. There may, however, be escape clauses if the services are subcontracted so savings would be made; alternatively, these could be separately insured.

The rent receivable item sum insured should be the maximum rent that is likely to be received during the selected indemnity period assuming that the

damage occurred on the last day of the period unless on a declaration-link basis, it should be the estimated rent receivable at the start of the policy (multiplied by the indemnity period).

The above solutions are workable if the Rent Receivable is a modest proportion of the overall business. In some cases, the Rent Receivable is substantial, for example, in the case of a property-owning division or subsidiary. In such cases, it would be better to have a separate item covering rent receivable and to specify a separate indemnity period for this item of cover.

### 1.5.3 **Rent Payable**

#### 1.5.3.1 **Current position**

Many policyholders pay some rent, even if the majority of their premises are owned. It is common for businesses to rent premises on long-term leases in premises that were specially fitted out to their specifications.

In contrast to consideration of Rent Payable insurance as part of the BI section, it can be provided within the material damage section of the policy. In these cases the cover applies until the landlord reinstates the premises; there is no cover during the additional fitting-out period or if there are delays before full production/trading can be recommenced.

Many businesses assume within their business continuity planning that they will be able to occupy temporary alternative premises from an early stage following an incident. Thus, there is a presumption that there will be relatively little impact on turnover and a short Maximum Indemnity Period is therefore adopted.

#### 1.5.3.2 **What is the problem?**

The fact that there are cessation clauses in leases sometimes encourages the policyholder to contemplate uninsuring Rent Payable, in order to save premium.

This is commonly the case if the rent is being paid to a related party such as a pension scheme for the benefit of the directors/shareholders of the business that owns the property.

Uninsuring Rent presumes that all BI claims arise from the total loss of buildings triggering a cessor of rent clause, which is incorrect. Damage to stock, plant, partial building damage or the operation of BI extensions can all give rise to BI losses, without there being any rent saving.

Even where a cessor of rent clause is triggered, rent will not necessarily reduce in line with turnover. Rent will become payable again when a building is available for occupation, subsequent to which the tenant will need to fit it out prior to generating any gross profit. Even if full capacity is restored there may still be an ongoing loss of turnover as the customer base is being restored to pre-incident levels. In the meantime, the full amount of rent will have become payable.

Additionally, the rent cessation clause may partially apply to a small part of the premises but if this part is key to production the gross profit could suffer and the majority of the rent will still need to be paid.

The clause usually says the cessation of rent operates until the premises are again fit for occupation by the lessee; but what happens if the premises are unfit for trading because, for example, fixtures and fittings still have to be installed? Generally, the loss of rent insurer will take the view that its liability for rent should cease once the premises are repaired and can be handed back to the tenant for fitting out. This applies where the fitting out relates to damage to the lessee's fixtures and fittings rather than the landlord's building. The lessee should have cover for rent payable under its own business interruption policy for the balance of the fitting-out period until it can recommence trading.

Where a short Maximum Indemnity Period has been selected on the assumption that temporary premises will be readily available, consideration may not have been given to the additional rental that may be involved, and could be especially significant in the absence of a cessation of rent clause.

### 1.5.3.3 **What are the consequences?**

Notwithstanding for the reasons noted above that Rent Payable should usually not be uninsured, it remains the case that the tenant will be paying for the premium as part of the rent that is paid to the landlord as well as the premium for his gross profit under the BI policy. This is unavoidable. If Rent Payable is deducted from turnover in calculating Gross Profit, it will often be the case that this will give rise to an uninsured loss in respect of Rent Payable.

The additional rental incurred on temporary premises beyond the expiry of a short Maximum Indemnity Period will not be covered.

### 1.5.3.4 **Potential solutions**

Best practice should be to insure rent payable within the BI rather than the material damage section.

Rent payable should be included within the gross profit cover (i.e., not be deducted as a specified working expense).

Where a short indemnity period has been adopted, anticipating occupation of alternative premises, an extended Maximum Indemnity Period may be required for Rent Payable. Such cover would have to form part of an extension to the BI policy for the simple reason that an additional item under a material damage cover would not provide for Increase in Cost of Working.

## 1.6 Declaration-Linked Policies – No Proportionate Reduction

### 1.6.1 Current position

Declaration linked policies generally allow for a maximum recovery of 133.33% of the declared amount. There is no facility for any proportionate reduction should the declared amount be too low. In some cases declarations are not requested or offered.

Gross Profit may be (wittingly or otherwise) under-declared, such that insufficient premium is paid for the risk that is underwritten (a loss to both the insurer and policyholders in the common fund).

There have been three CILA surveys that have considered this point and have revealed the following results.

<b>Event</b>	<b>In what proportion of policies is the declaration too low?</b>	<b>If a declaration is too low, how severe is the shortfall?</b>
CILA conference Sept 2008	37%	50%
CILA conference June 2009	52%	63%
CILA survey March 2012	40%	45%

While there is some degree of variation in the above findings, these statistics reflect a general consensus throughout the industry that declarations generally are significantly understated. Estimates of the extent of the problem are subjective, but the number of respondents in each case has been sufficient to make the findings statistically meaningful (roughly 110, 190, and 286 respondents for the three surveys, in chronological order).

### 1.6.2 **What is the problem?**

In the absence of any allowance for proportionate reduction, insurers may not be receiving an adequate premium to reflect the risk underwritten. Legal opinion has been expressed to the effect that a very significant under-declaration may constitute a failure to adequately disclose the nature of the risk presented, which might support avoidance of the policy. Notwithstanding this view, there are dissenting legal opinions which suggest that such an approach may be seen as a heavy-handed response, particularly where the BI element of a claim in a specific instance may not be large.

When there is a serious under-declaration, compromise arrangements can be reached, whereby proportionate reduction is voluntarily imported, or where the implied definition of Gross Profit suggested by the calculation of the Insurable Amount is adopted rather than the policy definition. Those are compromises on merit that might not be possible to achieve in all circumstances. Insurers may be dissatisfied with a choice between a potentially heavy-handed response impacting on the relationship both with the insured client and the placing broker, or meeting a claim in respect of which a proper premium has not been achieved. In some cases this can be to a very substantial degree.

### 1.6.3 **What are the consequences?**

The insured is at risk of claim payments being less than the losses sustained whether by policy avoidance, application of average or restricted by limit.

In situations in which declarations are substantially below what they should be, and there is a major or total loss, the insured may well be out of pocket because 133.33% of the estimated Gross Profit will be less than the loss suffered.

The insured will receive even less if proportionate reduction is imported.

### 1.6.4 **Potential solutions**

Clauses could be included in policies to the effect that, if the declared amount is less than 50% of what it should be, the policy reverts to a sum insured basis, subject to proportionate reduction.

Some other threshold could be used – many material damage covers allow an 85% adequacy on sums insured prior to applying proportionate reduction, and a similar principle could be imported with regards to BI wordings.

Insurers would benefit, it is suggested, from the protection of a collar arrangement that provides some protection in cases of significant under-declaration without requiring the avoidance argument to be presented. Policyholders who have paid an adequate premium would not be compensating for those who have not.

## 1.7 Declaration-Linked Policies – Overall Impact

Including the recent survey undertaken by the CILA, the average findings from the last three surveys (on a simple average basis) have been:

Proportion of BI policies that are written on a declaration-linked basis	62.5%
Proportion of declaration-linked policies that are under-declared	43%
Average level of inadequacy	53%

Having established the above, we had hoped to be able to quantify the overall financial impact of BI underinsurance across the UK market. Unfortunately, this has not proven possible. There is no single source of BI premium data to which the above proportions can be applied. The Association of British Insurers (ABI) has provided the following summary:

<b>BI gross written premiums:</b>	<b>£m</b>
2005	618
2006	615
2007	651
2008	613
2009	714
2010	676

*Note: Source ABI and FSA Statutory returns.*

However, these data relate only to those companies authorised by the Financial Services Authority (FSA) and do not reflect the whole UK market. There are several significant carriers whose gross written premium for BI is not included in the totals above. A variety of anecdotal evidence has been supplied to us from which extrapolations could be made, but this is not all consistent and we cannot be certain that the results would be meaningful. It is, however, worth observing that even with reference to the incomplete premium figures above, the under-declaration issue could be valued at almost £100 million on the basis of the CILA survey results.

## 2

## Damage

## 2.1 Damage – Definition

## 2.1.1 Current position

The term ‘Damage’ is usually, but not always, a defined term in policy wordings. Common definitions include ‘Loss or Damage’; ‘material loss, destruction or damage’; ‘direct physical loss or destruction of or damage to the Property Insured’; ‘accidental loss, destruction or damage to the Property Insured’.

The term may also be included in the same policy wording as an undefined term (i.e., not denoted with a capital letter), frequently in connection with denial of access wordings.

Whether something constitutes ‘damage’ will depend on the wording of the particular policy, and the individual circumstances of each claim.

In some instances, insurers have accepted that events constitute damage beyond the strict legal definition of the term.

From a strict legal perspective, the authorities make it clear that loss of use or deprivation of property must be fairly extreme to count as a ‘loss’ and cannot be temporary:

‘mere deprivation would not under ordinary circumstances constitute a loss. On the other hand, complete deprivation amounting to a certainty that the goods could never be recovered is not necessary to constitute loss.’

By way of example, pearls were consigned abroad on sale or return. In the meantime, the First World War broke out and the jeweller could not retrieve the jewellery. The court held that this did not amount to ‘loss’: there was no evidence that the Germans had seized the pearls, the jewellers would simply have to wait for many years to retrieve them.<sup>7</sup>

In contrast, Kuwait Airways aircraft, which were captured during Iraq’s invasion of Kuwait, did constitute a ‘loss’. The court reached this conclusion based on evidence that the assets of Kuwait Airways at Kuwait International Airport were a specific target of the Iraqi invasion. Iraq intended both to capture them and treat them as acquired from the moment the airport was

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7 *Moore v Evans* [1918] AC 185.

captured. Once the airport had been captured these assets were effectively lost to Kuwait Airways with no real prospect of recovery.<sup>8</sup>

Although an aircraft belonging to British Airways was also captured during the same operation and a claim was made for its loss, this claim was considered quite differently. It was held that the loss of the aircraft was temporary. There was a realistic prospect of recovery by UK forces and Damage as defined had not occurred in this instance.

The *Oxford English Dictionary* defines ‘damage’ as ‘Harm or injury impairing the value and usefulness of something or the health or normal function of a person’.

There has been significant judicial consideration of the meaning of ‘damage’ in many different contexts. As with ‘loss,’ whether ‘damage’ has occurred will be a question of fact and degree depending on the circumstances and on the nature and effect of what has been done. As such this question will need to be considered in the context of each individual claim.

In general terms, however, ‘Damage’ must be damage to tangible property, as opposed to pure economic loss (which is generally not thought to be insurable on its own).

There must be physical alteration or change in the characteristics of the property rendering it less useful or valuable and/or which requires some remedial work or expenditure of money to restore the property to its former usable condition.

The damage need not be permanent as long as there is a physical alteration. For example, surface contamination or defacement, which can be cleaned, can still constitute damage.<sup>9</sup>

## 2.1.2

### **What is the problem?**

The definition of Damage in policy wordings is frequently imprecise. The incorporation of defined and undefined uses of the term in the same policy causes confusion.

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8 *Scott v The Copenhagen Reinsurance Co (UK) Ltd* [2003] Lloyd’s Rep IR 696.

9 *Promet Engineering (Singapore) Pte Ltd v Sturge & Others (The Nukila)* [1997] 2 Lloyd’s Rep 146; *Tioxide Europe Ltd v CGU International plc and others* [2005] Lloyd’s Rep IR 114; *Pilkington (UK) Limited v CGU Insurance plc* [2004] EWCA Civ 23; *Losinjaska Plovidba v Transco Overseas Ltd (The Orjula)* [1995] 2 Lloyd’s Rep 395; *Patricia Hunter and others v Canary Wharf Ltd* (1997) 2 WLR 684.

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The court's approach to issues of what constitutes 'loss' and 'damage' for the purposes of triggering cover may not reflect the scope of cover that insurers wish to provide.

### 2.1.3 **What are the consequences?**

In the case of denial or hindrance of access, if the cause of the hindrance is undefined 'damage' (without a capital letter), that potentially gives wider cover than exists at the Insured Premises. This may not be the intention of the parties.

Several events in the recent past have highlighted the problem of temporary impairment of use (notably flooding). Market responses have varied from the legal definition of damage, and the differing responses can undermine contract certainty (policyholders with different insurers in the same locality will speak to each other and make comparisons).

### 2.1.4 **Potential solutions**

In some cases, the definition of 'Damage' will benefit from review. The specific inclusion or exclusion of impairment of use (temporary or otherwise) would add clarity.

Additionally, in respect of extensions, Damage might be defined as Damage that would be covered if it occurred at the Premises.

## 2.2 **Wide Area Damage**

### 2.2.1 **Current position**

The majority of losses involve Damage solely to the insured's own Premises, with possible subsequent collateral damage to some adjacent properties, for example, due to spreading fire/extinguishment operations. However, in the event of losses caused by perils of earthquake, storm, hurricane, flood explosion and tsunami there is *simultaneously* wide area damage (WAD). This is usually associated with general lack of access, a reduction in customers coming to the area, damage to suppliers and customers affecting economic activity generally, and/or suspension of utilities.

Such WAD can lead to aggravation of the loss that might have been suffered by each business, had it been the only one to suffer damage at the Premises. Such aggravation can occur in a number of different ways, for example:

- other businesses in the same supply chain, be they suppliers or customers, may be unable to trade at pre-incident levels;
- visitors, and in particular customers, may be deterred from visiting the affected area either because other businesses are not able to trade, or because the infrastructure and surrounding areas have been destroyed or damaged;
- WAD may extend the period it would otherwise take to reinstate the damage to the insured's property. This may be because materials and labour are scarce due to increased demand, or because of damage to infrastructure such as roads.

Typical UK wordings are quite clear in specifying that cover is only provided for loss that flows from Damage at the insured's Premises. Any sums payable under Item 1 (a) Gross Profit or 1 (b) Increase in Cost of Working need to be in consequence of the Damage. Furthermore, while the 'other circumstances clause' provides for trends in the business to be taken into account, these trends are only those that would have affected the Business but for the Damage.

The above interpretation was tested and confirmed by the UK courts in the case of *Orient Express Hotels v Assicurazioni Generali SpA* (2010).<sup>10</sup> The circumstances surrounding this case were:

- Orient Express Hotels owned the Windsor Court Hotel, a premier 23-storey hotel, situated in the Central Business District, close to the historic French Quarter of New Orleans;
- the hotel suffered significant physical damage from wind and water and was closed throughout September and October 2005. The hotel reopened on 1 November 2005, albeit not fully repaired and with its services and amenities not fully operational;
- a state of emergency had been declared and a curfew imposed on 27 August 2005; a mandatory evacuation of the city was ordered on 28 August. The city was only reopened and the curfew lifted at the end of September.

Orient Express Hotels claimed for BI losses suffered during the closure period and thereafter. Insurers rejected its claim for BI losses during the closure period by applying the special circumstances clause. Thus, for example, during September 2005 New Orleans was effectively 'closed' and the adjusted Standard Turnover should be zero.

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10 *Orient Express Hotels Ltd v Assicurazioni Generali SpA (UK) (t/a Generali Global Risk)* [2010] EWHC 1186 (Comm).

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Orient Express Hotels contested this application of the policy wording. Its key arguments included:

- it was entitled to an indemnity for losses caused by insured damage, even if its BI loss was also concurrently caused by damage in the vicinity;
- insurer's application of the 'but for' principle was not an appropriate causal test in this case;
- there was no exclusion for losses caused by vicinity damage. Furthermore it argued that the trends clause was being treated as an exclusion clause, which it was not;
- having regard to the purpose of the trends clause, its language and commercial common sense, the clause should be construed as not permitting an adjustment for the consequences of the very same insured peril that caused the insured damage which gave rise to the relevant BI loss;
- the trends clause should deal with the effect of 'real' trends, not imaginary or hypothetical trends;
- a mutuality of approach should apply. The concept of the windfall profit claim is counter-intuitive;
- the application of the insurers argument meant that, remarkably, the greater the wide area damage, the less cover is afforded to the business in respect of its own damage.

The BI cover was for 'loss due to interruption or interference with the business directly arising from Damage'. The capital 'D' for Damage confirms that the cover was related to Damage as defined, that is limited to property at the premises of the insured. More notably the clause includes the word 'directly', which is stronger than the normal 'in consequence'.

The High Court dismissed the argument about hypothetical issues for trend purposes, recognising that while the calculations required were potentially more difficult than normal, they were by no means insurmountable.

