

BUSINESS INCOME INSURANCE

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As business owners, we all understand the importance of insuring inventory, equipment and premises. While we may choose to risk limited coverage for such losses, it is a rare business that does not carry some form of property insurance. We also all understand (at least intellectually) that every loss of property carries with it a risk of lost business income. Yet curiously, business income insurance is more the exception than the rule. That oddity might be explained by the fact that entrepreneurs take risks, but it more likely arises either from a lack of understanding of business income insurance or a desire to save a few dollars on insurance premiums. While this article won't help you with the premiums, it should give you a sufficient understanding of business income insurance to enable you to ask your broker the right questions about coverage.

First the disclaimer: this article is a primer on the principles of business income insurance and to some extent insurance generally. No particular policy is being considered, and your policy may provide different coverage than is discussed in this article. If you are unsure of your coverage, talk to your insurance broker.

Every instance of damage or destruction of inventory, equipment or premises carries with it the potential for two losses; the loss associated with the cost of restoring or replacing the damaged property and the loss of earnings that the business could have generated through the use of the damaged property. Standard property insurance policies are designed to cover the first type of loss while business income insurance endorsements are designed to cover the second.

The nature of business income insurance is to compensate the insured for earnings lost as a consequence of the damage to or destruction of its inventory, equipment or premises. Bound up in this simple expression of the insuring intent are a number of basic presumptions. All of these must exist before any indemnity will be paid for lost earnings.

1. The property damaged or destroyed was insured.
2. The property was insured by the business
3. The property was insured against the peril that caused the damage.
4. The damage to the property caused an interruption of business, and
5. The interruption of the business caused a loss of earnings.

If any one of these presumptions is not true, business income insurance will not cover the loss.

Insurance coverage is entirely dependent on the words used in the policy and their interpretation. For that reason, the remainder of this article and a portion of the next will identify and define some basic insurance concepts and common words and phrases found in business income insurance.

Endorsement

As mentioned earlier, property insurance and business income insurance are tied together. The business usually purchases a property insurance policy and the business income insurance is grafted on by way of an "endorsement". This is simply a "mini-policy" that (at least with respect

to business income insurance) increases the coverage provided by the property policy. I call this a “mini-policy” because while it contains its own particular insuring agreement and definitions, it also relies upon some of the conditions and definitions in the main property policy.

Insured

This is the person(s) named in the coverage page (also known as the “Declarations Page”) of the property insurance policy. These are the only person(s) entitled to claim for loss of business income arising from an interruption. Thus, if the “insured” named in the Declarations Page is an incorporated company, it is that entity which must suffer a loss of business income. A loss of wages suffered by an employee due to the interruption of business is not a loss to the insured, and therefore is not claimable under the business income endorsement of the policy

Premises

The Declarations Page of the property policy always identifies the location being insured. These are “the premises”. The business income endorsement may define “premises” with more precision by including the entire area within the property lines of the location identified in the Declarations. In either case, only business income loss that arises from damage to property located on “the premises” would be covered under the business income endorsement of the property policy. Suppose inventory is stored in the garage of the sole director and shareholder of an incorporated company and not at the location shown on the policy. If it is destroyed causing a loss of sales, no coverage will be available under the business income endorsement of the property policy.

Direct Physical Loss

Property policies typically indemnify the insured only for “direct physical loss” of insured property. In other words, property that is rendered useless because of a power outage is not physically damaged (assuming no arcing is caused by a power surge). Since the power outage did not cause a “direct physical loss” of insured property, any business income loss arising from the inability to use the property during the power interruption would not be covered under the business income endorsement of the property policy.

If you are reading this hoping for details on how business income losses are actually calculated, you will be disappointed. The definition of “measure of recovery” contains phrases and definitions that are particular and convoluted. Explaining those concepts would take considerably more space than is available here. Contact your insurance broker for complete details.

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Insured Peril

Property insurance is designed to compensate the insured for damage to property caused by specific perils. Direct physical loss caused through vandalism will not be insured under a policy that insures only against losses caused by fire. Compensation for business income loss is similar. If the damage that causes the business income loss is caused by a peril against which no insurance has been obtained, or a peril that is specifically excluded from coverage under the property policy, then no compensation for the resulting business income loss will be available.

Indemnity Period

This is the period of time during which a business income loss must occur before the insured will be entitled to compensation. The indemnity period starts on the day that the insured property is damaged and ends on the date when the damaged property could, with the exercise of reasonable diligence, be repaired or restored. The length of time that it takes to return the business to its former state of profitability is not usually a factor in determining the length of the indemnity period, although business income endorsements of this sort can be obtained. Most business income endorsements will also contain an absolute limitation on the indemnity period (typically, 12 consecutive months). The insured will only be paid for business income loss which occurs within the indemnity period. No compensation will be paid for business income losses which occur after the end of the indemnity period even if those losses arise for direct physical damage to insured property by an insured peril.

Actual Loss of Business Income

The purpose of business income insurance is to return to the insured the amount of **profit** it would have earned had there been no interruption of its business. The loss must be real in the sense that it is readily identifiable. A loss of reputation due to an inability to fulfill orders will only be covered if a reduction of profits during the period of indemnity is proven.

Duty to Mitigate

Every insurance policy requires the insured to take reasonable steps to reduce or eliminate losses caused by damage from an insured peril. This is known as the “duty to mitigate”. For example, if the insured can reduce its loss by continuing operations at another location, it must do so. Similarly, if the insured is able to use existing stock and/or inventory to continue at the same level of sales during the indemnity period, then the insured is obligated to do that as well.

Pulling it together

As we have seen, there are a number of specific requirements that need to be met in order to establish a business income loss claim. If we tie them together, we can now define what business income insurance provides: coverage to the insured for profits that are unavoidably lost during the period between the date upon which damage to property that is insured under the property policy occurs and the date upon which the same property could, with reasonable diligence, be repaired or restored provided that the property is damaged while located upon the insured premises by one of the perils set out in the policy.

If you already possess business income coverage, you may find that your policy differs from the general principles discussed in this article. If you are uncertain as to your coverage, consult your insurance broker.

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