# BUSINESS INTERRUPTION INSURANCE: FROM COVERAGE TO CLAIMS

OTLA Professional Development

Webinar

September 26, 2019

Presented by: Tim Zimmerman & Jason Singer



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# Tim Zimmerman, BComm, CBV, CFE, ABV
# Partner

- Practice area leader for commercial insurance claims and commercial disputes at RSM Canada
- 2018 Top CBV Under 40 – Canadian Institute of Chartered Business Valuators
- Qualified & testified as an expert in loss quantification and business valuation at the Ontario Superior Court of Justice
- Developed and delivered over 100 education seminars





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# Jason Singer,
# Partner, Singer Katz LLP

- Certified by the Law Society of Ontario as a Specialist in Civil Litigation
- Obtained 2 punitive damages awards against insurance companies in property loss claims in *Brandiferri v. Wawanesa* and *Haji-Fazul v. Lloyds Underwriters*
- Litigation practice focus on commercial and homeowner’s insurance claims





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# Agenda

1. What is Business Interruption Insurance?
2. Components of Business Interruption Loss
3. How a Profits Loss is Calculated?
4. Common Problems with Measuring Loss
5. Differences Between Insured and Uninsured Losses
6. Limitation Periods in Business Interruption Cases
7. Business Interruption Case Law Review
8. Questions & Answers





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# What is Business Interruption Insurance?






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# What is Business Interruption Insurance?

- Form of insurance that provides coverage for business losses sustained by a policyholder as a result of an insured peril.
- Coverage period is typically from the date of Incident up until end of indemnity period or until:
  a) the business resumes its normal operations; or
  b) the damaged property has been repaired or replaced.
- Coverage typically includes:
  - Profits loss - actual loss sustained or stated amount
  - Increase in cost of working (ex. additional overtime labour)
  - Extra expenses (ex. temporary location) (Stand alone form)





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# Examples: Business Interruption Perils

## Fire Claims





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# Examples: Business Interruption Perils

## Floods and Natural Disasters





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# Examples: Business Interruption Perils

## Power Outages






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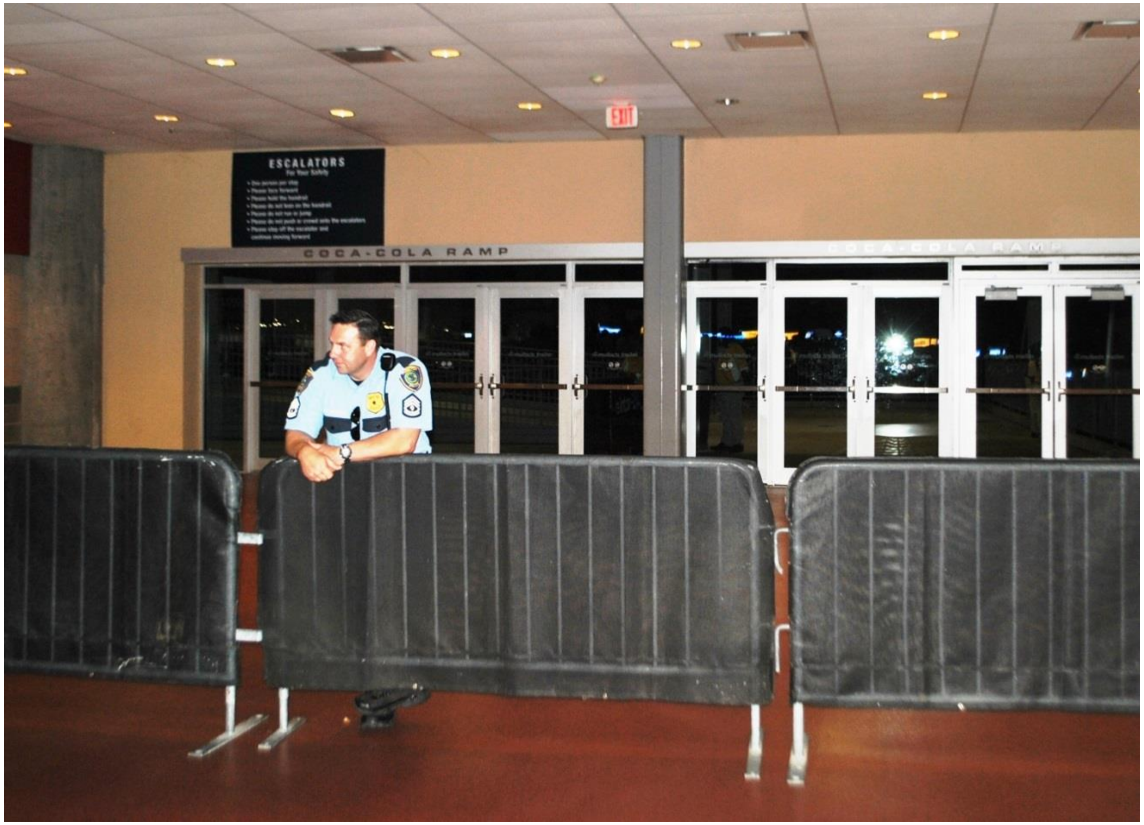
# Examples: Business Interruption Perils