Most significantly the court agreed with the tribunal that:

- the other circumstances clause is concerned only with the Damage, not with the causes of Damage.
- Orient Express Hotel's construction required words to be read into the

clause or for it to be re-drafted (even then the other circumstances clause might be inconsistent with the main insuring clause);

- the trends clause provides clear support for adopting the ‘but for’ approach to causation.

## 2.2.2

### **What is the problem?**

An anomaly can arise in relation to WAD, as illustrated by the flooding of Cockermouth, Cumbria in 2009 and the impact on shops, restaurants and other businesses in Main Street. The effect of the severe flooding of all businesses in Main Street was to turn the centre of the town into a virtual building site for a period of four to six months. Had any one of the businesses avoided suffering Damage these would have nevertheless suffered substantial trading losses because of the impact that the flooding had on the rest of Main Street.

While business A may have suffered Damage to its property, application of the other circumstances clause by the insurers citing the difficulties of B, C, D ... Z would serve to reduce the claimable loss. A similar argument submitted to business B in respect of businesses A, C, D ... Z would apply and so on. This leads to an anomalous position for which the greater the WAD, the less is insurers’ overall liability for BI losses. But, as in Cockermouth, strict application of this principle could lead to accusations in the community and in the press of insurers seeking to rely on the ‘small print’ in the policy to avoid paying BI claims.

Not only can the effects of WAD drive down the economy of a geographic area, but also they can lead to increased demand for businesses such as suppliers of building materials and hoteliers. In the case of very widespread and severe damage, retailers and service providers generally might observe that if they had not been damaged (but the competitors were), they would have seen a growth in business. Thus, the other side of the above coin is that these businesses that might have enjoyed an upturn but for the Damage they suffered themselves, can invoke the other circumstances clause and claim for a windfall profit from their insurers.

## 2.2.3

### **What are the consequences?**

Policyholders who find their claims reduced by insurers to reflect WAD feel short-changed. Most policyholders, and indeed and their advisers, expect their loss to be measured in relation to the impact of the event that caused both Damage at their Premises and more widely as well. They see the two as inextricably linked and consider arguments along the lines of the *Orient Express Hotels* case to be artificial. Their wish is to be compensated at a level that assumes the event

itself had not occurred. When taking out cover, policyholders are not looking to insure for windfall profits that they might enjoy under certain circumstances, nor are they anticipating the introduction of windfall losses.

The policy interpretation rightly endorsed by *Orient Express Hotels* does not accord with most insurers' intentions either. Insurers are often disinclined to meet claims for windfall profits. Consistent with this approach was that adopted by the market to Cockermonth, where seeking to apply a windfall loss adjustment was not adopted either.

In his book *Interruption Insurance: Proximate Loss Issues*,<sup>11</sup> Gordon Hickmott suggested it was always insurers' intention to pay for losses that an insured would have suffered based on the actual Damage sustained. It does not appear to be the intention of the market to reduce the cover available in respect of Damage at the Premises on the basis that there has been WAD also. This market intention is inconsistent with the strict meaning of the policy, and the decision in *Orient Express Hotels*. Policyholders can consequently no longer rely on the continued concession of the market interpretation of WAD claims, as evidenced in Cockermonth, for example.

The decision reached in *Orient Express Hotels* is unlikely to be overturned, so the market needs to develop a wording that is in line with its own intentions and goes further towards meeting policyholder requirements and expectations.

## 2.2.4

### Potential solutions

The policyholder can seek to address any shortfall in cover by requesting policy extensions such as suppliers, customers, denial of access and loss of attraction. Indeed, *Orient Express Hotels* had denial of access and loss of attraction extensions but, as in its case, contingent BI covers are normally subject to inner limits imposed so that insurers mitigate exposure to an accumulation of risk.

There would appear to be no alternative other than to amend the existing policy wording if both policyholders' expectation and insurers' intentions are to be met. In the United States, it is common for policies to specifically state that windfall profits are not covered. Such wordings do not, however, preclude insurers from applying a windfall loss argument.

The challenge remains to develop a wording that precludes both windfall profits and losses while, at the same time, limiting insurers' exposure to the BI losses associated with the insured's own damage. Recognition needs to be given to the

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11 G J R Hickmott, *Interruption Insurance: Proximate Loss Issues* (London: Witherby & Co Ltd, 1990).

fact that certain policyholders may wish to insure for windfall profits. Clearly, with such an option comes the need for the sum insured to reflect this potential. At the same time, any policyholder seeking recognition of potential windfall profits must also accept the potential for the application of windfall losses.

It may be that the least complicated way to deal with this issue is to clarify the operative clause (which sets out the requirement for Damage to property owned or used by the policyholder for the purpose of the business at the Premises as the trigger for cover). Policies could include an additional clause to the effect that if there is widespread damage in the vicinity in addition to Damage at the Premises, the Damage consequent on which the BI loss is measured includes the damage generally and not just that at the Premises. This would, on its own, still leave policyholders in a 'Cockermouth scenario' feeling disgruntled. If it is the intention of the parties, this might be addressed by an additional clause allowing for the impact of WAD to not reduce the BI cover below that which would arise over the physical repair period at the Premises.

With regard to non-UK wordings, it is relevant to note that while US wordings commonly exclude windfall profits they do not explicitly deal with windfall losses.

## **2.3 Premises**

### **2.3.1 Current position**

A typical BI wording requires 'Damage to property owned or Used by the Business at the Premises'. If there is material damage to such assets, the BI cover will be triggered (this requirement for physical damage as a trigger for the BI cover is referred to as the material damage proviso). The BI loss is not restricted to the particular location at which the damage occurred.

Many policies do not define the term 'Premises'. Where these do, the majority define 'Premises' as 'those listed in the Schedule' (or similar). Some policies simply give the address of the premises; others will refer to 'those premises used by the business anywhere in the world'.

The terminology in the BI section of the policy does not mirror that in the material damage section, which is likely to define 'Buildings' in some detail. The material damage section of the policy does not use the term 'Premises'.

### **2.3.2 What is the problem?**

The core BI policy cover requires Damage at the Premises.

In the case of a site solely occupied by the insured, most policies do not clearly define premises as relating only to the building or to the whole demised site to the boundary (which would be more consistent with the material damage definition of the building).

Where there is multi-occupancy of a site, such as in a multi-tenanted building, there is again a lack of clarity as to whether Premises relates only to the part of the building occupied by the insured or to the whole building or indeed, to the whole site.

Consequently, if an incident occurs in the car park or in the common area of a multi-tenanted building, there might be disagreement over whether cover is triggered or not. Shared or common parts, such as drives giving access to the premises, may not be insured, and this would lead to coverage issues.

The above issues are relevant with regard to 'Damage at the Premises', but also present themselves when considering the scope of BI extensions such as utility failures at the terminal ends or Denial of Access.

Additionally, the lack of a precise definition of Premises can impact on consideration of warranties. There may be warranties that relate to waste removal from the premises, for example, that will focus attention on the precise meaning of the term.

Defining 'Premises' as those listed in the Schedule can be a particular challenge for expanding businesses, because newly-acquired additional premises may be inadvertently left off such a list. An incident occurring at one of those might not trigger cover.

Group companies may be highly dependent on inter-company trading but group cover may not be in place.

### 2.3.3 **What are the consequences?**

In the absence of a satisfactory definition, insurers may have different views on the intended meaning of the term. Consequently, policyholders might misunderstand the extent of coverage available, particularly if they move cover between insurers; there can also be different definitions and/or terminology used within a single policy (e.g., in endorsements compared to the main cover).

There may be a failure to adequately insure outbuildings, yards, fences, and property in the open generally; this may lead to inadequate sums insured and application of average on the material damage claim, which may

impact on the scope of the BI cover. If there is any misunderstanding in the terminology, losses in the open may not be covered due to failure to insure up to the curtilage of the premises; any failure to insure all property belonging to or used by the insured outside of the premises may lead to coverage issues.

There can be confusion in the application of policy extensions, notably Denial of Access and Utility Failure, particularly if these are triggered by incidents within the demised curtilage but outside of the building.

On one occasion, for a claim initially estimated in the region of £8 million, a warranty required the removal of waste from the Premises daily. Waste was bagged and removed to the perimeter fence daily and removed from site once per week. In due course, a fire started externally – the cause was not proven but assumed to be youths lighting an external skip about 10 metres from the building – that was blown by the wind onto the building. The entire building as well as the contents and stock were totally destroyed. The matter was litigated. The term ‘Premises’ was undefined apart from an address on the schedule. If the Premises constituted the demised premises, that is, the site, the warranty was not complied with, and the claim would not be payable. If the Premises constituted the buildings only, the warranty would have been complied with. The policyholder remained bemused at the significance placed on an undefined term.

#### 2.3.4 **Potential solutions**

Policies could specify whether the Premises means the whole demised Premises site or just the buildings. In the case of part occupation, it could be specified whether the Premises is restricted only to that part of the building in sole occupation of the tenant. There is no ideal solution here. Defining the term one way or another would allow some claims brought under extensions to be paid, but denying others; consistency and clarity would nevertheless be achieved and avoid an expectation difficulty.

### 2.4 **Denial, Prevention and Hindrance of Access**

#### 2.4.1 **Current position**

Traditionally, the extension related to damage in the vicinity, albeit more recently, non-damage extensions have become available, for example when the competent authority denies the use of a road leading to the Insured Premises.

A typical damage extension might read:

Property in the vicinity of the Premises, loss destruction of or damage to which shall prevent or hinder the use of the Premises or access thereto, whether the Premises or property of the insured therein shall be damaged or not, but excluding ...

This extension acknowledges that, while an incident in the vicinity of the Insured Premises would not satisfy the material damage proviso, it could still severely affect the business and result in a reduction in Turnover.

Cover is provided for denial/prevention or hindrance of access to Insured Premises, but not egress from them.

## 2.4.2

### **What is the problem?**

Key words in a typical extension are not usually clearly defined, for example, 'vicinity', 'damage', or 'hinder'. Dictionary definitions are insufficient to provide certainty of cover.

#### *Vicinity*

Typical definitions might be:

- a surrounding area or neighbourhood;
- the immediate surrounding area;
- proximity in space or relationship (Latin *vicinus* – neighbouring).

There is no consistency in specified distances where there is a definition.

#### *Damage*

Dictionary definitions of the term 'damage' are discussed at section 2.1 above.

For an insured business interruption loss to arise following an incident at the Premises, Damage (as defined by the policy) must have occurred. However, the extension does not usually adopt the defined term 'Damage'. The extension does not restrict the damage causing the hindrance to be Damage from which BI losses would be covered if it occurred at the Premises. In particular, this extension would benefit from clarification of the definition of Damage in terms of temporary impairment of use (see at section 2.1 above).

#### *Hinder*

Typical definitions might be:

- to be or get in the way of someone or something;
- to prevent, hamper or impede;
- to cause delay, interruption, or difficulty in;
- to prevent from doing, acting, or happening;
- to be an obstacle or an impediment.

There is no reference point for the degree of disruption required to satisfy the policy requirements. For example, vehicular access may be impacted differently to pedestrian access.

Furthermore, it is unclear as to whether hindrance may only be construed in a physical way, such that disruption to the Internet or telecommunication networks is not covered by such an extension.

Following the widespread flooding in the UK in 2007, the issue arose as to whether a fortuitously flooded road, which was then impassable, was damaged or not for the purposes of this extension. There was a lack of clarity in some cases as to whether impairment of use should be accepted as damage, or whether the focus should be on whether the underlying road surface required subsequent repair or not, irrespective of a volume of water on it.

### 2.4.3 **What are the consequences?**

#### *Vicinity*

In some cases, the (undefined) damage denying/hindering access is very close to the insured Premises, for example next door. Difficulties arise though, when there is clear evidence of denial/hindrance resulting from damage at more distant locations.

Where 'vicinity' is specified as a discreet distance, there remains uncertainty as to how this should be measured for example, as the crow flies, or by road or rail routes.

#### *Damage*

The extension, by not using the defined term 'Damage', and instead using the word damage in an everyday sense (without a capital letter), potentially provides cover for a wider range of losses than are insured at the Premises themselves.

#### *Hinder*

In the absence of a definition, expectations between the parties often vary widely. Consequently, inconsistencies arise.

The CILA issued a guidance note to its members in 2007 (and a subsequent note in 2009) attempting to avoid inconsistency where possible for the insuring customers, but the need to do that demonstrates the need for greater clarity.

#### 2.4.4 **Potential solutions**

To the extent that it is intended for this extension to cover egress as well as access, wordings could be amended to say so specifically.

With regard to the key terms discussed above:

##### *Vicinity*

At first blush, it might be attractive to define ‘vicinity’ as a specified distance from the insured Premises. However, this would potentially give rise to several issues, for example:

- the methodology of measurement;
- the problem of adjacent businesses that suffer equally, being treated differently if one is just within the measurement and the other not;
- the coverage position may still be unclear if part of the insured Premises falls within the specified distance, but the access/egress points fall outside it.

Consequently, while specifying a distance may resolve some uncertainties, it may create others. Therefore, notwithstanding the discussion under ‘what is the problem’ above, not defining the term ‘vicinity’ remains a viable option, accepting that each claim will need to be treated on its merits.

##### *Damage*

If the intention is to avoid the term ‘damage’ having a wider meaning than ‘Damage’ as defined in the policy, it may be appropriate to use the defined term ‘Damage’ in the extension. As noted at section 2.1 above, the term ‘Damage’ would benefit from a better definition – specifically inclusion or exclusion of temporary impairment of use would assist with regard to application of this extension.

##### *Hinder*

To the extent that the intention is for the cover to relate to *physical* (as opposed to electronic) denial/prevention or hindrance, it would be appropriate to include the word ‘physically’ before hinder.

To limit the cover to losses resulting from denial/prevention of access, without the addition of hindrance would be an option. While this would avoid existing uncertainty, it would also diminish the scope of cover provided.

## **2.5 Suppliers and Customers Extensions**

### **2.5.1 Current position**

Cover is typically available under these extensions either in the form of a specified (named) Customer or Supplier, or for unspecified (unnamed) customers or suppliers generally. There is often an inner limit in both cases, and the cover may not be as wide as that available at the Premises, for example the main cover may be All Risks, with specified perils only at the third parties. There also may be geographical restrictions.

A typical wording might be:

Subject to the conditions of the policy, loss as insured hereby resulting from interruption of or interference with the business in consequence of damage at the premises of any of the Insured's suppliers, manufacturers or processors of components, goods or materials shall be deemed to be loss resulting from damage to property used by the insured at the Premises, but excluding the premises of any supply undertaking from which the Insured obtains electricity, gas or water or telecommunications service.

On occasions, cover may be provided for suppliers of suppliers, customers of customers, suppliers of customers, or customers of suppliers.

### **2.5.2 What is the problem?**

With regard to Specified Supplier or Customer covers, there is no misunderstanding as to the scope of the cover.

For unspecified policies, however, a wide range of wordings are available, not all of which are clear as to whether the cover relates only to the Supplier or Customer with which the policyholder directly transacts, or whether the supply chain in a broader sense is included.

The supplier relationship can be very complex and can burden the parties with major costs that they did not expect. Here, we look at the problems that resulted from the catastrophic and well-publicised incident that occurred at Buncefield fuel storage terminal near Hemel Hempstead, Hertfordshire on 11 December 2005.

After a series of explosions and a subsequent major fire, the facilities at Buncefield (which included aviation fuel) were destroyed. This threatened the ability of airlines to operate out of nearby Heathrow and required immediate action to mitigate potential losses.

Airlines wishing to purchase fuel at Heathrow drew that fuel from tanks/pipes, which were shared by the leading oil companies. These oil companies operated joint venture companies that provided fuel, and also charged for access to Heathrow's facilities and the use of the pipelines from which the fuel was supplied. While the oil company billed for these facilities, the fuel was not owned by that oil company but was drawn from a shared resource.

The fuel was delivered to Heathrow through two pipelines, the most important of which was sited at Buncefield. It reached Buncefield via pipelines running from docks and terminals on Humberside.

Following the incident, the question arose as to who was the true supplier of the aviation fuel at Heathrow. Was this the owner of the pipeline or the oil company from whom the airline chose to buy the fuel? Insurers had to decide whether the owners of the pipeline were suppliers to the policyholder (the airline) and at stake were costs of £20 million.

This was a very complex situation. A more straightforward example would be a business buying a machine from the UK representative of an overseas manufacturer. There might be a dispute as to who the supplier is in the case of loss.

Additionally, in the absence of a definition of the term 'supplier', it may be unclear whether providers of services (other than utilities) fall within the scope of the cover or not, for example outsourced payroll bureaux. We refer to relevant discussion under 'Outsourcing and Blundell Spence' at section 3.2.

