Business Interruption Training Series

Webinar – Module 6

Traps & Pitfalls – Common Issues and How to Avoid Them

21 September 2017

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Introduction

- Welcome
- The Presenters
- The Steadfast / MSM Webinar Series
- The Webinar Tools
- The Agenda

Presenters

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The Steadfast / MSM Webinar Series

- **April 19** Introduction to Business Interruption
- **May 8** Business Interruption – The Fundamentals
- **June 13** Declared Values/Sum Insured – How to do the Calculation
- **July 19** Indemnity Period and Common Steadfast Endorsements
- **August 31** Insuring Payroll – What are the Options?
- **September 21** Traps and Pitfalls
- **October 25** The Claim Process
- **November** The Year in Review

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CPD Points

- The name you enter when registering will appear on your certificate:

  Please use your full name when registering

- If you are joining in groups, you still need to register everyone attending and please advise Carol Gobrial via email:

  carolg@steadfast.com.au

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Agenda - Traps & Pitfalls

Common Issues and How to Avoid Them

- Average / Co-Insurance
- Inadequate Indemnity Period
- Limits and Sub-Limits inadequate
- Impact of Exclusions. Can the Wayne Tank principle be overcome?
- Would an extra Endorsement have provided a better outcome?

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AVERAGE/CO-INSURANCE

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Average

- Also referred to as Underinsurance
- Applied to claims when the Sum Insured for Gross Profit is less than Gross Profit for the 12 months immediately before the date of the Damage, adjusted for trend and other circumstances
- **Effect:** Lowers the maximum amount payable to the Insured in a claim

Average

- Does not apply if the claim is for less than 10% of the Sum Insured for Gross Profit

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Average

- Sum Insured is the Gross Profit amount stated on the Policy Schedule based on the most recent results for the business, plus growth trend

- **Common Mistakes:**
  - Not relying on proper Financial Statements
  - No Uninsured Working Expenses listed
  - Wrong Uninsured Working Expenses selected
  - Not understanding or applying a proper trend figure

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Avoid the Mistake
Average

- If you have a Steadfast ISR Policy with a default Indemnity Period of 24 months, ensure that trend is applied to the Gross Profit before it is multiplied by 2
- Sum Insured for Gross Profit should be a minimum of 12 months on the Policy Schedule (important if less than 12 months Indemnity Period selected)
- When the length of the Indemnity Period is greater than 1 year, the Sum Insured would be a multiple of the number of years. For example: a 3 year Indemnity is 12 months Gross Profit, including trend, multiplied by 3

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Average

Average Example – Underinsurance

❖ Insurance Renewal Date	30 June 2017
❖ Indemnity Period	12 months
❖ Sum Insured Gross Profit at Renewal	$500k
❖ Date of Incident/Claim Commences	29 June 2018
❖ Estimated 12 month Gross Profit	$1.25m (“Value at Risk”)
❖ Apply 80%	$1m (“Value at Risk”)

The Company is therefore only insured ($0.5m/$1m) = 50%

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Average

Consequence of Underinsurance

- Total Value of Gross Profit Claim $300k
- Insurance Recovery:

  Value of Insurance Claim x Value Insured $300k x 50% = $150k

Uninsured Losses: Client out of pocket $150k

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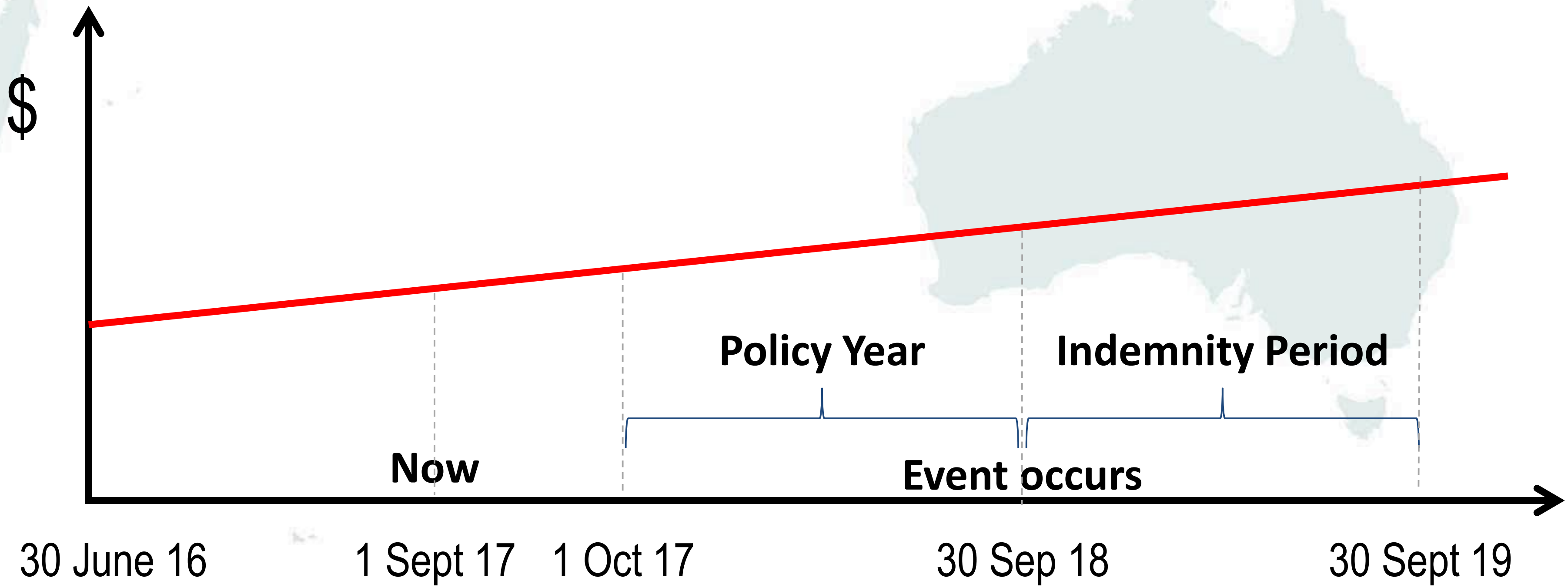
Gross Profit – Trend Adjustment



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Gross Profit – Trend Adjustment

Common Mistakes with Trend Adjustment

- Product price changes ignored
- New products not allowed for
- Expanding sales volume (growth) not considered
- Expansion plans not considered
- Acquisitions not allowed for
- Historic and anticipated growth too low or not included

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Uninsured Working Expenses

- Uninsured Working Expenses can be referred to as the **Variable Expenses**, being those expenses that cease or diminish in proportion with a reduction in Turnover or Sales
- Uninsured Working Expenses need to be established based on the assumption of a small, partial interruption only
- Fixed Costs are those that remain constant irrespective of the level of Turnover

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Uninsured Working Expenses

Directly variable expenses	Purchases, discounts, commissions, freight
Expenses with fixed/variable components	Electricity (office lighting, air conditioning), other utilities, repairs and maintenance
Fixed expenses	Insurance premiums, interest, lease costs, accounting and audit fees

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Uninsured Working Expenses - Myth

- If you insure some fixed costs for a percentage, for example:
    - Light / heating / power: 70% (i.e. UWE is 30%)
    - Repairs: 60% (i.e. UWE is 40%)

- You will get 100% of the expense up to the 'limit' of 70% or 60%...

  Wrong. You only get 70% or 60% of the normal expense during the interruption period

Payroll

- Steadfast Business Packs
  - Payroll <u>cannot</u> be insured separately and must be insured fully under Gross Profit

- Steadfast Industrial Special Risks (ISR)
  - Payroll can be insured separately under a **Dual Basis** methodology

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Payroll

- Dual Basis and other Payroll mistakes:
  - Not all classifications of Payroll are included
  - Different Insureds have different descriptions and Payroll classifications
  - Hidden in Cost of Goods Sold figures, etc.
  - Inadequate Initial Period selected (e.g. only 2 weeks)
  - Remainder percentage selected is too low (e.g. 20%)
  - No growth allowed for on historic amounts
  - Severance pay not considered

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Payroll

The __remeration__ paid to all employees of the insured, including but not limited to			
Holiday pay	Sick pay	Long service leave	Bonuses

PLUS (for example)				
Payroll tax	FBT	Superannua- tion	Workers Comp premiums	Accident Compensation Levies

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Payroll

Definition

(2017 Steadfast ISR)

"The remuneration (including but not limited to payroll tax, fringe benefits tax, bonuses, holiday pay, sick pay, long service leave, workers' compensation insurance premiums and/or accident compensation levies, superannuation and pension fund contributions and the like) paid to all employees of the Insured."