## Interruption by Civil Authority





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# Examples: Business Interruption Perils

## Ice Storm






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# Examples: Business Interruption Perils

## Cyber Breach

# Examples: Business Interruption
# Other Fun Possibilities!


Impact by Spacecraft


Impact by Land Vehicle

Lightning


Riots and Vandalism





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# Other Coverage: Contingent Business Interruption

- When a business cannot operate because a supply of goods or services necessary for operating the business has been disrupted.
- Ex: a car assembly line is shutdown because the car parts supplier had a fire that shutdown their manufacturing plant.





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# Most Common Policy Forms

- Profits Form
  - Bottom-up approach
  - Net profit + insured standing charges
  - Indemnified until sales return to normal levels
- Gross Earnings Form (manufacturing or non-manufacturing)
  - Top-down approach
  - Sales – variable operating expenses
  - Indemnified until repairs are completed with due diligence
- Business Income Form
  - Top down approach
  - Similar to gross earnings form (indemnity period)
- Extended Business Income Form
  - Top-down approach
  - Similar to profits form (indemnity period)





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# COMPONENTS OF A BUSINESS INTERRUPTION LOSS



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# Components of a Business Interruption Loss

- Loss of profits
  - Loss of sales / customers / contracts
  - Loss of profit margin
- Stock loss
  - Loss of inventory that was damaged, destroyed or spoiled
- Additional costs
  - Increased operating expenses (i.e. additional overtime labour, COGS)
  - Extra expenses (i.e. temporary location, expedite costs)
  - Other reasonable costs incurred to mitigate loss and resume operations
- Saved expenses
  - Reduction in certain fixed or semi-fixed expenses that are a savings to the business (i.e. if rent abates during period of loss)
- Continued financial obligations
  - Loan obligations
  - Rent
  - Insurance premiums





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# HOW A LOSS OF PROFIT IS CALCULATED?

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# How to calculate profits loss?

Profits Form (Most common)

1. Determine the loss period (indemnity period)
2. Project sales (standard turnover) within indemnity period
3. Deduct actual sales (turnover) within indemnity period to calculate sales shortfall (reduction in turnover)
4. Determine the rate of gross profit earned on the reduction in turnover
5. Add any increase in cost of working
6. Deduct any saved expenses (reduction in insured standing charges)
7. Co-Insurance (if applicable)
8. Add any extra expenses





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# Determine Loss Period

- Start with the Date of the Incident
- Loss period ends at the earliest of the following:
  - The end of the repair or restoration period (Gross earnings/business income)
  - When the business resumes operating and sales levels return to pre-Incident levels (profits form/extended business income)
    - Requires a sales analysis including business trends leading up to Incident
  - The maximum duration of the indemnity period (per the policy)
    - Standard period is 12 months but 18 or 24 months is not uncommon