### 2.5.3 **What are the consequences?**

There is a possibility that policyholders may have assumed that cover for Suppliers includes suppliers of Suppliers, rather than solely the direct Supplier with which they transact (and the corollary for Customers).

If an extension applies only to Suppliers, and not to suppliers of Suppliers, the policyholder may find him/herself without cover if the real risk is at the ultimate manufacturer's premises rather than the distributor's premises.

Expectation issues may arise if the scope of the cover is more restricted than anticipated. On the one hand, policyholders may conclude that they have not been treated fairly, but on the other hand, insurers may be presented with claims significantly beyond the anticipated scope of cover, in respect of which a full premium has not been received.

Following the fire at Buncefield, supplies of fuel had to be diverted direct to Heathrow avoiding Buncefield for the period that the terminal was out of operation. This necessitated alterations to the pipelines and rationing of supplies in the short term at Heathrow. To compensate for this, airlines refuelled at other airports and thus incurred additional costs; also, supplies were ferried by road, rail and other regional pipelines to bolster the reduced capacity at Heathrow.

Combined losses during the period of interruption amounted to £20 million.

After representations were made to them, insurers agreed to adopt a broad interpretation of the supply chain and accepted the increase in cost as a valid claim. Had they not done so, the total cost would have been borne by the airlines.

#### 2.5.4

### **Potential solutions**

It would avoid uncertainty if the definition of a Supplier or Customer were restricted to the company with which a policyholder directly transacts, and stated that suppliers of Suppliers, etc. do not fall within the scope of cover, if that is the intention.

Alternatively, if the wider supply chain is intended to be covered, that could be explicitly stated, without any, or limited, geographical restrictions. However, this may lead to an unacceptable increase in exposure for insurers.

A definition of the term 'Supplier' is likely to be beneficial.

**3****Increased Costs****3.1 Increase in Cost of Working – Apportionment****3.1.1 Current position**

Standard UK wordings provide cover for additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in revenue/turnover, which, but for that expenditure, would have occurred during the Maximum Indemnity Period, subject to the economic limit discussed in section 5.5.

**3.1.2 What is the problem?**

The two most significant problems arise from the terms ‘sole’ and ‘incurred’.

*Sole*

The word ‘sole’ potentially eliminates from consideration any expenditure, which even partially benefits the insured or other parties. Thus, the wording does not permit an apportionment of additional expenditure on an equitable basis and yet it is current market practice. Such circumstances may arise when additional expenditure is incurred for the benefit of:

- (a) both the insurers and the insured, for example when costs are incurred for the benefit of two or more of the periods below:
  - (i) before the expiry of a time excess or waiting period;
  - (ii) the remainder of the Maximum Indemnity Period; or
  - (iii) beyond the expiration of the Maximum Indemnity Period;
- (b) both the landlord and the tenant(s) of a building;
- (c) different subsidiaries within the same Group.

*Incurred*

There are two potential causes of confusion. First, in the absence of a policy definition of the term, it can be unclear whether incurred represents the point at which expenditure is committed to, invoiced, or the point at which cash is paid. Second, in relating increased costs to the underlying Indemnity Period, it is not always sufficiently clear that this relates to the period during which Gross Profit losses would have otherwise accrued, rather than the period during which the costs arise.

Additionally, there can be confusion where expenditure is incurred that will both provide an economic benefit within the Maximum Indemnity Period and a benefit outside of it. A common example is the need to take say a five-year lease on alternative premises (minimum allowed by the third party landlord), irrespective of the fact that the policy only has a two-year Maximum Indemnity Period. If the policyholder remains in the alternative premises for say three years, one third of the occupation would relate to the year after the Maximum Indemnity Period has expired.

### 3.1.3 **What are the consequences?**

Different insurers/loss adjusters might have different interpretations over whether additional expenditure is admissible within the terms of the policy. Inconsistency will arise even for very similar wordings.

In relation to (a) (i) at 3.1.2 above, there may be an inclination to defer expenditure until after a waiting period in the erroneous belief that this would affect whether it was covered or not (see discussion at section 5.5). By way of contrast, expenditure may have been incurred without consideration having been given to the implications of any benefit being derived in respect of (a) (ii) and (iii) above.

The involvement of third parties such as in (b) and (c) above introduces further difficulties in determining an equitable apportionment. It remains the case, however, that clear provision under the policy to meet a proportion of the cost concerned should help encourage loss mitigation.

The difficulties involved may be exacerbated when the additional expenditure is beneficial to both the insurer within the Maximum Indemnity Period, and the policyholder beyond it. Without appropriate clarity, policyholders fearing an open ended, unquantified and uninsured element of expenditure may not necessarily contract to incur expenditure, which would otherwise be of benefit during the Maximum Indemnity Period. In extreme cases, this might constitute failure to mitigate loss.

In some cases, it will be clear that the expenditure, although it benefits turnover both within and beyond the Maximum Indemnity Period, will be economic within the Indemnity Period alone. It has been argued that the entirety of such expenditure, being economic, constitutes a valid Increase in Cost of Working to be borne solely by insurers. In other cases, while the cost of moving in and out might be included in a settlement, it might be considered appropriate for the operating costs beyond the Maximum Indemnity Period (the third year in the example above) to be borne by the policyholder – that expenditure could be viewed as giving

a benefit beyond rather than for the sole benefit within the Maximum Indemnity Period.

From the above, it should be apparent that the absence of any provision for the equitable apportionment of additional expenditure could work to the detriment of either the insured or the insurer, depending upon the circumstances.

### 3.1.4 **Potential solutions**

Consideration could be given to deleting the word 'sole' from the policy. This may, however, have other unintended consequences and may therefore be undesirable (e.g., discussion below at section 3.4 'Fines and Penalties').

The word 'incurred' could be better defined in the policy, albeit in so doing care would have to be taken to avoid inadvertently reducing support for mitigation costs.

It may be desirable to insert an additional clause in the policy permitting apportionment of additional expenditure that would otherwise fail to satisfy the 'sole' purpose requirement. Such a wording might read:

To the extent that any additional expenditure is incurred which would be payable but for the fact that it is not incurred solely to avoid a reduction turnover, it being also of benefit to the policyholder, or a party other than those to whom the policy is issued, the admissible expenditure shall be apportioned between the parties in relation to the respective values at risk or benefits derived.

This wording is imperfect in the absence of a definition of values of risk or the necessary calculation of the benefits achieved, and further definitions might assist, but the flexibility of the policy wording, a great asset in the majority of instances, would still require the application of some common sense.

## 3.2 **Outsourcing and Blundell Spence**

### 3.2.1 **Current position**

Business Interruption policies respond to Damage at the Premises (subject to extensions in the policy), measuring the loss either as a reduction in turnover or an increase in costs. Historically, BI loss could be related to Damage at the same premises as the reduction in turnover or increased cost presented themselves. Increasingly, this is not the case. Companies of significant size

are generally multi-site and the growing importance of both internal and external supply chains means there can be a knock-on effect at other locations, be these other premises listed in the schedule or those of suppliers/customers.

More recently, there has been a concentration to increase efficiency on core activities and increased outsourcing of other processes. Businesses have analysed the various stages and processes that they undertake (e.g., design, stock control and distribution, IT, after sales support, etc.) and have outsourced these, as appropriate, to specialist firms.

Just about any activity can be outsourced, often to specialist outsourcing companies, and often not to UK-based companies.

Some of the outsourced activities are revenue generating or would cause revenue or turnover to reduce (within the indemnity period) if the outsourcing company ceased to operate following an incident caused by an insured peril, for example IT, transport and marketing.

Irrespective of whether these activities are outsourced or not, some will be more likely to impact on revenue than others following an incident. To some extent this will be time related with the impact being reflected immediately in some cases and only in the long term for other activities. Examples include:

- Accounting
- IT
- Payroll
- Premises/facilities management
- HR
- Legal services
- Insurance
- Internet service provider
- Call centres/help desks
- Marketing and PR
- Secretarial support
- Cleaning
- Catering
- Archiving
- Transport
- Technical support/warranty repairs

### 3.2.2

#### **What is the problem?**

The key issue is that under a standard BI policy wording there has to be a reduction in turnover or revenue for a claim to be paid (that includes the Increase in Cost of Working item). However, loss of a head office or back office function may not impact the turnover/revenue within the Indemnity Period (if at all). In effect, the standard wording means that there is no cover for damage to the head office or back office function if revenue is not impacted

within the Indemnity Period, whether the functions are carried out by the insured or by an outsourcer.

With regard to nonproductive departments within a business, this is not a new issue for BI insurers, and it has traditionally been addressed via something known as the Blundell Spence letter.

The historic position was best summarised in *Riley on Business Interruption Insurance*<sup>12</sup>:

‘Another aspect of this matter to be considered is the possibility of fire or other damage occurring at a group’s administrative head office separate from manufacturing premises. If there is any possibility of damage at the central administrative offices having an adverse effect on turnover, or causing increase in cost of working, at any group member’s premises it is essential to include the head office premises in the overall business interruption insurance of the group and obtain cover for the interdependency. ... Even where damage at the head office would appear to have no discernible effect on the business of the group, insurers agree that reasonable increased costs are payable as a claim under the group policy (including the head office premises), because it is accepted that the central administrative function is a necessary part of the overall group activities. This is known in the United Kingdom as the ‘Blundell Spence’ agreement.’

The Blundell Spence agreement was a market agreement that agreed that insurers would, if requested, issue a letter of intent to recognise that an office burning down but the factory being undamaged, would still have a negative effect on a business, even if any loss of turnover were not easily apparent. This agreement was a Fire Offices Committee (FOC) market agreement and the format of the letter of intent is at least 50 years old.

The Blundell Spence letter of intent issued by insurers agrees that damage to the offices attached to a factory (or the head office) would be covered and reasonable Increase in Cost of Working would be paid in the same way as if the factory itself had been damaged, irrespective of what the policy actually says. Although the letter of intent is rarely issued, claim payments continue to be made on the Blundell Spence basis – the policy wording seems to be generously interpreted.

The Blundell Spence agreement does not form part of any policy wording and in the context of contract certainty it is anachronistic to rely on a practice of which the policyholder will have been completely unaware. Insurers, which

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12 David Cloughton, *Riley on Business Interruption Insurance* (7th edn, London: Sweet & Maxwell Ltd, 1991).

may be aware of the agreement, are not bound by it, particularly in the light of the demise of the FOC.

The agreement only related to head office functions at locations listed as Premises in the schedule and not third party locations. Consequently, outsourced administrative functions are inadequately catered for in standard business interruption wordings (productive outsourced functions can be covered under supplier extensions).

Work done at the premises of non-productive outsourcers is unlikely to be covered by most standard BI wordings. Supplier extensions are available, but a supplier is commonly defined as a supplier of raw materials. Therefore, many businesses supplying outsourced administrative services would fail to satisfy the definition of a supplier.

### 3.2.3 **What are the consequences?**

In the event of a claim, disputes may arise over whether expenditure incurred to maintain either a head office function or that of an outsource provider is covered by the policy or not. The presence of an item insuring Additional Increase in Cost of Working (AICW) should provide grounds for payment of any reasonable additional expenditure incurred at any of the premises listed in the policy, or covered by any extensions thereto.

A common issue is that of outsourced logistics providers, especially where their services include warehousing. In one case, a policyholder outsourced all logistics including warehousing of finished materials. The suppliers' extension was limited to suppliers of raw materials and there was no third party premises extension. The stock was included on the property schedule including the location of the warehouse. However, the definition of Premises in the BI section of the policy included only premises owned, occupied or used by the insured. Insurers declined the claim for Increase in Cost of Working following damage to the warehouse where no stock was damaged, because the logistics outsourcer did not meet the definition of a supplier. The insured argued that the warehouse was 'used' by it as the only work that was carried out at the warehouse was in respect of its logistics contract although the warehouse was managed by the logistics firm.

Insurers refused to accept this interpretation and the claim was declined.

### 3.2.4 **Potential solutions**

If it is the intention of underwriters to maintain cover with regard to Damage at head office functions on the basis previously envisaged in the Blundell Spence agreement, a wording reflecting the principles summarised in the

*Riley* extract at 3.2.2 above could be included in the policy. Further clarification could be provided to indicate whether such cover is envisaged to be available or not. If so, the wording could indicate whether costs arising fall within the definition of Increase in Cost of Working or, alternatively, AICW.

Notwithstanding this, at the time of the Blundell Spence agreement, head office functions were generally not outsourced, an issue that requires additional consideration. It may not be the intention of insurers to extend the Blundell Spence principles to outsourcers. If it is, there is still a need to confirm whether the basis is Increase in Cost of Working or AICW. This presupposes that the hurdle that Damage has not occurred at the Premises as defined in the policy can be overcome.

Outsourcing can relate to processes that would affect turnover if they were impacted by an insured incident and those that would not.

Some outsourced activities are integral to business and a loss at the outsourced company premises could lead to a reduction in turnover or revenue within the Indemnity Period. For these activities, the policy can respond subject to some policy wording amendments required (see further points below). Even with full underwriting details of the third party risk – details of the contracts and premises, the broad cover and lack of client control will probably concern insurers and they may want to restrict their liability. In these circumstances the following is a possible solution:

*a) Treat Outsourcers as suppliers*

The suppliers' extension responds to a reduction in turnover and amends the definition of premises by adding suppliers' premises to the definition of incident. By adding outsourcers the same way as suppliers are added to the policy, each location will need to be listed and for a specific limit that can be based on an assessment of the revenue at risk. This will also enable insurers to better assess accumulation issues.

It should be noted that, many policies do not include a definition of suppliers. Arguably though, insurers may not intend for these extensions to include suppliers of service, for example telecommunications services, and even these clauses may need to be suitably refined.

Many insurers' 'Unspecified Suppliers' extensions would be wide enough at present to include outsourced locations providing a service to the insured.

Different considerations are required when a loss at the outsourced premises would not affect turnover. A specific extension could be added to policies to

provide cover for outsourcing expenditure as has been done under a research and development extension, that is, no link to a reduction in revenue. It is expected that insurers would charge an additional premium for this cover but again the clause would generate better disclosure and a greater understanding of the risk. An unspecified outsourcers' extension wording that provided both a loss of revenue cover (just in case) and Increase in Cost of Working/AICW with the economic limit removed could be drafted for this proposed extension.

### **3.3 Increase in Cost of Working (Only) Covers**

#### **3.3.1 Current position**

Business interruption cover may be bought in the form of an Increase in Cost of Working (ICW) policy on its own (i.e., there is no parallel cover for Loss of Gross Profit). However, the majority of these policies do not have a savings clause. While ICW (only) covers do not include an economic limit requirement, the rest of the wording is likely to largely follow ICW wordings within Revenue or Gross Profit covers.

#### **3.3.2 What is the problem?**

Where a business incurs (new) expenditure temporarily relocating to alternative premises, the Increase in Cost of Working cover, at face value, may respond to the whole of the cost of the alternative premises. It may be argued that the whole of the cash outflow only arises because of the insured event and is all therefore additional. In response to the view that only the net additional cost should be claimed, it may be argued that there is no specific facility in the Increase in Cost of Working policy wording to deduct costs saved (in terms of rent or rates, for example) at the premises suffering damage. Were the policy to pay out the whole of the new cost, the insured business might benefit from a cessation of some expenses, such as rent and rates, that would have been incurred but for the fire.

For example, a business with a rent bill of £2 million may need to relocate after a fire. It can be assumed that there is a rent cessation clause in the lease, so that rent will not be incurred while the landlord effects reinstatement. The new rent on alternative premises might be £2.5 million. In the absence of a savings clause, it might be considered that the alternative rent is a new cost caption that was not paid at all before the fire such that the ICW claim should be the full amount of £2.5 million. The commercial reality is that the cost has increased by only £0.5 million.

The position could be more extreme if the rent on the damaged building was expensive, the policyholder having inadvertently locked into a fixed amount over a long period, and the alternative rent might reduce. If the alternative rent was £1.5 million, that might still be claimed in its entirety as an increased cost when in fact costs have in reality reduced by £0.5 million.

Assuming that the intention of any such wording would be to provide an indemnity (i.e., the insured is in no better or worse position than it would have been had the incident not occurred), it may be that only the incremental amount should be payable.

### 3.3.3 **What are the consequences?**

The insured's expectation may be over indemnification, which cannot be the intention of the policy. Most policyholders are only seeking an indemnity in respect of their loss. Experience shows, however, that the existing policy wording can serve to increase policyholder expectations when, say, under stand-alone Increase in Cost of Working cover, alternative premises are located. A claim is submitted for the additional expenditure, but excluding any deduction for savings, such as cessation of rent, or maintenance costs at the affected premises. The insurers, or their appointed adjuster, may be able to persuade the policyholder that only the incremental cost is covered, but this may prove to be a time consuming process. Worse still, the policyholder may be antagonised by this part of the process and this can then impact on other aspects of the settlement process.