Key Points

- Includes all salaries, as well as wages, plus direct wage on-costs such as those mentioned in the definition

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INADEQUATE INDEMNITY PERIOD

Inadequate Indemnity Period

Common Mistake

- Underestimate the time for rebuilding, replacing and commissioning equipment

Effect

- At the end of the Indemnity Period the Insured is still suffering a loss of Turnover and incurring increased costs which cannot be claimed

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Inadequate Indemnity Period

Common Mistake

- Underestimate the time to regain customers and market share

Effect

- At the end of the Indemnity Period the Insured is still suffering a loss of Turnover and incurring increased costs which cannot be claimed

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Inadequate Indemnity Period

Common Mistake

- Insured has a 6 month Indemnity Period and the Broker does not a declare a 12 month Gross Profit figure

Effect

- 6 month Gross Profit figure is halved and the claim is subject to Average clause

Inadequate Indemnity Period

Common Mistake

- Insured has a multiple year Indemnity Period and Sum Insured for Gross Profit is not multiplied by 1.5, 2 or 3, and/or trend is not accounted for

Effect

- Business Interruption is inadequate for the Indemnity Period selected and the claim is subject to the Average clause

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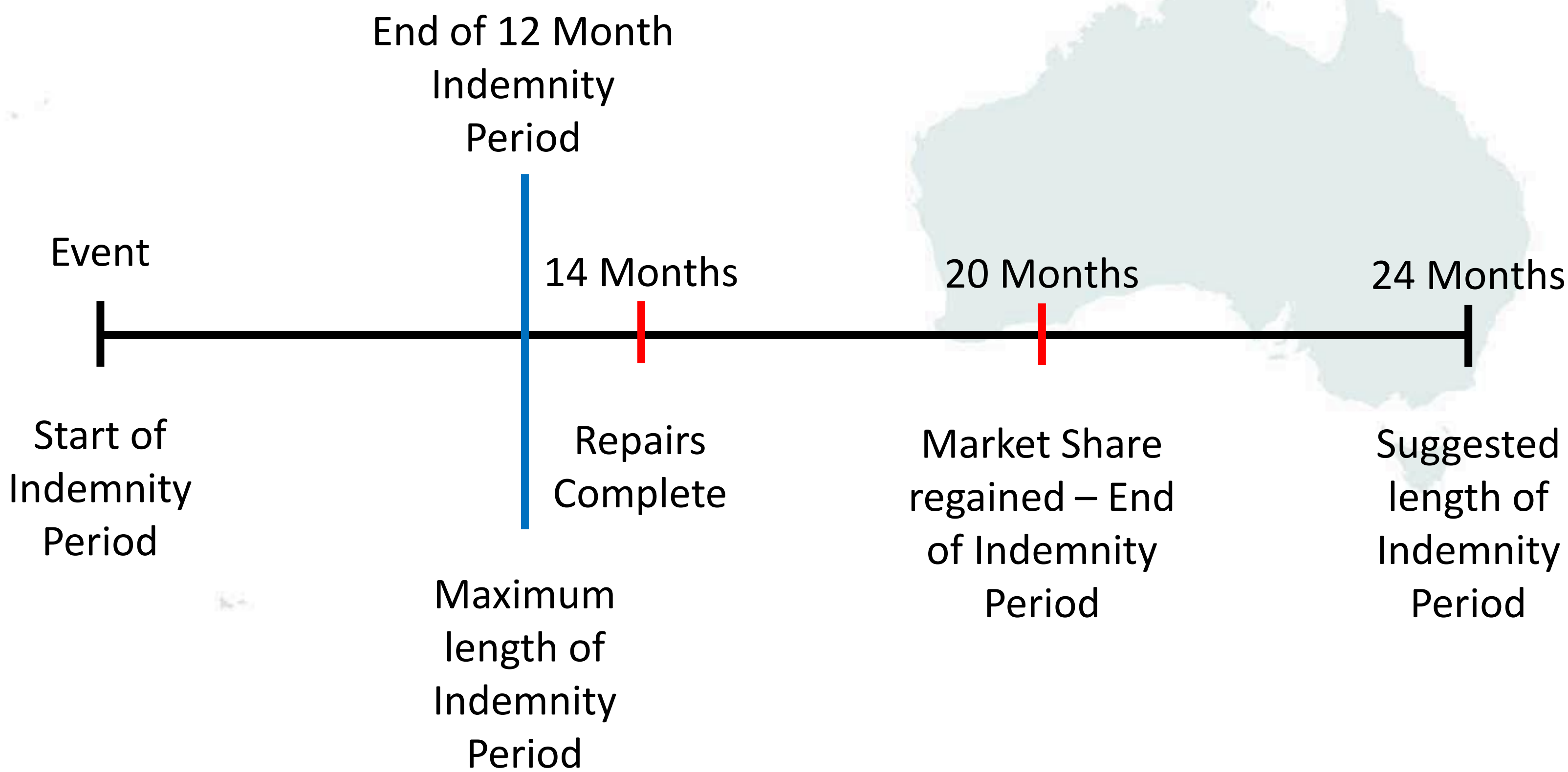
Inadequate Indemnity Period