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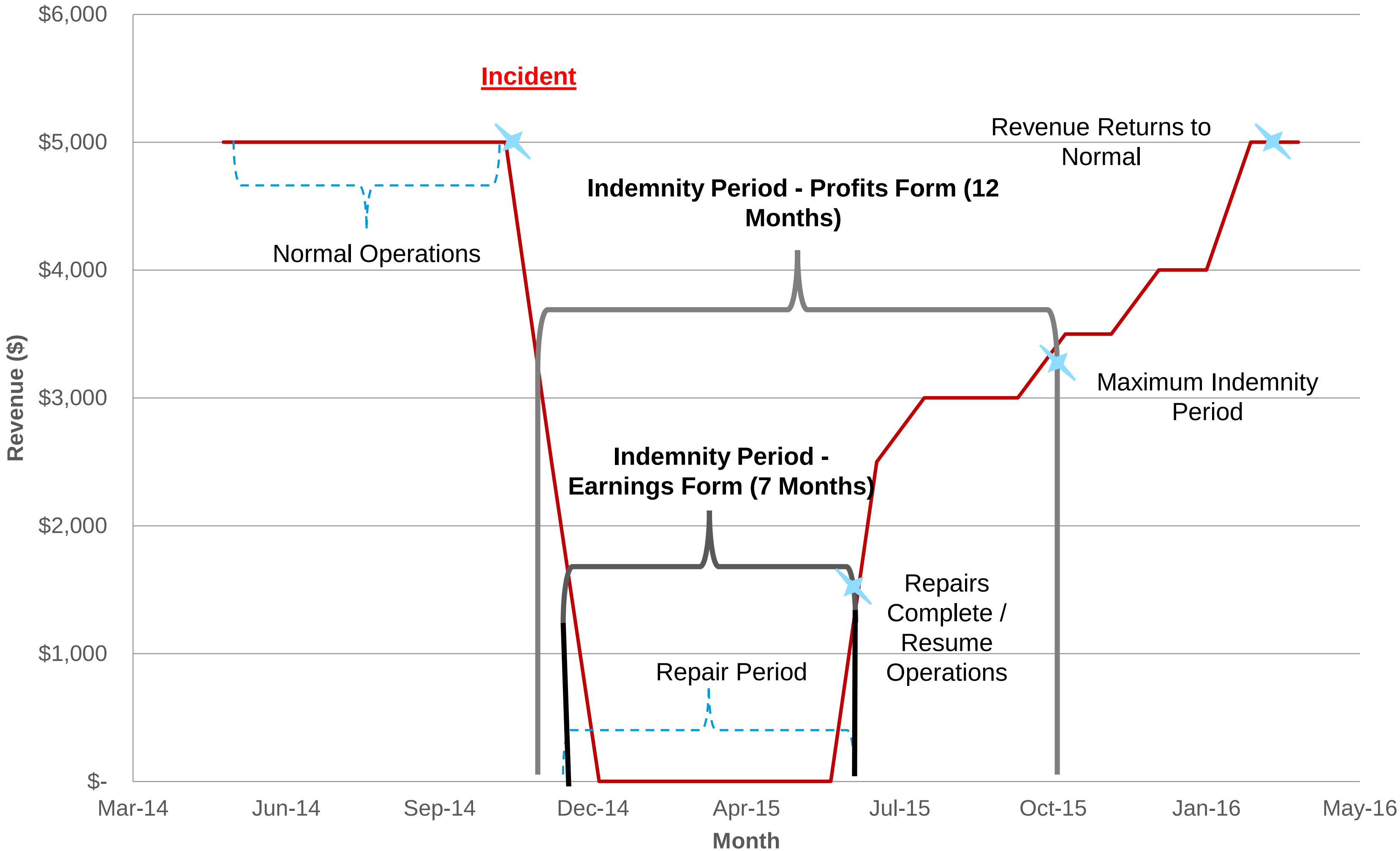
# Timeline of Loss Period





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# Projected Sales (Standard Turnover)

- Depending on the duration of the loss, a sales analysis may be based on:
  - Daily or weekly sales analysis in the immediate period prior to the Incident (typically for short loss period);
  - Monthly or annual sales analysis in the 12 months to 3 years prior to the Incident (typically for longer loss periods);
- Select an appropriate base period;
- Calculate a sales growth rate for the projected sales based on the trends of the business (positive or negative); and
- Consider any unusual or non-recurring transactions that may have an impact on the sales projection.