### 3.3.4 **Potential solutions**

In relation to ICW-only covers, and on the assumption that only the incremental amount is intended to be covered, the introduction of 'net' or 'incrementally increased' before the term 'Increase in Cost of Working' would clarify that only the additional amount is to be paid (assuming that is the policy intention). While Gross Profit covers include provision for the deduction of savings, the committee believe that there would still be benefit in similar wording clarification being adopted for these policies.

Thought has been given to the recommendation that a savings clause might be included, but this presents difficulty in the case of an ICW cover, given that some savings may arise as a consequence of a loss of Gross Profit (which would not be insured) rather than as a consequence of increased costs being incurred (such as moving to alternative premises). Thus, it would at face value appear to be inequitable to take a saving in relation to a gross profit stream which is not itself insured. Separating out savings, which arise from a loss of Gross Profit as opposed to a new additional expense, would be difficult.

## **3.4 Fines and Penalties**

### **3.4.1 Current position**

Following an insured incident, businesses may be required to pay compensation to customers on the basis of damages in contract, or customers may arbitrarily impose fines and penalties for non- or late delivery. In practice, the customer would impose this by issuing a debit note and withholding payment. There may be a contractual requirement entitling the customer to take this action, but irrespective the policyholder may feel commercially obliged to pay but in turn will expect to recover these costs through insurance. Such payments may therefore arise as a result of a contractual requirement or non-contractually.

In certain sectors it is becoming commonplace for compensation payments to be made. Suppliers to the major supermarket chains are a good example. It is routine, albeit not inevitable, for incentives to be requested in return for the resumption of pre-incident levels of business.

While non-contractual payments might fall for consideration as an Increase in Cost of Working, contractual payments will not on the basis of a typical wording. To cover these losses it is, therefore, necessary to purchase specific cover (with a limit of indemnity) for Fines and Penalties exposures.

The majority of policyholders have either not explicitly considered this point in advance of a loss, or have assumed that it would be covered as an increased cost as part of the Gross Profit cover.

### **3.4.2 What is the problem?**

Claims for costs paid to customers seeking compensation after disruption flowing from an incident, have grown steadily in recent years. These are now common and significant.

Increased costs are generally defined as 'costs solely reasonably and necessarily incurred to avoid a reduction in turnover'. Contractual penalties are primarily and/or solely paid because a contract is in place requiring such payment be made, rather than to avoid a future loss of turnover.

On this basis, while a policy may not clearly state that fines and penalties are not an increase in cost of working, the word 'solely' precludes contractual fines and penalties being paid under the increase in cost of working cover.

This is because a contractual payment has to be made whether the business is retained or not (i.e., irrespective of whether there is a reduction in turnover or not).

This contrasts with non-contractual (commercial) payments made to avoid customers taking business elsewhere, which may constitute increased cost covered by the policy.

The position can be less clear with regard to oral understandings or payments based upon custom and practice and the degree to which such payments are contractual or not, may be debatable. Further, *force majeure* clauses can vary the contractual position, potentially giving rise to cover where none previously existed, or the contrary (a contractual payment ceases to be a payment in contract following a *force majeure* event, if a payment is still made to keep a customer).

There is an additional complication regardless of whether payments are made on a contractual basis or not, and that is they are likely to be made to protect the business, both in the short and long term, and therefore potentially after the end of the Maximum Indemnity Period.

The fact that compensation payments to customers are a routine part of business necessitates that policies are clear as to whether there is cover for those or not.

### 3.4.3 **What are the consequences?**

The potential contrast with contractual as opposed to non-contractual payments may be confusing.

Policyholders might incorrectly believe that fines and penalties, contractual or otherwise, are included within ICW cover. In stark contrast, there is often an equally incorrect presumption on the part of insurers that any form of fine or penalty, contractual or otherwise, will only be covered if a specific Fines and Penalties extension has been purchased.

Insurers may consider that the premium taken was never intended to cover (and is inadequate to cover) the significant compensation payments that are now widely known to be routine in retail and increasingly across most other sectors.

In the absence of clarity, the same issues are being decided on a case-by-case basis and avoidable inconsistency can arise.

3.4.4

**Potential solutions**

Policies (incorporating the ‘solely’ wording) could clearly state that increased costs do not include contractual payments, or any payments not voluntarily incurred post-loss to avoid a reduction in turnover.

In the absence of the word ‘solely’, wordings could make it clear within the Increase in Cost of Working cover that fines and penalties are, or are not, to be covered. Additionally, policies could clarify whether payments made irrespective of both the short and long term should be apportioned or paid fully if they are economic within the Maximum Indemnity Period.

With regard to Fines and Penalties wordings, consideration could be given to the removal of the word ‘legal’ within the general definition of fines and penalties extension, such that contractual and non-contractual payments are covered.

An alternative approach might be to remove all cover for fines/penalties/compensation payments, but to offer this as a ‘buy back’ extension, with a financial cap on the amount claimable.

**4****Sundry****4.1 Auditors' and Accountants' Charges****4.1.1 Current position**

Most policies provide cover for the costs of a policyholder's auditors spending time producing analyses requested by the insurers in advance of such work being done. The wording generally in use is standardised between insurers and policies.

Fees may be payable irrespective of the adequacy of cover.

**4.1.2 What is the problem?**

Policyholders are confused by what is or is not covered under this section of the policy.

Insurers may be asked to pay accountants/auditors to produce data that is readily available to the policyholder – the historic intention of the clause was to provide assistance for further analysis that would otherwise be onerous.

Delineation between claims preparation, claims presentation and information provision specifically required by insurers is not clear – only the costs of information provision are likely to be dealt with by this cover. It is not always clear cut as to what degree of claim detail is required to establish a prima facie loss, and which exercises fall within this (investigation) cover thereafter.

In the absence of advance discussion, disagreement often arises over the meaning of what is reasonable in terms of rates (and the scope of work undertaken) for the use of accountants/auditors.

Problems can arise over the use of auditors/accountants that are not normally used by the insured, particularly when those experts might not be suited to the task in hand.

**4.1.3 What are the consequences?**

There may be a reluctance to provide information unless it is certain that payment will be received for the auditors'/accountants' work. Delays arise during resolution of who undertakes the work and for what rate, delaying progress of the claim.

Many firms no longer have audits, and the terminology in the policy might become anachronistic.

In the case of dispute, the policyholder may resent paying for costs, which they perceive to be covered under the policy. Insurers may consider that they are being held to ransom in terms of proposed fees that are high.

#### 4.1.4 **Potential solutions**

This clause should include suitable wordings to advise that claims preparation/presentation costs are not included. A reminder could be added, referring to the Claims Condition, that it is the duty of the insured to make the claim (at its own cost). A separate claims preparation cover could be provided if this is the intention of the parties.

Wordings could incorporate pre-agreed rates, or refer to current indicative rates on the Internet. The scope of the minimum information required in a claim (without fees being due) could be set out.

## 4.2 **Time Deductibles**

### 4.2.1 **Current position**

Some policies do not have a monetary deductible, instead preferring a time period to be deducted instead. While this is a common feature of engineering BI covers, it is not unique to them.

Policies usually state that losses occurring or arising within the period stated on the schedule immediately after an incident are excluded. Example periods are usually 24 hours, 48 hours, three days or seven days, but are occasionally longer.

Policies with time deductibles can be written either on a loss of gross profit (or revenue) basis or a loss of output basis. Historically, policies incorporating time deductibles provided for agreed daily rates of loss, where there was a complete cessation of production. No liability attached in the case of partial interruption.

### 4.2.2 **What is the problem?**

For policies with agreed daily rates of loss, time deductibles were relatively straightforward to apply. Applying time deductibles to more modern policies, which include Gross Profit and Increase in Cost of Working (only) covers, is not straightforward.

For a Gross Profit policy, there is a disjoint between applying a time deductible to interference to production with a subsequent reduction in turnover, which is the specified measure of loss. This problem is less marked with an Output policy.

Not all policies clarify whether the time deductible relates to the chronological period commencing immediately after an incident, or to some other measure. If the deductible is three days, it can be unclear if this represents the first three calendar days after the loss (including Saturday and Sunday, e.g., after an incident on the preceding Friday regardless of whether the business trades over the weekend) or three days equivalent of loss. Likewise, if the deductible period is measured in hours, it may be unclear if this is intended to mean working hours or all hours.

Interpretations in the market vary so that it is sometimes argued that a time deductible should only be applied during periods when an actual loss is being sustained. Other interpretations include deduction of the specified period based on the average rate of loss sustained as a result of the incident.

A case that highlights the difficulties with existing wordings occurred in a plant manufacturing chipboard and similar sheet materials for the building industry.

The claim involved a press used to take wooden parts, add glue and press the material into moulds using a press bull plate. The plate developed a crack, and while this reduced the effectiveness of the manufacturing process, it was not sufficient to render it inoperative.

The insured established it would take approximately one month to manufacture a replacement plate. During this period the plant continued to operate at reduced capacity and was subject to daily checks to ensure it remain serviceable.

Once the replacement was available the necessary repairs were carried out. These took approximately three weeks to complete. The policy wording did not envisage this outcome and assumed that a time deductible would apply as soon as the Damage occurred.

#### 4.2.3

### **What are the consequences?**

Lack of clarity in the wording as to the chronological or other application of the time excess, frequently results in debate. The financial impact of different interpretations can be significant.

For example, if an engineering policy is written on a gross profit (or revenue) basis it may well be that no loss will be suffered during the deductible period because for example there are stocks of finished goods to meet sales in the short term.

In respect of increased costs, it is not always appreciated that it is the timing of Gross Profit losses that is important, not the timing of increased costs to avoid those Gross Profit losses. As a result, an insured may be tempted to delay Increase in Cost of Working expenditure until after the deductible period, incorrectly believing that any expenditure incurred during the deductible period will not be covered, although it serves to avoid a loss of turnover during the remainder of the Maximum Indemnity Period. On a consistent basis it is unreasonable to expect insurers to pay for increased costs incurred beyond the deductible period to mitigate gross profit losses that would otherwise fall within it.

In the above example the insurers were faced with a claim of €2 million. The policy carried a 10-day time deductible, which applied when there was ‘sudden and unforeseen damage requiring repair’. This wording assumed that the plant would cease operation and be immediately taken out of commission. Because it was possible to continue operating the press at reduced capacity, the repair was delayed.

Consequently, the deductible did not function in the way that the wording had intended. The result was that instead of a deductible of €820,000 applying to the loss, the deductible that was applied was €160,000.

#### 4.2.4 **Potential solutions**

If it is the intention of underwriters to allow for a deductible specific to each production department (with the implication that flexibility is needed to do that), then a time-based approach is necessary. Clarity with regard to the chronological or other measure interpretation of the time deductible would assist.

Alternatively, replacing time deductibles with monetary deductibles is likely to prove less contentious.

### **4.3 Definition of Maximum Indemnity Period**

#### 4.3.1 **Current position**

The Maximum Indemnity Period is typically defined as ‘the period beginning with the occurrence of the Incident and ending not later than the Maximum

Indemnity Period thereafter during which the results of the Business shall be affected in consequence thereof’.

An Incident is usually defined as ‘Loss or destruction of or damage to property used by the Insured at the Premises for the purpose of the Business’. The results of the business include sales/gross profit, increased costs and savings.

In addition, under the alternative trading clause the impact of goods sold elsewhere also needs to be specifically accounted for during the Maximum Indemnity Period.

By responding to the period during which the results of the business are affected, a policy in the UK provides cover during the period of repair and subsequently while the business rebuilds its customer base, ending no later than the expiry of the Maximum Indemnity Period. This is to be contrasted with the US policy form, which typically provides cover only during the period of repair, sometimes with a short, additional ‘build-up’ allowance.

#### 4.3.2

### **What is the problem?**

Policyholders may assume that the Indemnity Period relates to the period during which results are depressed rather than affected. Sometimes, and while this is not normally the case, assets reinstated after an incident can generate more business than would have been the case had an incident not occurred.

Consider the example of a hostel with 100 rooms charging £25 per night. A small fire might disable 10 rooms but spread smoke throughout, requiring extensive redecoration. After three months, the premises, benefiting from that redecoration, might reopen charging £45 per night. Without the fire, assuming the business is open 360 days per year, and assuming it was 75% occupied, the income would have been £675,000.

After the fire, there would be no turnover for the first quarter. The income loss would be £168,750 at that time. However, the remaining nine months would see income of £911,250 (100 rooms at 270 nights at 75% occupancy at £45 per night). The net benefit of the fire and redecoration would therefore be £742,500 (£911,250 less £168,750). Over the affected period, there is no loss, notwithstanding the reduction in the first quarter. Nevertheless, a policyholder might be confused if the insurer does not pay for the (undisputed) loss in the first quarter.

Owners of SMEs might feel the results are back to normal once turnover reaches the level it would have been but for the damage. They may be

surprised if the adjuster seeks to argue at that stage that some of the sales revenue lost in the earlier part of the Indemnity Period is subsequently clawed back. This surprise may be exacerbated by the fact that the policy makes specific provision for alternative trading, but is not explicit on the claw back issue (i.e., where an initial loss is less than a benefit subsequently experienced).

The issue can be complicated if the insured has at its own expense upgraded its production facility which itself results in extra capacity and revenue.

As the above problems relate to the 'build-up' period after the repairs are complete, they tend not to arise under a US policy form.

#### 4.3.3 **What are the consequences?**

The policyholder may have expectation issues if there is a claw back of loss and if they had been previously assumed the interim payments to date represented incurred and agreed losses.

Avoidable bad public relations issues arise.

#### 4.3.4 **Potential solutions**

Policies could clarify the definition of the Indemnity Period to include words such as 'during which the results of the Business shall be **adversely or positively** affected'.

As noted above, these issues arise under UK wordings rather than US wordings and the adoption of the latter avoids them. However, this also removes the protection of a 'build-up' period, and purchasing a significantly different policy form merely to address this point may not be proportionate.

### 4.4 **Depreciation Savings**

#### 4.4.1 **Current position**

Policies currently allow for savings in costs that would have been paid or payable had the insured incident not occurred. The issue with depreciation savings was tested in the courts in the case of *Synergy Health (UK) Ltd v CGU Insurance plc and Others*.<sup>13</sup> The judge in that instance found

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13 *Synergy Health (UK) Ltd v CGU Insurance plc (t/a Norwich Union) and Others* [2010] EWHC 2583 (Comm).

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that depreciation reductions constituted savings per the policy wording. That case was to be appealed solely on the depreciation issue, but was settled by a payment being made to the policyholder.

#### 4.4.2

### **What is the problem?**

The term 'paid or payable' is generally undefined. There is a question as to whether this should represent only cash reductions, which arise because of an insured event, or whether the term is sufficiently broad to encompass all costs and expenses charged to the profit and loss account. This is essentially a question of whether or not the intention of the policy is to restate accounting net profit to a level most closely similar to what it would have been had the damage not occurred, or whether the policy is primarily relating to cash flows.

This is a complicated area which has been debated many times and the arguments on both sides are summarised in a technical note on the BI SIG website. After several decades of debate, it appears to be the case that no easy consensus will be reached in respect of this issue, and this may give rise to inconsistency in the approaches taken by claims staff, loss adjusters, forensic accountants and others.

By way of illustration, let us explore the case of a claim made by an equipment leasing company. This particular organisation rented out electronic testing equipment to the aviation and telecommunications industries.

Its purchases were its largest 'Uninsured Working Expense'. Unlike, say, a manufacturing company, those Purchases were depreciated by the leasing company over many years and were not converted into stock that could be sold. Consequently, the Rate of Gross Profit applicable to those activities was unusually high at approximately 90%. Indeed, depreciation represented approximately 50% of the company's operating costs, whereas in most organisations this might be expected to be limited to say 10%.

The value of the insured's claim for lost income from equipment rental was calculated at £15 million. Using the Rate of Gross Profit of 90% mentioned above, its Gross Profit on equipment leasing activities equated to £13.5 million and this would have been the amount payable if depreciation savings were not taken into account.

Enquiries revealed that depreciation totalled £7.2 million and in the event of a saving on depreciation being taken into account when settling the claim, it would have a serious impact on the insurer's liability with the net amount payable being reduced to £6.3 million.

The outcome in the *Synergy* case leaves matters in the same unsatisfactory position as they were beforehand. The legal decision stands but it is a matter of public record that, as with so many other BI issues, a compromise was reached depriving all parties of further legal consideration and any greater certainty that this might have provided.

#### 4.4.3 **What are the consequences?**

The insured cannot predict the insurer's attitude and thus the ultimate amount payable; consequently there is a risk that they may be left with a serious cash flow shortfall.