A real example of where there was a 12 month Indemnity Period



Avoid the Mistake
Indemnity Period

Regaining Lost Market Share

No magic formula: speak to the client

- Potential loss of major customer(s)
- Competitiveness of market
- Effectiveness of recovery and mitigation strategies (e.g. advertising campaigns)
- Time to get back to pre-incident levels

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Avoid the Mistake
Indemnity Period

- Set the Indemnity Period based on a catastrophic loss scenario
- Consider the time to:
  - Complete investigations and statutory enquiries
  - Rebuild buildings
  - Purchase and commission new equipment
  - Regain lost market share (sales) to pre-loss position
- Best to be conservative and select longer period
- Allow a buffer

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LIMITS AND SUB-LIMITS INADEQUATE

Limits and Sub-Limits
Ensure they are Adequate

Limits of Liability

- Limits of Liability stated on the Policy Schedule represent the Insurer(s) maximum Limit(s) of Liability for any one loss, or series of losses, arising out of any one event at any one situation, subject to any Sub-Limits of Liability specified elsewhere in the Policy and the Schedule

Section 2 – Business Interruption Limit

- Made up of:
  - Sum Insured for Gross Profit (and Payroll for Dual Basis)
  - Other Applicable Sub-Limits (e.g. AICW and Claims Prep)

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Limits and Sub-Limits

Common Mistakes

- No amount selected for Additional Increased Cost of Working (AICW) or Claim Preparation
- Amount selected for AICW or Claim Preparation too low

Note: The Steadfast Business Pack includes $25,000 of Claim Preparation cover as standard, but this may not always be enough

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Additional Increased Cost of Working often too Low and Exhausted

Extremely useful – for example:

- Some Underinsurance scenarios
- Avoiding Sole Purpose
- No Economic Limit - e.g. buying in finished goods at a loss to keep customers
- Gaining remaining elements of lost market share

General guideline: 5% to 10% of Gross Profit

- We recommend a minimum of $100,000

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Claim Preparation Costs

General Guidance

3-5% of Gross Profit

Greater than $10m Gross Profit

Case by case

- **Number of locations, dependencies and interdependencies**
- **Level of sophistication**
- **Dual Basis Payroll**
- **Indemnity Period**

- We recommend a minimum of $50,000

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IMPACT OF EXCLUSIONS

Common Exclusions

Steadfast Business Pack

- Wear and tear, gradual deterioration, scratching, marring, developing flaws, normal upkeep or any gradual cause
- Corrosion, rust, oxidation, any form of fungus, wet or dry rot, dampness of atmosphere, variation in temperature, evaporation, disease, shrinkage
- Error or omission in design
- Erosion, subsidence, landslip or mudslide or any other earth movement
- Flood

Wayne Tank Principle:
The Pitfall

- The Wayne Tank Principle is that if there are two or more simultaneous proximate causes, but one of those causes was excluded under the policy, then the Insurer is not liable to indemnify the Insured for the loss
- Insureds fail to recognise and document Damage caused by an Insured Peril prior to the impact of an Excluded Peril

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The Pitfall

Not Recognising and Recording the Facts:

- What caused the Damage first?
- Claim (or part thereof) can be allowed if there is Damage prior to the exclusion triggering
- Timing of Damage needs to be documented

Note: If two causes of Damage occur simultaneously then the Wayne Tank Principle applies if one cause is excluded

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WOULD AN EXTRA ENDORSEMENT HAVE PROVIDED A BETTER OUTCOME?

The Trap: Common Endorsements are not used (or Values Elected are Inadequate)

- An Endorsement is an additional cover to the Standard Policy attaching to and forming part of the Policy. This is sometimes overlooked
- Important to know what is already included in the Standard Policy Wording and what is excluded (Additional Benefit vs Optional Cover) – the limits automatically provided may not be adequate
- Some need to be listed on the Policy Schedule with appropriate Sub-Limits, others form part of the Policy

Endorsements: Examples of Optional Endorsements

- Specified Customers and Suppliers
- Severance Pay

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Don’t miss the next Webinar

October 25 - *The Claim Process - Achieving the Best Outcome for the Insured*

- Measures of Success
- Key Roles
- Insurer Notification
- Appointment of Advisors
- Policy Response – Decision on Indemnity
- Cost Capture
- Claim Preparation
- Claim Settlement

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THANK YOU FOR ATTENDING

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