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# Example of Sales Analysis

| Month | Pre-Incident 2011 | Pre-Incident 2012 | Growth % | Projected 2013 |
|---|---|---|---|---|
| January | 760,000 | 780,000 | 2.6% | 800,280 |
| February | 760,000 | 750,000 | -1.3% | 740,250 |
| March | 730,000 | 720,000 | -1.4% | 709,920 |
| April | 700,000 | 690,000 | -1.4% | 680,340 |
| May | 700,000 | 725,000 | 3.6% | 751,100 |
| June | 680,000 | 700,000 | 2.9% | 720,300 |
| July | 850,000 | 860,000 | 1.2% | 870,320 |
| August | 640,000 | 640,000 | 0.0% | 640,000 |
| September | 630,000 | 650,000 | 3.2% | 670,800 |
| October | 675,000 | 700,000 | 3.7% | 725,900 |
| November | 700,000 | 750,000 | 7.1% | 803,250 |
| December | 720,000 | 730,000 | 1.4% | 740,220 |
| Total | 8,545,000 | 8,695,000 | 1.8% | 8,852,680 |
| | | | Rounded | 8,800,000 |





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# Calculate Sales Shortfall (Reduction in Turnover)

- Using the following assumptions
  - Projected sales (Standard Turnover) are $8,800,000
    (Sales earned had no Incident occurred)
  - Actual sales (Actual Turnover) are $8,000,000
    (Sales earned after Incident)

| | | |
|---|---|---|
| Standard Turnover | $ | 8,800,000 |
| Less: (Actual) Turnover | | 8,000,000 |
| Reduction in Turnover | $ | 800,000 |





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# Rate of Gross Profit

- Rate of gross profit refers to the ratio of “Defined Gross Profit” to sales
  - Defined Gross Profit = (Annual) Net Profit + Insured Standing Charges
  - Rate of Gross Profit = Defined Gross Profit / Annual Sales
- The rate of gross profit  is typically calculated based on the financial results of the business in the last fiscal year or last 12 months prior to the Incident and adjusted for trends in the business during the loss period.
- Insured standing charges refer to the fixed expenses and semi-fixed expenses that would likely continue if the business was not operating
  - Ex. Insurance premiums, professional fees, monthly bank charges

# Key and Ordinary Payroll

- Total Payroll = Key Payroll + Ordinary Payroll
- Key payroll refers to the essential employees that would not be dispensed of or could not be replaced if an Incident occurred. Key payroll is always considered an insured standing charge and includes management wages. These positions may include
  - Executives
  - Officers
  - Department Managers
  - Employees Under Contract
- Ordinary payroll: When a partial or complete suspension of the business occurs these employees would be terminated and replacement staff would be hired upon the resumption of operations, without causing significant detriment to the business. Ordinary payroll is not an insured standing charge unless optional coverage is purchased.
- These position may include:
  - General and unskilled labour
  - Non-management employees





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# Example: Calculation of Rate of Gross Profit

For the year ended December 31

| | Last Fiscal Year | | Insured Standing Charges | | Comments |
|---|---|---|---|---|---|
| Sales | $ 1,000,000 | D | | | |
| Cost of sales | 450,000 | | | | 100% variable |
| Gross margin | 550,000 | | | | |
| Operating expenses | | | | | |
| Advertising | 5,000 | | $ 5,000 | | Assumes 100% fixed |
| Bank charges and interest | 10,000 | | 7,500 | | Assumes 75% fixed |
| Insurance | 25,000 | | 25,000 | | Assumes 100% fixed |
| Management wages | 100,000 | | 100,000 | | |
| Supplies | 75,000 | | | | Assumes 100% variable |
| Professional fees | 5,000 | | 5,000 | | Assumes 100% fixed |
| Rent | 80,000 | | 80,000 | | Assumes 100% fixed |
| Salaries and benefits | 125,000 | | 50,000 | | Assumes $50,000 in key payroll, no ordinary payroll coverage |
| Telephone | 2,500 | | 2,500 | | Assumes 100% fixed |
| Utilities | 10,000 | | 7,500 | | Assumes 75% fixed |
| | 437,500 | | 282,500 | **A** | |
| Net Income before income taxes (Net Profit) | 112,500 | | 112,500 | **B** | |
| | Defined Gross Profit | | $ 395,000 | **C = A + B** | |
| | Rate of Gross Profit | | 40% | **C / D** | |