There is no contract certainty for this aspect, since the intentions of both parties are not clear at the outset/subsequent renewals.

At the time of a significant claim, if appropriate, the issue will be raised by the loss adjuster; this can upset expectations and impact on goodwill when more significant matters require addressing.

Risk managers do not understand why the insurance market has been debating this matter for years without a resolution. This can affect the credibility of all stakeholders.

There is no consistency of approach to this issue.

#### 4.4.4 **Potential solutions**

No other expense gives rise to the same level of debate with regard to the savings calculation and there is a need to establish greater clarity for all parties concerned.

It is recommended that the intention of underwriters be explicitly drawn out in respect of depreciation savings. This could be achieved by amending the savings clause so that it states whether savings should or should not include depreciation.

The different professional views of experienced people would not in such a circumstance produce the range of different approaches currently seen. Underwriters would benefit from a premium reflecting the risk undertaken and both brokers and their insured clients would understand the scope of the cover pre-incident.

### 4.5 **Alteration Condition**

#### 4.5.1 **Current position**

Many policy wordings allow insurers to terminate cover for businesses when

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they enter liquidation or receivership. The intention of the wording is to cater for changes in circumstance that occur during the currency of the policy.

By way of example, the ABI form of Wording 1996 reads:

This policy shall be avoided if after commencement of this insurance

- (a) the Business be wound up or carried on by a liquidator or receiver or permanently discontinued or
- (b) the interest of the Insured ceases other than by death or
- (c) any alteration be made either in the Business or in the Premises or property therein whereby the risk of loss destruction or damage is increased unless admitted by the Insurer in writing.

#### 4.5.2 **What is the problem?**

Some policy wordings may benefit from updating the terminology to include administration, and administrative receiverships under various conditional voluntary arrangements (CVAs) that are currently available. It may be the intention of insurers to cease providing cover when these modern forms of corporate insolvency response are in place, but the wordings may not currently reflect the intention.

Use of the term 'avoided' can create confusion as to whether the effect of the clause and whether it avoids the policy from inception or from the date of the material change in circumstance.

#### 4.5.3 **What are the consequences?**

The clause may not cover all the circumstances it was intended to.

#### 4.5.4 **Potential solutions**

It is recommended that the Alteration Condition in wordings be updated to include modern voluntary arrangements to the extent that such changes reflect the intention of broker and underwriter in respect of the scope of cover. These may include administration, administrative receivership, conditional voluntary arrangements, or a term encompassing all such developments. And that they be revised to make the consequence of a change in circumstance clear.

A suggested wording is:

This Policy shall be terminated from the date of the material change if after commencement of this insurance

- a) the Business does any of the following:
  - i. make a composition or arrangement with creditors; or
  - ii. have a proposal for a voluntary arrangement for a composition of debts or scheme of arrangement approved in accordance with the Insolvency Act 1986; or
  - iii. have an application made under the Insolvency Act 1986 to the court for the appointment of an administrator; or
  - iv. have a winding-up order made or (except for the purposes of amalgamation or reconstruction) a resolution for voluntary winding up passed or have a provisional liquidator, receiver or receiver and manager of the business or undertaking duly appointed; or
  - v. have an administrative receiver, as defined in the Insolvency Act 1986, appointed.
- b) the interest of the Insured ceases other than by death; unless its continuance be admitted in writing by the Insurer.

**5****Procedural****5.1 Declaration-Linked Policies – Fundamentals****5.1.1 Current position**

Business interruption policies are usually subject to declarations of actual Gross Profit/Revenue at the end of each period of insurance.

Wordings differ across the market but usually contain:

- a requirement that a declaration is made;
- a requirement that the declaration made is supported by auditors' figures;
- where a provisional premium has been paid (deposit or declaration-linked), a requirement that the declaration is made within a set time limit (usually six months).

In some wordings, a declaration requirement is made a condition precedent via the use of a due observance clause.

Declarations are rarely requested/made and premiums are therefore not adjusted.

**5.1.2 What is the problem?**

It can be unclear who has responsibility for obtaining the declaration – broker or insurer.

Many insurers do not specifically request the declarations, nor do brokers/policyholders offer them.

On a declaration-linked policy, the insured is usually responsible for providing the declaration, signed-off by their accountants, even where this is not specifically requested. Failure to have done this in accordance with the policy terms could cause issues in the event of a claim (although insurers may not turn down a claim for non-declaration alone, it may be a factor in a declination).

It is often not clear in the wording that the declaration should be adjusted to represent the Maximum Indemnity Period of the policy so often declarations made are annual only and therefore too low if the Indemnity Period is more than 12 months.

Insureds are requested to provide a declaration of actual Gross Profit and often this figure is not correctly calculated; indeed, on some occasions the Gross Profit sum insured has been correctly calculated but declarations come from accountants and so are incorrect.

### 5.1.3 **What are the consequences?**

In extreme cases, a significantly low declaration may be considered to constitute grounds for policy avoidance.

Insurers are not collecting the additional premiums that may be due on declaration-linked policies. This results in loss to the insurer as well as loss to the common fund (to the detriment of policyholders making declarations accurately).

Insured's are not being provided with return premiums for overestimating a non-declaration-linked sum insured, so encouraging insured's to underinsure.

### 5.1.4 **Potential solutions**

The onus to ensure declarations are made might be more explicitly stated in the policy wording, along with the consequences for not doing so. If a wording requires insurers to specifically request the declarations, brokers should be explicitly required to educate clients to expect such a declaration request.

If brokers do not want clients to have to provide a declaration the wording should be specifically amended to delete the declaration requirement, which will then have the explicit agreement of insurers to dispense with the same.

## **5.2 Declaration-Linked Policies – Two Declarations**

### 5.2.1 **Current position**

In principle, declarations are made at the start and at the end of a policy period, with either additional or return of premium arising if the final declaration shows that the initial amount Declared was understated or overstated respectively.

### 5.2.2 **What is the problem?**

It would appear to be the case that 'end of period' declarations are not always secured. There are instances where they are neither offered by policyholders

nor requested by insurers. The self-balancing mechanism, which compares a declaration at the start and the end of the period, is therefore not always applied.

### 5.2.3 **What are the consequences?**

If end of period declarations are not secured, sufficient premium may not be paid. As above, the common fund may be under-resourced to the loss of customers that have made adequate declarations. Insurers might not receive sufficient premium to reflect the risk underwritten.

### 5.2.4 **Potential solutions**

Alternative mechanisms to ensure that end of period declarations are received could be explored. The end of period declaration could be dispensed with and pricing models altered to reflect any general level of under-declaration across the policyholder population.

## **5.3 Declaration-Linked Policies – Basis Periods**

### 5.3.1 **Current position**

The amount to be 'Declared' varies between policy wordings. Some require the initial declaration to be based on the 12 months prior to the policy period beginning, some require a declaration to be based on the annual Gross Profit extracted from the accounts ending most recently prior to commencement of the policy period, and others require a forward estimate of the 12 months in the policy period to come.

### 5.3.2 **What is the problem?**

The differing bases of declaration in the market can produce confusion if there is a change of insurer, and the insurers require declarations to be made on different base periods.

### 5.3.3 **What are the consequences?**

Declarations may be understated if policyholders do not appreciate the fact that different policies may require differing approaches. Sufficient premium may not be paid. The common fund may be under-resourced to the loss of customers who have made adequate declarations. Insurers may not receive sufficient premium to reflect the risk underwritten.

#### 5.3.4 **Potential solutions**

Some wordings could be clearer in terms of the basis period to be used. Consistency with terminology used to explain the basis of claims settlement might assist.

### 5.4 **Declaration-Linked Policies – Periods Other Than 12 Months**

#### 5.4.1 **Current position**

For periods longer than 12 months, an appropriate increase in the Declared amount is required – double the annual amount for 24 months, treble for 36 months, etc. There is seldom a requirement to assess future turnover beyond 12 months – the annual figure is multiplied incrementally instead (in other words, for a 24-month period, the 12-month amount is doubled).

For periods shorter than 12 months, however, the 12-month value should still be 'Declared'; it is not reduced to a fraction of the annual figure.

#### 5.4.2 **What is the problem?**

There is confusion around the need to increase the annual amount. This is often overlooked, resulting in a 'Declared' amount being only 50% of what might reasonably be required for a 24-month period, if the 12-month equivalent is not doubled, for example. In some cases, it has been perceived that declarations are annual equivalents, which insurers will gross up.

The fact that the 12-month equivalent figure should not be reduced for Maximum Indemnity Periods that are shorter than 12 months (in contrast to periods exceeding 12 months) again results in under-declarations.

#### 5.4.3 **What are the consequences?**

Declarations may be understated if policyholders do not appreciate the need to make a declaration for a minimum 12-month period, or to increase it proportionately for longer Maximum Indemnity Periods. Sufficient premium may not be paid. The common fund may be under resourced to the loss of customers who have made adequate declarations. Insurers might not receive sufficient premium to reflect the risk underwritten.

#### 5.4.4 **Potential solutions**

With regard to multipliers applied to annual Gross Profit for periods other than 12 months, it would be far simpler from the policyholder's perspective

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if they merely had to declare annual figures in all cases. Insurers could then make any adjustments to reflect Maximum Indemnity Periods not set at 12 months. This would not present any difficulty in the vast majority of cases, albeit the insured businesses are at liberty to insure for more than twice the annual gross profit for a 24-month cover (for example), which they might choose to do in anticipation of a steep upward growth trend. Some facility to retain that option could still be maintained within the context of the declaration of annual amounts

## **5.5 Increase in Cost of Working – Applying the Economic Limit**

### **5.5.1 Current position**

Standard UK wordings provide cover for additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in revenue/turnover which, but for that expenditure, would have occurred during the Maximum Indemnity Period over which the policy provides cover but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided.

There is no requirement for an insurer to accept liability for additional expenditure until it is clear that it was incurred economically for the benefit of the revenue/turnover that was protected during the Maximum Indemnity Period.

There is likewise no requirement for a policyholder to advise an insurer that increased costs are being incurred or not; if they ultimately meet the cover requirements, they would be payable.

### **5.5.2 What is the problem?**

There have been occasions when insurers have rejected claims for additional expenditure which they were aware was to be incurred at the time the decision to commit to it was made, but which subsequently proved to be uneconomic. There have been other examples where significant additional costs have been brought to the attention of insurers very late in the claims process, and they have not been invited to participate in the decision-making process.

Incurring increased costs usually mitigates the overall Gross Profit loss, to the benefit of insurer and policyholder. Any uncertainty over the provisions of the policy, or the application of the economic limit, is likely to undermine the insured's confidence.

In many cases it is not possible to specifically identify the benefits derived (e.g., Gross Profit generated through additional advertising). Even when this can be done, there can be confusion with regard to measuring the economics of an overall mitigation strategy, rather than individual micro-transactions. In relation to each strategy, there is also the need to consider offsetting savings against related increased costs.

### 5.5.3 **What are the consequences?**

On occasions, policyholders, believing initially that additional expenditure would be recoverable, and in some cases requiring the support of the policy to be able commit to it, incur significant costs to mitigate a potential loss. If the additional expenditure, against expectation, subsequently proves to have been uneconomic, insurers may withdraw their support for it.

Any uncertainty on the part of the policyholder may lead to failure, or even delay, in implementing one or more mitigation strategies and could well result in an otherwise avoidable loss of Gross Profit.

Even on the part of loss adjusters/insurers, there can be uncertainty/inconsistency in considering costs that are all part of the same mitigation decision. If this results in an erosion of confidence, it may lead to additional loss.

### 5.5.4 **Potential solutions**

There are many claims for which difficulties in assessing the economic limit do not arise. However, particularly given the interdependencies in modern business both internal and external, there is an increasing and substantial minority of cases for which the inability to prove that it is economic to incur the cost may induce hesitation and consequently, additional loss.

One option would be to reflect the inability to prove the economic limit with a wording such as:

The necessary and reasonable additional expenditure ... incurred for the sole purpose of avoiding or diminishing the reduction in Turnover that would otherwise have occurred during the Maximum Indemnity Period in consequence of the Incident, but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction reasonably anticipated at the time the expenditure was incurred.

The quid pro quo would be the need for a substantiated business case against which insurers might 'sign off' and then forego the opportunity for retrospective reassessment. The latter would still be reasonable if the business case that was signed off was inadequate or materially understated the costs involved.

An additional paragraph after the standard Increase in Cost of Working (Item 1b) clause would be required, to the effect that the Economic Limit will be waived/not retrospectively applied if insurers have signed off, but only to the extent that a business case supporting the sign off was reasonably scoped.

## 5.6 Payments on Account

### 5.6.1 Current position

Most businesses can survive several periods of making a loss but they can only run out of cash once.

While policies are generally written on the basis of a loss of profit rather than cash flow, the importance of cash management is particularly pertinent when an incident occurs giving rise to property damage and/or business interruption losses.

Against this background, it is therefore relevant to note that:

- many commercial insurance policies contain no payment on account or partial payment clause, or any direct reference to such payments; and
- there is little formal guidance or recommendations from official bodies on the matters of payments on account.

Business interruption texts have historically inferred an entitlement to payments on account as part of the policy cover, albeit such inferences are not always supported by the actual wordings. A typical payment on account clause might read:

In the event of a loss the insurers will make interim payments to the insured if desired/appropriate.

Neither the regulator nor the courts have needed to offer assistance in this regard because interim payments are frequently requested/recommended and paid by insurers. Notwithstanding this, however, the wordings commonly available often do not include payment on account clauses reflecting normal practice.

The Association of Risk Managers in Industry and Commerce (Airmic) has addressed this issue in its *Statement of Principles Regarding Insurers' Speed of Settlement*.<sup>14</sup> This document, which applies to losses in excess of £2.5 million, recognises the importance of timely payments of claims in accordance with

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14 *Statement of Principles Regarding Insurers' Speed of Settlement* (London: Airmic, undated)

the circumstances of the loss and the terms of the policy. The aim is to use staged payments during the lifetime of the claim to reflect the insured's cash flow needs and try to achieve a cash flow neutral position in respect of insured losses, minimising the need for any alternative funding requirements.

In other parts of the world more detailed wordings are in operation. For example, in the United States partial payment of loss clauses are included as standard in most policies. A typical wording might be:

in the event of a loss covered by this policy it is understood and agreed that the company will issue partial payments of claim subject to the policy provisions and such payments shall not be more than the undisputed estimate of loss or damage between the Insured and the Company.

Alternatively, in continental Europe, a wording might read:

Advanced payment of losses:

It is agreed and understood that the insured is entitled to an advance payment equal to 50% of the amount indemnifiable or €5 million – whichever is the lower – providing the estimate made by the insurer, or by the appointed loss adjuster is not less than €2.5 million and the claim is undisputed.

The advanced payment shall be affected by the insurer within 30 days of the insured's request subject to all the Terms and Conditions of the policy.

Similarly, in central and eastern Europe many policies contain a clause obliging insurers to pay to the insured 50% of the value of the loss reserve within 60 days of the estimate being set.

## 5.6.2

### **What is the problem?**

Current practice does not always reflect policy wordings. Indeed, the incidence of payments made is far greater than might be expected based on strict policy interpretation.

Without any payment on account clause within the policy wording, the policyholder, despite the best endeavour of insurers, may not remain alert to the need to request interim payments to mitigate loss, and may fail to appreciate that support by way of interim payments is available.

An inferred entitlement to interim payments is unsatisfactory because the contract lacks clarity, which is inconsistent with the FSA's concept of Treating Customers Fairly.

5.6.3

**What are the consequences?**

Without any certainty that interim payments will be received, the policyholder is presented with a business risk that could, potentially, result in the directors being accused of wrongful trading.

The absence of interim payments could lead to a policyholder having inadequate working capital to operate the business. This is likely to diminish the ability of the policyholder to mitigate the loss resulting in a higher claim against insurers and a BI loss continuing for a longer period, likely beyond the Maximum Indemnity Period.

If the business appears to be starved of cash its bankers may consider it in their best interests to apply interim payments received, without reference to the policyholder, to reduce the overdraft facility. The payment is consequently not available to mitigate the loss.

5.6.4

**Potential solutions**

Given the consequences of a lack of funds outlined above, it is likely to be in the interests of all parties for a partial payment of loss clause to be incorporated into business interruption policies. The clause could incorporate the following elements:

- Insurers' recognition of the importance of adequate working capital to support loss mitigation measures.
- As soon as practicable after the incident the insured should submit a request for partial payment accompanied by an estimate of loss. This is not the claim but merely an estimate of the likely extent of the loss.
- The estimate should be supported by a cash flow statement demonstrating the estimated ongoing BI cash flow losses.
- The estimate and cash flow plan should form the basis of an agreement between the insured and the carriers for the extent and timing of partial payments.

A potential wording might be:

Partial payment of loss:

The Company accepts the importance of the maintenance of cash flow and in the event of a loss covered by this policy it is understood and agreed that the Company will issue partial payments of claim subject

to the policy provisions. In order to trigger the partial payment clause, it is agreed that the Insured shall submit an estimate of loss which will include a cash flow projection and this document will form the basis for the calculation and agreement of partial payments of loss under this policy.

The usefulness of the estimate of loss is that it makes the insured concentrate on:

- The potential size of the claim and all of the various aspects of the business that may be affected. It thus sets down a marker which will be helpful in calculating a reserve.
- It ensures that the insured gathers in, or at least puts in a process to gather in all of the necessary supporting documents and to set up the accounting codes that will capture the information required.
- Within the insured entity the obligation to provide an estimate of loss will help to concentrate minds around the provision of the necessary data to calculate a supported estimate of the likely loss. This is particularly important in respect of insured's that have losses at multiple site locations.
- It sets out a framework for future loss calculations.
- It forces all participants to think about the future timetable of such partial payments.

## **5.7 Notification of BI Claims**

### **5.7.1 Current position**

Most BI cover is now written in the form of a commercial combined policy. There is a wide variety of notification issues that can arise, such that notification can be a minefield.

While we have focused on the points most directly relevant to BI cover, we have appended to this Report a more comprehensive consideration of notification issues, to which the reader is referred.

When material damage has been suffered at the Premises, the policyholder will generally be aware of that, insurers will have been notified, and a mitigation plan will be in place. There are exceptions, including:

- progressive damage such as commercial subsidence where the policyholder is a tenant;
- minor damage at the Premises possibly falling within the policy excess, but which subsequently gives rise to a substantial BI claim;
- Damage at the Premises which the policyholder incorrectly assumes will be rectified by third parties;
- losses at suppliers/customers which are notified to the policyholder after a significant delay;
- losses covered by BI extensions that the policyholder did not appreciate formed part of the cover;
- an overseas subsidiary suffers damage and BI loss relates to either Difference in Conditions ('DIC')/Difference in Limits ('DIL') or to an interdependency loss; and
- the insured's controlling office (for the purposes of arranging insurance) is not immediately made aware of the loss themselves.

The *Loyaltrend Ltd v Creechurch Dedicated*<sup>15</sup> case, as discussed below, emphasises that the commencement of a business interruption loss may be deferred from the date of physical damage. Notwithstanding this, the indemnity period commences with the date of physical damage, which is also therefore the relevant date for purposes of notification.

## 5.7.2 What is the problem?

Policyholders are often not aware of the need for strict compliance. Ignorance of the necessity to give notice is not an excuse. Immediate notification may not always be possible and there may be justifiable reasons for delay.

In *Loyaltrend*, the insured took out a shop policy which provided cover for damage to tenants' improvements, fixtures and fittings, trade contents and stock at the insured premises and consequential BI as a result of a number of specified perils, including subsidence ('the Shop Policy').

The policy required the policyholder to give:

immediate notice ... on the happening of ... Damage in consequence of which a claim is or may be made under this Policy.

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15 *Loyaltrend Ltd and another v Creechurch Dedicated Ltd and Others* [2010] Lloyd's Rep IR 466.

The buildings were separately insured by the landlord of the insured premises ('the Landlord's Policy).

Crack damage was first noticed by the insured in August 2003. On the insured's best case notification to the shop insurers had taken place in August 2004. The insured failed to give notice prior to that because it believed that any losses it suffered would all be covered under the Landlord's Policy.

The insured argued that the obligation to notify arose in August 2004 because that was when it realised that it might have a claim under the Shop Policy. It was only at that stage that it became aware that the damage was due to subsidence and that the damage became sufficiently serious, such that it had the potential to cause loss to the business.

The judge rejected these arguments. What the insured knew or thought was irrelevant. It was clear on the evidence that it was apparent to the insured's engineer and should have been apparent to the insured by December 2003 that the damage was serious and therefore ought to have been notified to the shop insurers by the end of 2003. It was not, with the effect that the insured was not entitled to recover any of its losses under the Shop Policy.

### 5.7.3 **What are the consequences?**

Delay in notification potentially prejudices an insurer's position and can result in mitigation opportunities being missed. There is an increased risk of dispute. The insured may find itself without cover in respect of a claim or having to negotiate a reduced claim settlement through no fault of its own.

Absent a credible explanation it often gives rise to suspicions as to the validity of a claim: for example, where it is immediately clear that a claim would be made under a property policy and the insured has disposed of the damaged items before notifying insurers.

Specified time periods have to be strictly complied with. This means that while ensuring certainty and clarity, they provide no flexibility.

### 5.7.4 **Potential solutions**

Do the parties wish the consequences of late notification to deprive the insured of its entitlement to an indemnity? If insurers wish to mitigate the consequences of breach of the notification provision, they can include a provision providing that it will not exercise its right to reject indemnity in respect of a claim provided that there has been no fraudulent conduct or that the insured's conduct has not resulted in prejudice to the insurer.

The clearer and more prescriptive the clause, the less potential there is for confusion. Ideally, a claims notification would contain the following information:

- In what circumstances notice should be given – including where the Insured believes that it may fall within the policy excess.
- Within what time period: for the reasons set out above, a specific time period provides greater clarity. However, it allows little flexibility where the time period has expired.
- How notification should be given: verbal (by calling a dedicated 24-hour claims number) or in writing.
- To whom: head office or branch or local agent.
- What information is required: date of loss, location, brief description, etc.

In the case of large multinational organisations, where there may be a delay between an incident and senior management or the risk officer becoming aware of that incident, the parties may wish to provide that ‘knowledge’ of any claim will not constitute knowledge to the insured until the Risk Manager of the insured has received notice.

The time frame for notification could be extended by requiring notification within a stipulated time period such as 14 days, ‘as soon as possible’, ‘as soon as reasonably practicable’ or ‘within reasonable time’.

## **5.8 Information Disclosure**

### **5.8.1 Current position**

In contrast with US wordings, the UK BI policies offer an insurer only one opportunity to obtain loss information. The insured must present their claim within 30 days of the end of the Indemnity Period or the end of the Maximum Indemnity Period. This is set out in the following example wording.

not later than 30 days after the expiry of the Indemnity Period or which such further time as the insurer may allow, deliver to the Insurer in writing particulars of his claim.

In practice, information is most often supplied to insurers by way of justification for a payment on account. It should be noted that typical wordings giving the right to interim payments make no explicit requirement for information disclosure.

## 5.8.2 **What is the problem?**

The effect of the current wording is that an insurer has no right to information during the indemnity period. Most policyholders are likely to request an interim payment if their loss is substantial and will submit documentation to support the request. There are, however, some exceptional businesses where cash flow is not an issue and therefore, no interim payment requests may be made.

## 5.8.3 **What are the consequences?**

An absence of documentation can give rise to:

- Significantly over- or under-reserved claims, where quantum is based solely on estimates and discussion. While it is common practice for insurers and their adjusters to ask an insured about the effects on the business and to request pertinent details, and in most cases there is continuous dialogue and disclosure; occasionally, such requests are met with a refusal or a vague, superficial response. Invariably, when full details do eventually emerge, loss amounts can vary wildly from original estimates provided by the policyholder.
- An inability on the part of the insurer to accurately ascertain the professional resource that should be applied to support the policyholder. An insured may not grasp what is happening in its own business. In smaller firms, this is sometimes due to poor management accounting practices. The owner may also be overoptimistic about customer loyalty or the firm's ability to catch up on orders later. In bigger firms it may be that central management is not sufficiently in tune with progress in a remote location or in a subsidiary. Typically, in these cases the insured either thinks there will not be a claim at all or it believes it will be very small and consequently the loss ends up larger than anticipated.
- Submission of documentation 30 days after the end of the indemnity period deprives insurers of the opportunity to participate in the mitigation process on a timely basis. As a result they can only review the claim retrospectively, possibly leading to criticism of decisions taken by the policyholder that would preferably have been debated at the time.

## 5.8.4 **Potential solutions**

Where there is regular and effective communication between insurer and policyholder, experience suggests that more beneficial outcomes are achieved for all parties. To this end, a Condition requiring the provision of

information (irrespective of any request for an interim payment) might be included in policy wordings.

A potential wording that might be considered is:

In the event of a claim being made under this Policy the insured at his own expense shall deliver to the Insurer for examination at such times that the Insurer may reasonably request:

- a) books of accounts, business records, bills, invoices, vouchers and other documents, or certified copies if originals are lost
- b) proofs, information, explanation and other evidence
- c) details of all other insurances covering property (or part thereof) used by the Insured at the Premises for the purposes of the Business
- d) a declaration of the truth of any claim and of any matters connected with it that the Insurer may reasonably require for the purposes of investigating or verifying the amount of any Business Interruption

If no loss information is offered and the policy falls due for renewal, it should be possible for insurers to enforce their rights for disclosure of material facts and insist upon full claim details and a loss estimate being provided; but renewal could be anything up to 12 months away.

**6****Conceptual****6.1 Should Gross Profit be Replaced by Gross Revenue?****6.1.1 Background**

In section 1.6.1 ('Declaration-Linked Policies'), we described the results of surveys held at the CILA technical conferences in 2008 and 2009. At the 2008 conference, delegates suggested that 52% of declarations on declaration-linked policies were too low and where the declaration was inadequate, the amount of underinsurance was approximated at 50%. This rose to 63% in the second survey.

Admittedly, these surveys were based solely upon experience of declaration-linked policies, but nonetheless demonstrated a significant level of underinsurance across the UK market.

One of the factors contributing to this level of underinsurance is thought to be the lack of clarity associated with the Gross Profit wording. The Gross Profit definition topic (section 1.1) debates these issues and offers some potential solutions.

Undoubtedly, many policyholders do not fully appreciate that Gross Profit as defined in an insurance policy is often calculated in a different way than it is in the commercial world. This leads to under-declaration and of course underinsurance. As a consequence insurers do not receive the correct premium for the risk and the policyholder does not receive a full indemnity when a loss happens.

One way in which this risk could be minimised would be to replace Gross Profit as the means of rating the risk.

**6.1.2 Current position**

The majority of BI cover is rated on the basis of Gross Profit. Exceptions to this rule include certain industries (including the hotel and services industries), and package policies where Gross Revenue is often used.

When the level of cover is discussed at a renewal meeting with the broker, the policyholder can offer a reliable figure for sales or gross revenue with a high degree of accuracy. However, if the rate of Gross Profit used by the business is different from the rate that should be applied under the policy wording,

it is likely that both the policyholder and the broker will underestimate the sum insured.

Consequently, the level of premium charged for the risk will be too low and in the event of a claim, the policyholder will find that their loss will be reduced through the operation of average. Often, this leads to the dissatisfied policyholder suing its broker for professional negligence.

So, should we consider ways of reducing this risk?

### 6.1.3 **Proposed change**

It is proposed that the means by which the sum insured is calculated (and the risk is rated) should be altered from Gross Profit to Gross Revenue. This change seems to offer significant benefits to policyholders, their advisers and to insurers.

While a proportion of policyholders may elect to underinsure, the majority do so unwittingly. This is usually because the policyholder misunderstands how the Gross Profit sum insured should be calculated. Gross Profit is usually calculated differently by a business than is required by an insurance policy. A good example is the treatment of wages; in commerce, Gross Profit is calculated net of wages, whereas wages are usually included in the definition of Gross Profit in most insurance policies. This is particularly the case with manufacturers but certainly not exclusively so.

If Gross Revenue were insured, this confusion would not arise and the risk of a policyholder underinsuring would be dramatically reduced.

### 6.1.4 **Potential advantages**

In addition to reducing the risk of underinsurance, there are several other practical situations that may benefit from the proposed change.

First of all, let us consider the issue of purchases. In his book *BI Cover Issues*,<sup>16</sup> Damian Glynn observes that in some industries, purchases do not vary in direct proportion to turnover and, often, cannot be stopped merely because turnover has ceased. Businesses are sometimes obliged to continue to purchase from a supplier even though the means with which to process those purchases may have been destroyed in a fire. This may be as a result of a contractual or a commercial commitment. In such circumstances, a Gross Profit cover will be frustrated because there would be no means by which the policyholder could achieve the pro rata reduction in purchases.

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16 Damian Glynn, *BI Cover Issues* (London: Witherby & Co Ltd, 2008).

Further, some purchases are the subject of stepped discounts, particularly motor dealers, where a relatively modest loss of turnover can result in a significant loss of gross profit. Usually, this is because the reduction in purchase volumes leads to the loss of the additional discounts that would have been earned by the policyholder had they continued to purchase at the previous level.

There can be significant differences in gross margins between different departments within the same business. For example, hotels might earn as much as a 100% margin on their room income but a much lower margin on their food and beverage offering. Unless the business is able to identify the different rates of gross profit that are being achieved by the different income streams and can take advantage of a departmental clause within the policy, the loss of a high margin element of their business will not result in a pro rata reduction in purchases such that they can actually achieve a proper indemnity in the event of a loss.

Insuring on a Gross Revenue basis would eliminate these problems.

#### 6.1.5

### **Issues**

Replacing Gross Profit as the standard basis of rating with Gross Revenue will be a significant and fundamental alteration and will not be without its challenges. The following is a summary of some key points that may need to be considered:

- the basis of rating will need to be changed to reflect the adoption of much higher sums insured;
- the certification and authorisation levels for various underwriters will need to be reviewed;
- the co-insurance and reinsurance arrangements will, in many cases, need to be reassessed and reset;
- tolicy extensions – for example a supplier’s extension – will need to be altered to a Gross Revenue basis.

The wording in relation to Increase in Cost of Working cover would need to be modified. For example, ICW would take its economic test at the Gross Revenue level. It might be suggested that it would be more appropriate to take the economic measure at the Gross Profit level but that would then necessitate ‘Gross Profit’ becoming a defined term with all of the inherent problems that this change is seeking to address.

There is a risk that insurers’ exposure to Increase in Cost of Working (ICW) and the likely payments made in connection with ICW may increase. However, such ICW would still need to satisfy a ‘necessary, fair and reasonable’

test. In addition, the introduction of a higher threshold for the economic test would mean that payments under any 'Additional Increased Costs of Working' (AICW) extension would be far less frequent.

Purchases will be included within the clause 'less any sum saved during the Indemnity Period in respect of such of the charges and expenses of the Business payable out of Gross Revenue as may cease or be reduced in consequence of the Incident'. In most cases, the saving in Purchases will be calculated as a percentage of Gross Revenue. However, this is a calculation that can be carried out, after the incident and with advice, so that the Purchases figure takes account of opening and closing stock and thus equates to an accurate 'Cost of Goods Sold' figure.

## 6.1.6 **Conclusions**

There are several advantages to this proposed change.

Insurers would achieve increased premium income by virtue of reduced levels of underinsurance; if the surveys referred to in section 6.1.1 above are accurate, then this increase could be as much as 30%. Discussions with insurers suggest that approximately a third of all premium paid on a commercial policy relates to BI cover. With this in mind, there is a potential for as much as a 10% shortfall in premium income.

Even though the incurred cost will be higher this should be balanced out by the payment of more accurate levels of premium. While there will be far fewer deductions for underinsurance and potentially there could be a modest increase in the ICW exposure, the net increase in premium income should outweigh any additional claim payments. It is reasonable to assume that as claims ratios are generally less than 100% this will mean that the premium income will rise faster than the claims payment expense.

Genuine policyholders will benefit by receiving a fuller indemnity because mistakes currently made when setting up the business interruption cover will be substantially reduced. This should lead to improved customer satisfaction and result in the reputation of the insurance market being enhanced.

Insurance brokers may benefit with fewer potential claims being made against them by dissatisfied clients.

On balance, all parties should benefit from the greater certainty that this alteration would bring.

That said there are significant challenges in such a wholesale change. Ultimately, insurers may decide that while benefits will arise, some of these

could be equally achieved with other wording changes, for example, simplification of the Gross Profit definition. There would also be issues to address in carrying higher sums insured not least in securing support from the reinsurance and co-insurance market. Both these issues and the need for competition may dissuade some from change.

Many have adopted the use of Gross Revenue in selected products and broadening its use should offer a potential benefit to all sectors of the market.

## 6.2 Notification is a Minefield

### 6.2.1 Claims Condition – Notification of Claims

#### 6.2.1.1 Current position

The BI claims conditions used in the UK vary from one policy to another and it is therefore imperative to read the terms of the policy in question. However, claims conditions generally cover the following key areas:

- notification of loss/potential loss;
- a requirement that the policyholder minimises or stops interruption/avoids or diminishes loss ('mitigation');
- a requirement that the policyholder delivers papers to substantiate a loss:
  - i. at the policyholder's own expense; and
  - ii. within 30 days after expiry of the BI indemnity period;
- the consequences of non-compliance, which is usually that the claim will not be paid unless the policyholder complies with the condition.