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# Calculation of Loss of Gross Profit

| | |
|---|---|
| Standard Turnover | $ 8,800,000 |
| Less: (Actual) Turnover | 8,000,000 |
| Reduction in Turnover | 800,000 |
| Rate of Gross Profit | 40.00% |
| Loss of Gross Profit | $ 320,000 |

# Reduction in Insured Standing Charges (Saved Expenses)

- When a business ceases operating certain fixed expenses (Insured standing charges) may be saved by the business. These savings are referred to as a reduction in insured standing charges. The following illustrate various examples of expenses that may cease:
  - Rent: Often leases will have rent abatement clause (rent ceases if operations cease)
  - Property taxes: A property tax rebate may be available to the owner of a building not in use due to an unforeseen event such as a fire
  - Telephone: The phone may be disconnected during the period of interruption

# Example:
# Calculation of Reduction in Insured Standing Charges

| For the years ended December 31 | Post-Incident<br>Current Year | Pre-Incident<br>Last Fiscal Year | Insured Standing Charges | Reduction in Insured Standing Charges |
|---|---|---|---|---|
| Sales | $ 400,000 | $ 1,000,000 | | |
| Cost of sales | 180,000 | 450,000 | | |
| Gross margin | 220,000 | 550,000 | | |
| Operating expenses | | | | |
| Advertising | - | 5,000 | 5,000 | 5,000 |
| Bank charges and interest | 7,500 | 10,000 | 7,500 | |
| Insurance | 25,000 | 25,000 | 25,000 | |
| Management wages | 80,000 | 100,000 | 100,000 | 20,000 |
| Supplies | 75,000 | 75,000 | | |
| Professional fees | 5,000 | 5,000 | 5,000 | |
| Rent | 20,000 | 80,000 | 80,000 | 60,000 |
| Salaries and benefits | 50,000 | 125,000 | 50,000 | |
| Telephone | 2,500 | 2,500 | 2,500 | - |
| Utilities | 8,500 | 10,000 | 7,500 | |
| | 273,500 | 437,500 | 282,500 | **85,000** |
| Net Income before income taxes (Net Profit) | | 112,500 | 112,500 | |
| | | Defined Gross Profit | $ 395,000 | |
| | | Rate of Gross Profit | 40% | |



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# Increase in Cost of Working

- When a business resumes operations after an Incident, often they will be doing so at a reduced capacity and will need to incur additional costs in order to mitigate their loss.

- The policy defines an increase in cost of working as the additional expenditure necessarily and reasonably incurred for the sole purpose of avoiding or diminishing the reduction in turnover.

  - For example, if a manufacturing plant had one of their machines damaged in a fire but they were able to continue operating with another machine by running two shifts per day instead of one they would likely have to pay overtime or additional labour costs in order to prevent a complete loss of income related to the damaged machine. The overtime or additional labour costs incurred mitigate the loss of income and as such would be considered an increase in cost of working.

# Extra Expense

- Not to be confused with an increase in cost of working, extra expense coverage is a separate and optional coverage which provides reimbursement of certain expenditures that may not serve to reduce the loss during the indemnity period, however, they are important in order to sustain the business in the long-term.
- For example:
  - If a business needed a temporary location in order operate the business to provide service to its existing customer base
  - If substitute products were purchased at retail cost and sold to its customers to maintain service and relationships during the period of interruption





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# Summary of Loss

| | | |
|---|---|---|
| Standard Turnover | $ 8,800,000 | |
| Less: (Actual) Turnover | 8,000,000 | |
| Reduction in Turnover | 800,000 | |
| Rate of Gross Profit | 40.00% | |
| Loss of Gross Profit | $ 320,000 | |
| Add: Increase in Cost of Working | 80,000 | Assumed |
| Less: Reduction in Insured Standing Charges | (85,000) | |
| Add: Extra Expense | 35,000 | Assumed |
| Total Loss Payable | $ 350,000 | |





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# COMMON PROBLEMS WITH MEASURING LOSSES



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# Cash Sales and Unreported Income

- Cash Sales
  - Typically unreported income with minimal records available to quantify amounts
  - May be a substantial portion of the sales of the business
  - Need to understand the nature of the business and the types of activities that are on a cash basis
  - Inherent bias to report all expenses but not report all sales
- Dealing with Cash Sales
  - Industry comparable ratio analysis
  - Bank statement deposit analysis
  - Overall reasonability analysis of cash component of business
    - Customer counts, booking logs, purchasing records (# of units)

# Cash Sales – Industry Comparable Analysis Example

- Reported

| Non-cash sales | $1,000 | 100% |
|---|---|---|
| Cash sales | - | 0% |
| Total Revenue | $1,000 | 100% |
| Less: Expenses | $950 | 95% |
| Net Income | $50 | 5% |

- Actual

| Non-cash sales | $1,000 | 75% |
|---|---|---|
| Cash sales | $333 | 25% |
| Total Revenue | $1,333 | 100% |
| Less: Expenses | $950 | 75%* |
| Net Income | $383 | 29% |

* Per Statistics Canada SME Benchmarking Tool for all businesses in the Construction Industry in Canada.

# Incomplete Financial Records

- Often small businesses will have records that do not reconcile to tax returns or financial statements
- Need to understand nature of discrepancies
- Review underlying financial information and supporting documentation
- Review accounting policies for recording income/expenses
- Re-file tax returns/financial statements if necessary





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# Professional Fees Coverage

- Policy often has coverage for expert fees to measure the business interruption loss and/or stock loss
- Wording may vary “Professional Fees” “Cost to prepare proof of loss” “Accountant Fees”, etc.
- Certain professionals such as public adjusters are often excluded
- Fees are not for the use of the insurers forensic accountant
- Generally best practice to advise the insurer that you are engaging an expert under the professional fees coverage
- Does not cover professional fees for insurance litigation, insurance appraisal or non-measurement related activities





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# DIFFERENCES BETWEEN INSURED AND UNINSURED LOSSES



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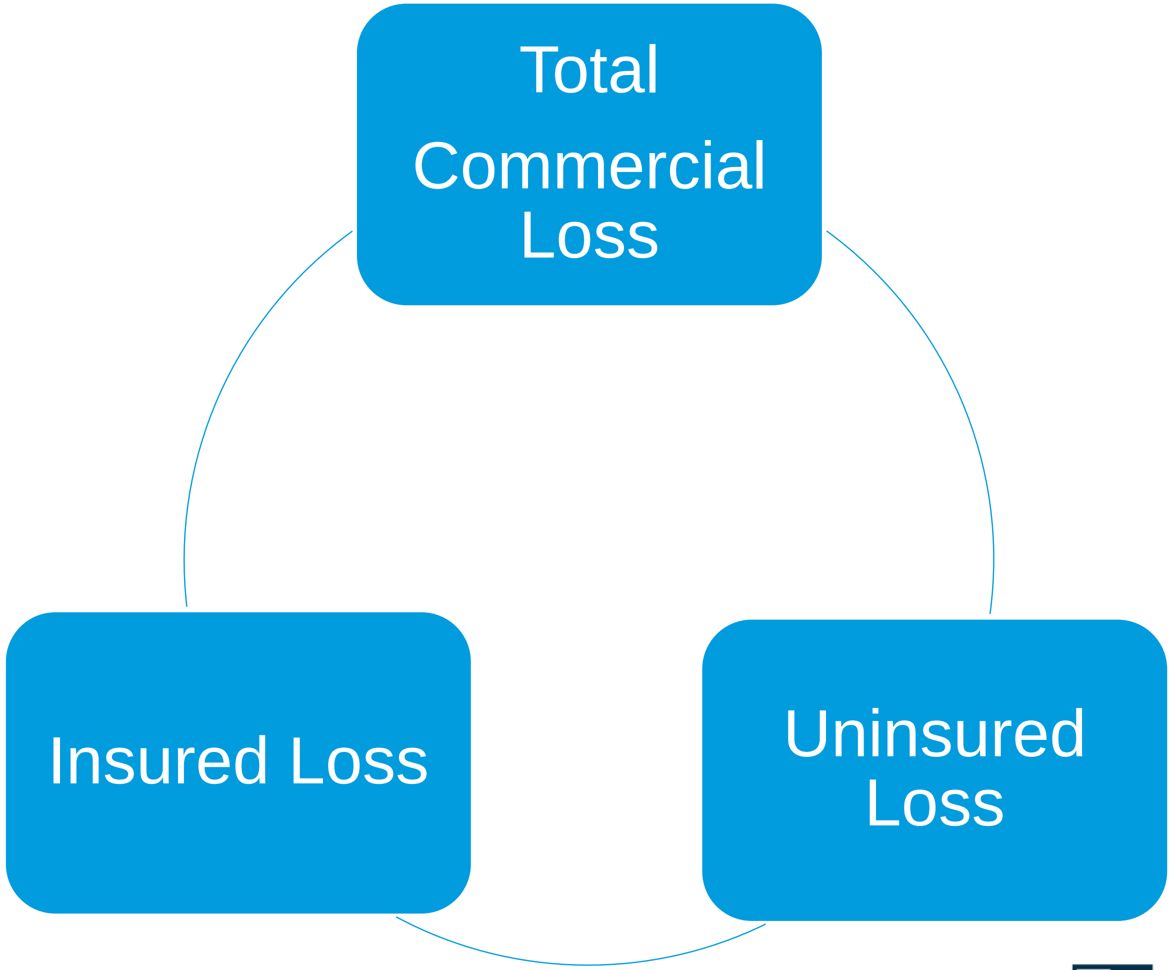
# Commercial Loss