The current ABI standard claims conditions for BI cover (1996) provide:

- (a) In the event of any loss, destruction or damage in consequence of which a claim is or may be made under this policy the Insured shall
  - (i) notify the Insurer immediately.
  - ...
- (c) If the terms of this condition have not been complied with
  - (i) no claim under the policy shall be payable
  - (ii) any payment on account of the claim already made shall be repaid to the Insurer forthwith.

#### 6.2.1.2 Purpose

The purpose of the condition is to enable insurers to immediately appoint their own surveyors and adjusters in order to:

- investigate the circumstances of the loss;
- protect their interests (by way of negotiations with other interested parties, such as the landlord of the damaged premises);
- ensure any necessary steps are taken to mitigate any loss;
- calculate proper reserves;
- assess the impact, if any, on future premium for the purposes of renewal;
- notify reinsurers; and
- protect their position regarding any subrogated claims at the earliest opportunity.

### 6.2.1.3 **When does the obligation to notify arise?**

The trigger date for notification is the date on which loss or damage occurs or that the insured reasonably becomes aware of the damage in consequence of which a claim is or may be made under the policy.

Notification will be required where there is loss or damage or an event, which, when:

‘objectively evaluated, creates a reasonable and appreciable possibility that it will give rise to a loss or a claim ... There need not be a certainty that it will do so, there need not be a probability or likelihood that it will do so. All that need exist is a state of affairs from which the prospects of a claim (whether good or bad) or loss emerging in the future are ‘real’ as opposed to false, fanciful or imaginary.’<sup>17</sup>

The benchmark for notification is therefore not high and will be judged objectively, by reference to the reasonable man. The test is not whether the insured realised that there would be a claim, it is whether a reasonable person in the insured’s position (i.e., taking into account the knowledge the insured possessed) would have recognised that the damage might give rise to a claim under that policy.<sup>18</sup>

The *Loyaltrend* case<sup>19</sup> illustrates some of the potential difficulties.

The insured took out a shop policy which provided cover for damage to tenants’ improvements, fixtures and fittings, trade contents and stock at the insured premises and consequential BI as a result of a number of specified perils, including subsidence (‘the Shop Policy’).

The policy required the policyholder to give:

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17 *HLB Kidsons v Lloyds Underwriters* [2008] 1 Lloyds Rep IR 237 at 264 (para 73).

18 As note 15 above.

19 As note 15 above.

immediate notice ... on the happening of ... Damage in consequence of which a claim is or may be made under this Policy.

The buildings were separately insured by the landlord of the insured premises ('the Landlord's Policy').

Crack damage was first noticed by the insured in August 2003. On the insured's best case notification to the shop insurers had taken place in August 2004. The insured failed to give notice prior to that because it believed that any losses it suffered would all be covered under the Landlord's Policy.

The insured argued that the obligation to notify arose in August 2004 because that was when it realised that it might have a claim under the Shop Policy. It was only at that stage that it became aware that the damage was due to subsidence and that the damage became sufficiently serious, such that it had the potential to cause loss to the business.

The judge rejected these arguments. What the insured knew or thought was irrelevant. It was clear on the evidence that it was apparent to the insured's engineer and should have been apparent to the insured by December 2003 that the damage was serious and therefore ought to have been notified to the shop insurers by the end of 2003. It was not, with the effect that the insured was not entitled to recover any of its losses under the Shop Policy.

#### 6.2.1.4 **What constitutes notice?**

Policyholders should always check the form and method of notification required under the policy.

Notice must be clear and unambiguous and leave the recipient in no reasonable doubt that the insured is giving notice by the communication.<sup>20</sup> For example, exchanges of correspondence around renewal time referring to a subsidence problem might not amount to notification of a claim for subsidence damage.<sup>21</sup>

Some specific detail will also be required such as circumstances and consequences. It will not suffice to refer to an unknown or unidentified incident, which may give rise to a claim under the policy.<sup>22</sup>

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20 *HLB Kidsons (a firm) v Lloyd's Underwriters* [2007] EWHC 1951 (Comm) (First Instance Decision) paras 72–78.

21 As note 15 above.

22 *Kajima UK Engineering Ltd v The Underwriter Insurance Company Ltd* [2008] EWHC 83 (TC).

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Verbal notification will suffice where the policy does not require notification to be made in writing.<sup>23</sup>

Where notice is given orally a note should be made at the time of the notification. If a note is not taken, particularly if the claim was notified by a broker, and there is no written record, the courts are highly unlikely to accept that notification took place.<sup>24</sup>

Notice can be given by an agent acting on behalf of the insured. It must be given to the insurer or an agent who has authority to receive it. When notifying an insured should check independently that the person that they intend to tell is authorised to accept notification of a claim on behalf of the insurer. If the insured has a number of different policies with the same insurer under which a claim may be bought as a result of the insured event, notice under one policy may not constitute notice under another.

#### 6.2.1.5 **Meaning of ‘immediate’**

The *Oxford English Dictionary* definition of the word immediately is ‘occurring at once’ ‘without pause or delay’. The courts have held that where ‘immediate’ notice is required, notice must be given ‘with all reasonable speed considering the circumstances of the case’.<sup>25</sup>

In each case this will depend on the particular facts. It requires swifter notification than ‘as soon as possible’ or ‘as soon as practicable’. By way of a recent example, in the context of a serious fire which occurred on 29 March 2004, the court concluded that the defendant should have known that it could give rise to a claim and therefore given notice ‘by early April 2004’.

In a licensing case, the court held that the term immediate was stronger than ‘within a reasonable time’. It implied prompt and vigorous action, without delay.<sup>26</sup> In that case, a delay of four days constituted non-compliance.

#### 6.2.1.6 **The position if the policy does not contain a claims notification condition or does not specify a time limit**

If the policy does not contain a claims notification provision or the provision does not provide a time limit for notification, one will implied. In such

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23 *Friends Provident Life & Pensions Ltd v Sirius International Insurance* [2005] All ER (D) 369.

24 As note 15 above.

25 *Re Colmans* [1907] 2 KB 798.

26 *Re Berkshire Justices* (1878).

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circumstances, the courts have held that notification must take place ‘within a reasonable time’.<sup>27</sup>

As above, each case will depend on its own facts but as a very rough indication:

‘within reasonable time’, ‘as soon as reasonably practicable’: up to 4 weeks would probably be acceptable; 6 weeks might be a bit border line and anything over 8 weeks would be too long a delay.

‘as soon as possible’ is closer to ‘immediate notice’ ‘than reasonably practicable’. 4 weeks has held to be too long.<sup>28</sup>

### 6.2.1.7

#### **Effect of breach**

In each case it will depend on the wording of the claims notification condition in the policy.

The current ABI standard claims condition is not described as a ‘condition precedent’ either in the heading or the wording itself. This is not always necessary as long as the wording makes it clear that it is intended to operate as such by use of mandatory language such as ‘must’ and ‘shall’ and setting out clearly setting out the consequences of non-compliance.<sup>29</sup> This clause does this and as such would be classified by the courts as a condition precedent.

Notification clauses can also be made condition precedents by reference to a general clause which makes the liability of the insurer conditional on the insured observing all the terms and conditions of the insurance, sometimes referred to as ‘due observance clauses’.<sup>30</sup>

The consequence of breach of a condition precedent is to automatically discharge the insurer from liability in respect of the claim for indemnity to which the breach relates.<sup>31</sup> There is no need for the insurer to demonstrate that it has been prejudiced in any way by the delay in notification.

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27 *Hadenfayre Ltd v British National Insurance Society Ltd, Trident General Insurance Co Ltd and Lombard Elizabethan Insurance Co Ltd* [1984] 2 Lloyd’s Rep 393; *Shinedean Ltd v (1) Alldown Demolition (London) Ltd (in liquidation); (2) AXA Insurance UK Plc* [2005] All ER (D) 336.

28 *Kier Construction Ltd v Royal Insurance (UK) Ltd* [1992] 30 Con LR 45.

29 *George Hunt Cranes v Scottish Boiler & General Insurance Co Ltd* [2002] Lloyd’s Rep IR 178 at para 21. *British Credit Trust Holdings v UK Insurance Ltd* [2004] 1 All ER (Comm) 444.

30 See *Aspen Insurance Co Ltd and others v Pectel Ltd* [2008] EWHC 2804 (Comm).

31 *Kosmar Villa Holidays plc v Trustees of Syndicate 1243* [2007] EWHC 458 (Comm).

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It would be open to insurers to decide not to enforce their legal rights in relation to the breach by, for example, agreeing an extension. In that situation, a policyholder should obtain written confirmation from the insurer of this decision.

The only way that an insurer could lose the right to rely on a breach of condition precedent would be if the policyholder could establish an estoppel. This would require the policyholder to show that the insurer had made an unequivocal representation that it would not enforce its legal rights. It would also require evidence that the policyholder had acted or taken no action in reliance upon that representation such that it would be inequitable for the insurer to go back on his word, which in practical terms means that the policyholder needs to show that it has suffered or would suffer some detriment as a result of that reliance. In practice, this can be difficult to establish. Best advice is that reliance by an Insured on estoppel should be a last resort.

## 6.2.2

### **What is the problem?**

Notification can be a minefield.

Policyholders are often not aware of the need for strict compliance. Ignorance of the necessity to give notice is not an excuse.

There may be lack of clarity for the insured as to how and to whom to notify a claim.

Immediate notification may not always be possible and there may be justifiable reasons for delay. For example:

- damage occurs at a third party location, for example suppliers, customers, joint venture;
- an overseas subsidiary suffers damage and BI loss relates to either Difference in Conditions (DIC)/Difference in Limits (DIL) or to an interdependency loss;
- the insured's controlling office (for the purposes of arranging insurance) is not immediately made aware of the loss themselves;
- damage to property occurs but it is not immediately obvious that this will lead to a BI claim, for example in the case of subsidence damage.

The insured may not realise that it has a claim under more than one policy.

### 6.2.3 **What are the consequences?**

Delay in notification creates the potential for dispute and the insured may find itself without cover in respect of a claim or having to negotiate a reduced claim settlement through no fault of its own.

Absent a credible explanation it often gives rise to suspicions as to the validity of a claim: for example, where it is immediately clear that a claim would be made under a property policy and the insured has disposed of the damaged items before notifying Insurers.

Disputes between policyholders and insurers are becoming more frequent.

### 6.2.4 **Potential solutions**

Given the diversity and complexity of modern business it is desirable to take a measured approach to notification – one that will place each party of the contract on an even footing.

The insured's claims experience will determine whether it renews with its current insurers and as such the process should be as clear as possible in order to avoid the potential for error or disputes arising.

This can be achieved by giving consideration to the nature of the business and practical issues that may arise prior to agreeing the terms of the policy.

In the case of large multinational organisations, where there may be a delay between an incident and senior management or the risk officer becoming aware of that incident, the parties may wish to provide that 'knowledge' of any claim will not constitute knowledge to the insured until the risk manager of the insured has received notice.

The time frame for notification could be extended by requiring notification within a stipulated time period such as 14 days, 'as soon as possible', 'as soon as reasonably practicable' or 'within reasonable time', subject to the following points:

Specified time periods have to be strictly complied with. This means that while ensuring certainty and clarity, they provide no flexibility.

Terms such as 'as soon as possible', 'as soon as reasonably practicable' or 'within reasonable time' are always assessed by the courts by reference to the facts of the case. Every case will depend on its own facts. This provides a degree of flexibility and discretion on the part of the court but it also leaves

room for uncertainty, confusion and conflict between an insured and the insurer if they disagree as to what a reasonable time frame is or what 'as soon as possible' means.

Do the parties wish the consequences of late notification to deprive the insured of its entitlement to an indemnity? If insurers wish to mitigate the consequences of breach of the notification provision, they can include a provision providing that it will not exercise its right to reject indemnity in respect of a claim provided that there has been no fraudulent conduct or that the insured's conduct has not resulted in prejudice to the insurer.

The clearer and more prescriptive the clause, the less potential there is for confusion. Ideally, a claims notification would contain the following information:

- in which circumstances notice should be given – including where the Insured believes that it may fall within the policy excess;
- within what time period: for the reasons set out above, a specific time period provides greater clarity. However, it allows little flexibility where the time period has expired;
- how notification should be given: verbal (by calling a dedicated 24-hour claims number) or in writing;
- to whom: head office or branch or local agent;
- what information is required: date of loss, location, brief description, etc.

If an insured has a broker, it will be the broker's responsibility to explain the notification provisions and the consequences of the insured's failure to comply with them. Similarly, once the broker is informed of the claim, it is their responsibility to assess the information and assess what notifications should be made.<sup>32</sup> It is increasingly important for brokers to consider carefully with their client what the consequences of the policy wording may be and the steps that they can jointly take to avoid issues arising out of notification.

If the insured does not have a broker and is dealing directly with the insurer, ICOBS 6.1 requires the insurer to provide information in a policy summary or key features document including contact details for notifying a claim and details of significant exclusions or limitations. This should include guidance in relation to notification and the consequences of non-compliance.

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32 *Alexander Forbes Europe Ltd v SBJ Limited* [2002] All ER (D) 349.

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### 6.3 Review of UK and US Wordings

In producing this document, we have concentrated on UK wordings rather than variations around the world. Nevertheless, we have been mindful that UK wordings represent only one approach to insuring BI, and have contrasted the UK form with US policies by way of acknowledging this. Indeed, the term BI was used in the United States long before it was adopted in the UK (where for many years the misleadingly wide term ‘consequential loss’ was commonly used).

Several of the issues that have been highlighted in this report are dealt with in different ways by US wordings. To take account of this, we have considered those wordings in our research of the issues.

The table at Appendix 1 contrasts some of the key differences between the UK and US approaches to BI.

It would, however, be wrong to assume that one could adopt a ‘mix and match’ approach. The specific provisions of a UK or US wording are inextricably linked to other aspects of their specific wordings and any form of ‘cherry-picking’ could create more problems than it might solve – see the illustration below. For the same reason it was concluded to be beyond the scope of this review to develop a single wording that could be operative on both sides of the Atlantic or indeed around the world.

One of the issues debated by the Study Group as a whole was the recurring problem of the chosen Maximum Indemnity Period proving to be short. Whether this was due to undue optimism over how long it might take to reinstate the damage, or a failure to appreciate how long it might take to rebuild the customer base after reinstatement, the conclusion drawn was that these failures were not symptomatic of an underlying flaw in the standard forms of UK BI wording. More likely the problem was attributable to a reluctance to opt for a longer period with attendant increase in premium.

One alternative might, however, be the approach adopted in the United States. Under US BI wordings the equivalent of the Maximum Indemnity Period is addressed in two separate sections. The basic US cover extends only until reinstatement is complete. For instance, the US Business Income Form states:

We will pay for the actual loss of business income you sustain due to the necessary ‘suspension’ of your ‘operations’ during ‘a period of restoration’.

This period of restoration is not normally subject to any time limit, and is based on the time required to repair, rebuild or replace with reasonable speed and similar quality. In addition cover can be obtained for an extended

period of liability, normally 30, 90 or 180 days, during which the business may continue to suffer a loss of market share.

Thus in respect of the ‘period of restoration’ the US forms do not require the insured to anticipate how long it might take to repair/reinstate any insured damage that might be suffered. The problems that commonly arise, say in relation to obtaining planning permission to rebuild, are overcome, and the risk of an extended period of repair is borne by the insurer. Notably, the US forms do not, however, provide a similarly open-ended period when it comes to the build-up period following reinstatement.

Nevertheless, the US practice would still assist in at least relieving the insured of the need to anticipate likely reinstatement periods, with which they are unlikely to be familiar. This benefit could, however, easily prove to be illusory because UK wordings, be they Declaration Linked or not, require an adequate sum insured/declaration to be made. Thus, unless the provisions for underinsurance (average) or limit of liability were completely reassessed, the insured would still need to consider the maximum BI loss they might suffer, including the extended reinstatement period, when setting the sum insured under a UK BI wording.

The project has not simply been a review of the UK wording. We have sought to highlight the issues that can arise when claims are considered under a UK wording. The committee members did not feel it had sufficient experience of claims and the issues arising under US wordings to be able to make any informed recommendations on them.

## Appendix 1

### Key Differences Between UK and US Approaches to Business Interruption Insurance

	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<b>Cover summary</b>	<p>The insurance is limited to loss of Gross Profit due to:</p> <ul style="list-style-type: none"> <li>a. Reduction in turnover and</li> <li>b. Increase in Cost of Working and the amount payable as indemnity thereunder</li> </ul>	<p>The recoverable Gross Earnings loss is the actual loss sustained by the insured of the following during the period of liability</p>	<p>We will pay for the actual loss of Business Income you sustain due to the necessary ‘suspension’ of your ‘operations’ during the ‘period of restoration’.</p>	<p>Actual loss sustained wording not common in GP policies.</p>
<b>What is covered?</b>	<p>Loss of Gross Profit due to a reduction in turnover and an increase in cost of working; less savings in expenses.</p> <p>Cover is sometimes provided for additional expenses.</p>	<p>Actual loss sustained of Gross Earnings less non-continuing expenses plus expenses to reduce loss.</p> <p>Cover is sometimes provided for extra expenses.</p>	<p>Actual loss of Business Income and extra expense.</p> <p>Careful consideration should be given to the meaning of Business Income.</p>	<p>All wordings incorporate cover for increase in cost of working/extra expenses although the limitations applying to this may differ.</p>

1 Source – Standard Gross Profit Policies.

2 Source – Standard Gross Earnings Policies.

3 Source – Standard Business Income Policies.

Loss measurement – summary GP, GE, Business Income	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
	<p>In respect of reduction in turnover:</p> <p>The sum produced by applying the Rate of Gross Profit to the amount by which the turnover during the indemnity period shall, in consequence of the incident, fall short of the standard turnover less any sum saved during the indemnity period in respect of the charges and expenses of the business payable out of Gross Profit as may cease or be reduced in consequence of the incident.</p>	<p>The recoverable Gross Earnings loss is the actual loss sustained by the insured of the following during the period of liability:</p> <ul style="list-style-type: none"> <li>i. Gross Earnings</li> <li>ii. Less all charges and expenses that do not necessarily continue during the interruption of production or suspension of business operations or services;</li> <li>iii. Plus all other earnings derived from the operation of the business.</li> </ul>	<p>Business income will be determined based on:</p> <ul style="list-style-type: none"> <li>i. Net income of the business before the direct physical loss or damage occurred;</li> <li>ii. The likely net income of the business if no physical loss or damage had occurred, but not including any net income that would likely have been earned as a result of an increase in the volume of business due to favourable business conditions caused by the impact of the covered cause of loss on customers or on other businesses.</li> </ul>	<p>Actual loss sustained clause similar to other circumstances clause.</p>
<p><b>Definition – Turnover/Net Sales/Business Income</b></p>	<p>The policy provides a measure driven by a loss of turnover.</p> <p>Turnover is defined as the money paid or payable for goods sold or services rendered in the course of the business.</p>	<p>The policy provides a measure driven by a loss of net sales (gross earnings).</p> <p>Gross Earnings is defined as:</p> <p>Manufacturing – net sales less the value of production</p> <p>Mercantile – total net sales less cost of goods sold or services rendered.</p>	<p>The policy does not provide a measure with direct reference to turnover/earnings but on the basis of business income.</p> <p>Business Income is defined as:</p> <ul style="list-style-type: none"> <li>i. Net Profit or Loss before income taxes; and</li> <li>ii. Continuing normal operating expenses including payroll.</li> </ul>	<p>Plus all other earnings allows flexibility, if earnings not included in the definition of net sales.</p> <p>All wordings have a similar objective in mind although the Business Income wording may be thought of as providing cover from the 'bottom up'. That is it covers a loss of net profit before taxes plus standing charges</p>

	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p><b>Definition – Turnover/Net Sales/Business Income – continued</b></p>	<p>Plus all other earnings derived from the operation of the business.</p>	<p>Standard turnover less actual turnover. Standard turnover: The turnover during the 12 months immediately before the date of the incident which corresponds with the indemnity period, to which adjustments shall be made as may be necessary to provide for the trend of the business.</p>		<p>rather than providing cover for a loss of gross profit/ earnings less savings ('top down approach'). Theoretically there should be no difference in the final measure.</p>
<p><b>Lost sales methodology</b></p>		<p>Actual loss sustained of net sales value of production or total net sales.</p>	<p>None specified – policy covers actual loss of Business Income.</p>	<p>No strict methodology under GE form or Business Income form; measurement is actual loss sustained. While the GP wording incorporates a basis of settlement, the adjustment clause applying to Standard, Actual Turnover and Rate of Gross Profit will help avoid limitations which a pre-defined approach may be criticised as being subject to.</p>

	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p><b>Definitions – Gross Profit/ Gross Earnings/ Business Income</b></p>	<p><b>Gross Profit:</b> The amount by which turnover plus the value of closing stock and work in progress exceeds purchases plus the value of opening stock and working in progress and the amount of uninsured working expenses, as defined in the policy.</p>	<p><b>Gross Earnings:</b> a. For manufacturing operations: the net sales value of production less the cost of all raw stock, materials and supplies used in such production;  For mercantile or non-manufacturing operations: the total net sales less cost of merchandise sold, materials and supplies consumed in the operations or services rendered by the insured.</p>	<p><b>Business Income:</b>  Net Income (Net Profit or Loss before income taxes) that would have been earned and (plus) continuing normal operating expenses incurred, including payroll.</p>	<p>Gross profits definition per the GP policy may be considered confusing to non-accountants.</p>
<p><b>Savings</b></p>	<p>Less any sum saved during the Indemnity Period in respect of the charges and expenses of the business payable out of Gross Profit as may cease or be reduced in consequence of the Incident.</p>	<p>Less all charges and expenses that do not necessarily continue during the interruption of production or suspension of business operations or services;  Clarifying language: – In determining the indemnity payable as the actual loss sustained, the Company will consider the continuation of</p>	<p>No provision – as policy insures continuing normal operating expenses, including payroll, the policy is silent on savings.</p>	<p>Not sure that clarifying language adds much.  As noted above the Business Income wording insures continuing expenses (standing charges) and does not refer to savings</p>

Savings – continued	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
	<p>only those normal charges and expenses that would have been earned had no interruption of production or suspension of business operations or services occurred.</p>	<p>There is recovery hereunder only to the extent that the insured is:</p> <ul style="list-style-type: none"> <li>i. Wholly or partially prevented from producing goods or continuing business operations or services;</li> <li>ii. Unable to make up lost production within a reasonable period of time, not limited to the period during which production is interrupted;</li> <li>iii. Unable to continue such operations or services during the period of liability; and</li> <li>iv. Able to demonstrate a loss of sales for the services or production prevented.</li> </ul>	<p>The Business Income loss will be reduced:</p> <p>To the extent you can resume your 'operations' in whole or in part, by using damaged or undamaged property.</p> <p>If you do not resume 'operations', we will pay based on the length of time it would have taken to resume 'operations' as quickly as possible.</p>	<p>Policy conditions attaching to the GP form will impose an obligation on the insured to take reasonable steps to minimise losses.</p> <p>If this condition is breached then the quantum of loss may be adjusted prior to settlement so as to not prejudice the Insurer for the policyholder's failure to act.</p>
<b>Actual loss sustained clarifying language</b>	<p>Policy wording is silent however, refer to comments.</p>			

Actual loss sustained (windfall profits)	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
	<p>Policy wording silent on this issue.</p>	<p>Policy wording silent on this issue</p>	<p>The measure of Business Income will be adjusted to remove any windfall due to any net income that was earned as a result of an increase in the volume of business due to favourable business conditions caused by the impact of the insured cause of loss on customers or other businesses.</p>	<p>Qualification under Business Income – no benefit to the insured for windfall profits caused by event's impact on customers or other businesses.</p>
<p><b>Period of liability</b></p>	<p>The Period:</p> <ul style="list-style-type: none"> <li>i. Beginning with the insured incident; and</li> <li>ii. Ending not later than the Maximum Indemnity Period shown in the schedule.</li> <li>iii. During which the results of the business shall be affected in consequence of.</li> <li>iv. Not to be limited by the expiration of this policy.</li> </ul>	<p>The Period:</p> <p><i>1. For building and equipment:</i></p> <ul style="list-style-type: none"> <li>i. Starting from the time of direct physical loss or damage of the type insured against; and</li> <li>ii. Ending when with due diligence and dispatch the building and equipment could be:                             <ul style="list-style-type: none"> <li>a. Repaired or replaced; and</li> <li>b. Made ready for operations, under the same or equivalent physical and operating conditions that existed prior to the damage.</li> </ul> </li> <li>iii. Not to be limited by the expiration of this policy.</li> </ul>	<p>The Period:</p> <p>Referred to as the period of restoration as a result of insured damage:</p> <ul style="list-style-type: none"> <li>i. Begins 72 hours after the damage for Business Income cover; or</li> <li>ii. Immediately after the time of damage for Extra Expense coverage.</li> <li>iii. Ends on the earlier of:                             <ul style="list-style-type: none"> <li>a. The date the property should be repaired/rebuilt or replaced with reasonable speed;</li> <li>or</li> <li>b. The date when the business is resumed at a new permanent location.</li> </ul> </li> </ul>	<p>GP policy: until business is no longer affected, subject to the maximum period stipulated in the schedule (usually 12 or 24 months).</p> <p>GE policy: until repairs completed with due diligence and dispatch. Provides the potential for the period of liability to be open ended.</p> <p>Business income policy: – the period of restoration is similar to the GE policy although it is more restrictive in that it ends if the business resumes at an alternative permanent location. It also</p>

Period of liability – continued	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
	<p>2. <i>For building and equipment under construction:</i></p> <ul style="list-style-type: none"> <li>i. The equivalent of the above period of time will be applied to the level of business that would have been reasonably achieved after construction and start-up would have been completed had no direct physical damage happened; and</li> <li>ii. Due consideration will be given to the actual experience of the business compiled after completion of the construction and start-up. This item does not apply to commissions, profits and royalties.</li> </ul> <p>3. <i>For stock-in-process and mercantile stock, including finished goods whether or not manufactured by the insured, the time required with the exercise of due diligence and dispatch:</i></p> <ul style="list-style-type: none"> <li>i. To restore stock in process to the same state of manufacture in which it stood at the inception</li> </ul>		<p>The policy includes an extension to cover for up to a maximum of 30 days after the period of restoration.</p>	<p>differentiates between a loss of Business Income and Extra Expenses.</p> <p>The period of restoration under the Business Income policy also has the potential to be open ended (losses will be limited to the limit of insurance shown in the declarations).</p> <p>Business income form gives 30-days extended period cover beyond date of repair or replacement of damaged property.</p>

	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p><b>Period of liability – continued</b></p>		<p>of the interruption of production or suspension of business operations or services; and</p> <p>ii. To replace physically damaged mercantile stock. This item does not apply to rental insurance.</p> <p>4. <i>For raw materials and supplies, the period of time:</i></p> <p>i. Of actual interruption of production or suspension</p> <p>ii. of operations or services resulting from the inability to get suitable raw materials and supplies to replace similar ones damaged; but</p> <p>iii. limited to that period for which the damaged raw materials and supplies would have supplied operating needs.</p>		
<p><b>Period of liability – extension of cover</b></p>	<p>Limited to the period specified in the Schedule.</p>	<p>Extension of cover for a period commencing when the normal period of liability but for the extension would have terminated.</p>	<p>Maximum Period of Indemnity:</p> <p>If shown applicable in the declarations, cover will be provided for insured losses being the lesser of:</p>	

Period of liability – extension of cover – continued	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p><b>Period of liability</b> – limitations to cover</p>	<p>Limited to period specified in the schedule</p>	<p>Can vary but usually provides an extended period of 30 or 60 days</p> <p>The period of liability does not include any additional time due to the insured's inability to resume operations for any reason, including but not limited to:</p> <ul style="list-style-type: none"> <li>i. Making changes to equipment</li> <li>ii. Making changes to the buildings or structures except as provided in the demolition and increased cost of construction clause in the property section.</li> <li>iii. Re-staffing or retaining employees.</li> </ul> <p>If two or more periods of liability apply such periods will not be cumulative.</p>	<ul style="list-style-type: none"> <li>i. The amount of loss incurred during the 120 days immediately following the beginning of the 'period of restoration'; or</li> <li>ii. The Limit of Insurance shown in the declarations.</li> </ul> <p>Period of Restoration does not include any increased period due to the enforcement of any ordinance or law that:</p> <ul style="list-style-type: none"> <li>– Regulates the construction, use or repair, or requires the tearing down of any property;</li> <li>or</li> <li>– Requires any insured or others to test for, monitor, clean up, remove, contain, treat, detoxify or neutralise, or in any way responds to the effects of pollutants.</li> </ul>	<p>GP policy: issues not specifically addressed but the extent of the indemnity period and the resulting losses must flow from insured damage.</p> <p>For example, increased losses resulting from extended periods of reinstatement due to betterment will not be covered.</p>

Measurement of loss – increase in cost – summary and economic test	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p>In respect of increase in Cost of Working:</p> <p>The additional expenditure necessarily and reasonably incurred for the sole purpose of minimising the reduction in turnover which but for that expenditure would have taken place during the indemnity period in consequence of the Incident, but not exceeding the sum produced by applying the Rate of Gross Profit to the amount of the reduction thereby avoided.</p> <p>Increase in cost of working is subject to the application of co-insurance.</p>	<p>In respect of Expenses To Reduce Loss:</p> <p>Such expenses as are necessarily incurred for the purpose of reducing loss under the policy but in no event shall the aggregate of such expenses exceed the amount by which the loss under the policy is thereby reduced.</p> <p>Such expenses shall not be subject to the application of co-insurance.</p>	<p>In respect of Extra Expenses:</p> <p>Necessary expenses incurred during the period of restoration which would not have been incurred but for the insured damage.</p> <p>Cover is provided for Extra Expenses to:</p> <ul style="list-style-type: none"> <li>– Avoid or minimize the ‘suspension’ of business and continue operations.</li> </ul> <p>Extra Expenses will also include costs to repair or replace property, but only to the extent it reduces the amount of loss that would have been payable under this Coverage Form</p> <p>The amount of Extra Expense will be based on:</p> <p>All expenses that exceed the normal operating expenses that would have been incurred by operations’ during the period of restoration’ if no direct physical loss or damage had occurred.</p>	<p>Extra expense under Business Income does not have a mitigation requirement, unless related to repair or replacement of damaged property</p>	

Measurement of loss – increase in cost – summary and economic test – continued	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
			<p>Deductions will be made from the total of such expenses for:</p> <ul style="list-style-type: none"> <li>a. Salvage values of property bought for temporary use during the period of restoration, once operations are resumed; and</li> <li>b. Any Extra Expense that is paid for by other insurance.</li> <li>c. Necessary expenses that reduce the Business Income loss that otherwise would have been incurred.</li> </ul>	
Extra expense/clarifying language		<p>Measurement of loss: The recoverable extra expense loss will be the reasonable and necessary extra costs incurred by the insured of the following during the period of liability:</p> <ul style="list-style-type: none"> <li>i. Extra expenses to temporarily continue as nearly normal as practicable the conduct of the insured's business; and</li> </ul>	<p>We will reduce the amount of your extra expense loss to the extent you can return 'operations' to normal and discontinue such extra expense.</p> <p>If you do not resume 'operations', we will pay based on the length of time it would have taken to resume 'operations' as quickly as possible.</p>	<p>Clarification useful in determining how to deal with residual value issues.</p>

	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p><b>Extra expense/ clarifying language – continued</b></p>		<p>ii. Extra costs of temporarily using property or facilities of the insured or others;  Less any value remaining at the end of the period of liability for property obtained in connection with the above.</p>		
<p><b>Additional cover for increased costs</b></p>	<p>Optional cover provided for Additional Increase in Cost of Working:  Similar cover to Increase in Cost of Working but not limited by the economic test.  Not always limited by the sole purpose test but cost will need to be necessarily and reasonably incurred.  Sub limit will apply.  Not subject to co-insurance.</p>	<p>Cover provided for Extra Expenses:  Similar cover to Expenses to Reduce Loss but not limited by the economic test.  Not always limited by the sole purpose test but cost will need to be necessarily and reasonably incurred.  Sub limit will apply.</p>		

Other time element clarifying language	Gross Profit (UK) <sup>1</sup>	Gross Earnings (US) <sup>2</sup>	Business Income (US) <sup>3</sup>	Comments
<p>In respect of reduction of turnover: The sum produced by applying the Rate of Gross Profit to the amount by which the turnover during the indemnity period shall, in consequence of the Incident. Incident – Damage to property used by the insured at the premises of the purpose of the business.</p>	<p>This policy insures time element loss, as provided in the time element coverage, directly resulting from direct physical loss or damage of the type insured by this policy</p>	<p>'Operations': Your business activities occurring at the described premises.</p>	<p>Clarifying language removes ambiguity</p>	

1 Source – Standard Gross Profit Policies.

2 Source – Standard Gross Earnings Policies.

3 Source – Standard Business Income Policies.

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