# Differences Between Insured and Uninsured Losses

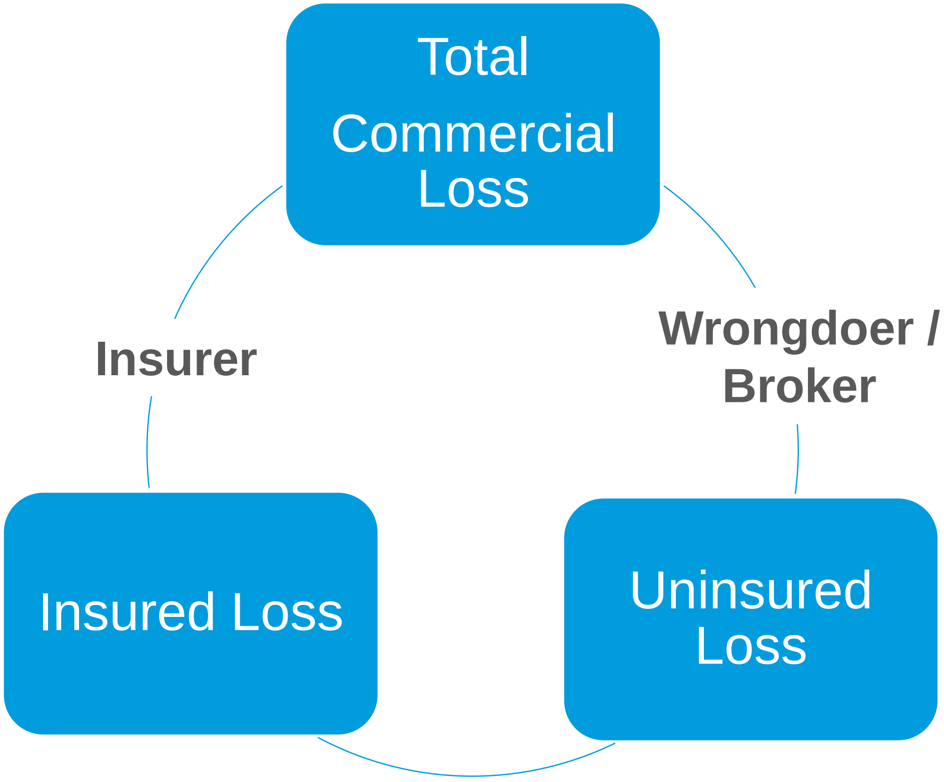
| Criteria | Insured | Uninsured |
|---|---|---|
| Profits Loss | Stated amount or actual loss sustained (subject to co-insurance) | Actual loss sustained |
| Indemnity Period | Limited to indemnity period in policy (i.e 12 months) | On a substantial indemnity basis |
| Permanent Loss of Business Value | No | Yes |

# Differences Between Insured and Uninsured Losses

| Criteria | Insured | Uninsured |
|---|---|---|
| Property Damage | Stated amount (Actual cash value or replacement cost) (co-insurance) | No stated amount (typically replacement cost) |
| Additional Costs | Must mitigate loss or reasonably incurred to resume normal operations | Duty to mitigate but not subject to same mitigation test |
| Saved Expenses | All saved expenses within indemnity period | All saved expenses |

# Uninsured vs. Insured Losses – Who pays?

- *Pursuing the Wrongdoer*
  - Negligence
  - Contract
- Pursuing the Broker
  - Negligence
  - Breach of Contract
  - Breach of Fiduciary Duty



# Brokers Negligence Claims

- Consider basis of negligence:
  - material misrepresentation on application or material change in risk → policy voided – claims for all insured damages
  - Inadequate coverage or insufficient limits → consider what is remaining after payment by insurer → consider whether insured would have paid for the coverage and whether it was available
- Consider basis for damages:
  - Claims over and above policy limits
  - Claims as a result of voiding of policy or non-payment
  - Claims where no coverage was available
- Co-insurance considerations → consider if an elevated assessment will lead to a larger reduction in claim

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# LIMITATION PERIOD IN BUSINESS INTERRUPTION CASES

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# Limitation Period for Business Interruption Claims

- **Boyce v. Co-operators Insurance (2013 ONCA 635) leave to SCC denied)**
- Insured clothing store brought action for clothing damage after 1 year of loss but before 2 years.
- Policy contained a 1 year limitation provision
- Court of Appeal reviewed *Limitations Act*. Neither party was a "consumer" therefore can contract out of default 2 year limitation period.
- Insurers can contract a shorter limitation period into a policy that is not a personal or "consumer" based policy (homeowner's policy or LTD not applicable)
- TIP: Confirm Limitation Period with Insurer and review entire policy including Statutory Conditions





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# Limitation Period for Business Interruption Claims

- **Marvelous Mario's Inc. v. St. Paul Fire (2019 ONCA 695)**
- Insured commenced 2 actions beyond 1 year limitation period including claim for ongoing business interruption losses.
- Lower Court held that business interruption claim was brought within time because a rolling limitation period applied. "A new claim accrues each day for the business losses sustained that day."
- Court of Appeal overturned this finding.
- Business interruption claims are NOT subject to rolling limitation period
- Court of Appeal held that business interruption claim arises on date that insured knew they had suffered a loss or damage. E.g. the date of loss





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# BUSINESS INTERRUPTION CASE LAW REVIEW

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# Business Interruption Case Law Review

- <u>**J.I.L.M. Enterprises & Investments Limited v. Intact Insurance (2017 ONSC 357)**</u>
- Insured Motel/Restaurant near Thunder Bay sustained a fire loss. Insurer stalled for 3 years before paying ACV on building loss claim. Delay was found to be unacceptable by trial judge as investigation into arson should have been completed within 6 months
- Insurers failure to pay ACV prevented rebuild of the Motel and breached contractual obligations to insured
- Insurance policy provided for 1 year business interruption claim
- Trial Judge awarded a further 3 year period to due to delay in paying ACV and allowing a period of time to rebuild




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# Business Interruption Case Law Review

- **<u>Pereira v. Hamilton Township Farmers Mutual Fire Insurance Company (2006 CanLii 12284 (ONCA)</u>**
- Arson allegation by insurer following a fire loss at a mushroom farm. Various allegations of denial including material misrepresentation as to status of business activities.
- Policy provided for loss of profits coverage of $150,000.
- Jury awarded $1.2 million in lost profits.
- Post trial – Plaintiff successful in amending pleadings to claim additional losses.
- Court of Appeal:  new trial ordered on various grounds including finding of no evidence to support loss of profits award.





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# Business Interruption Case Law Review

- **Le Treport Wedding & Convention Centre Ltd. v Co-operators General Insurance Co., [2019] O.J. No. 2595**
- Water damage claim to a banquet hall. Hall owner attempted to keep operations open during repairs.
- Policy provided for Business Interruption coverage based on loss of gross profit.
- Trial Judge held that coverage did not apply because interruption means a complete cessation of the business operations. Interpretation was based on legal dictionary definition.
- Because the business continued to operated business was not interrupted. Business must be shut down.
- Decision is under appeal – Trial judge appears to have ignored rules of insurance interpretation, as well as formula for gross profit that contemplated a reduction in business profit in its formula





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# QUESTIONS AND ANSWERS?

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