FACE OFF WITH MOTHER NATURE!

GET SMART ABOUT YOUR BUSINESS INTERRUPTION INSURANCE

Lance McNeel, of Capstone Associated Services, Ltd., discusses the importance of business interruption coverage in the captive insurance industry

Reports of impending natural phenomena can strike fear in the most prepared business owners, depending on the time of year and where they live in the world. In the US, businesses contend with property and casualty threats from hurricanes, tornadoes, earthquakes, and floods. More indirect business interruptions, such as supply chain disruptions due to conflicts overseas, are real possibilities. The true costs of business interruption had been proven time and time again and could financially cripple companies that haven't taken the right precautions. The number of natural disasters is on the rise. The annual total has increased from 400 major incidents in a typical year to more than 600, according to a recent survey by global insurer Allianz.

Business interruption insurance was instituted to protect companies from the risk of reduced income associated with a loss to physical property and provide some level of protection against unforeseeable threats. Cost may be a factor in why entrepreneurs self-insure such coverage: policy prices range from $750 to $10,000 or more, depending on the limits purchased.

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Many property policies will cover the direct physical loss, damage, or destruction to property as well as the actual loss of business income you might sustain when you're forced to halt operations while you rebuild. There's just one problem: The loss or damage must be caused by or be the result of a covered cause of loss in order for your coverage to kick in. Put plainly, if your building or equipment is damaged by a hail storm, fire, hurricane, etc., you are likely to be covered. But if there is no property damage after a major disaster, your business interruption insurance may not cover income loss resulting from the event.

And let's say you have incurred an extra expense during the restoration/recovery period, such as employing freelance workers or renting equipment just to keep your business running at a basic level. Most commercial coverages will cover the expense. But again, this coverage would only be triggered if there was property damage to your facilities or equipment. It is a catch-22 in the insurance world—a necessary precaution with gaps that may leave business owners extremely vulnerable.

Gaining clarity with captive insurance programmes

The frequency of adoption of business interruption coverages has greatly expanded among small and mid-size organizations. Although this type of insurance has become broader and more mainstream, the pitfalls of its exclusions still plague many businesses seeking comprehensive coverage. Take the case of a moving and storage company, based on the Gulf Coast. The company owned a large inventory of moving vans and storage facilities, essential to its business operations.

In September 2008, reports of an approaching category four hurricane hit the airwaves. Residents along the Gulf Coast were urged to vacate, as the storm, Hurricane

Ike, was headed for landfall in Cuba, Texas, Louisiana and Mississippi. Prospective clients of the moving and storage company heeded warnings. They cancelled their moving contracts en masse. Through an unfiltered lens, it made sense—who would want to keep their scheduled move in place when there was a devastating hurricane on the horizon? Hurricane Ike would prove indiscriminate in its destruction.

In the immediate aftermath, businesses were reeling. Trees were strewn on roadways and residential streets, preventing regular pickup and delivery of goods. Infrastructure breakdowns were abound and the price of gas shot up to levels unseen in years. A shift in Ike's path into a heavy cluster of Gulf Coast refineries sent gasoline futures surging by 11 cents a gallon, to $2.86 a gallon. Along the Gulf Coast, wholesale prices skyrocketed to nearly $5 a gallon, up from $3 to $3.30, according to Tom Kloza, publisher of the Oil Price Information Service.

The moving and storage company in question did have a business interruption insurance policy in place. The problem was that its coverage didn't address the business interruption losses associated with the hurricane because there was no direct damage to the company's vans or storage facilities. All its equipment was left intact. The business owners made up some of the difference in the following months, but the impact of losing their contracts was felt. Since the trigger for most conventional business interruption insurance coverages is a loss to property, and not indirect risks like the cancellation of contracts due to severe weather, the company made the decision to form a captive insurance company. Its loss of income, extra expenses, etc. would be covered by a supplemental weather-related business insurance policy, issued by its captive—an important alternative risk management tool that would save the company thousands of dollars.

Coverage written by the captive included language that encompassed claim triggers not offered by conventional programs. If a hurricane or other storm were to come through the area again, the trigger would be determined by passing a latitude and longitude stipulated in the policy form. The policy was designed to cover the loss of income due to a weather-related event without the company having to suffer direct physical damage to its facilities or properties. The cancellation of the company's contracts or other indirect consequences of unforeseen disasters would now be fully covered. It is a success story that showcases one of the many benefits of captive insurance as it relates to business interruption and restoration.

The broad scope of captive insurance coverages

In the conventional market, insurers' interests revolve around making a profit. Essentially, it is their duty to pay claims so that the insured is left in the same position as they were before the loss. But it is in the insurer's best interest to keep the claim payments as low as possible. This is a point of contention during claims.

In general, coverages written by a captive insurance company can be written with a company's specific risks in mind. With a captive, the claims process proves less adversarial, as the captive is often owned by the operating company's business owner. Loss of income and extra expenses are covered by broader, more inclusive policy language.

Qualified captive managers can help with the claims process, adhering to forensic accounting guidelines, as found also in the conventional market. Expenses, taxes, and revenues from the previous year are calculated against the drop in net income from the current year.

The benefits of forming a captive insurance company to mitigate business interruption risks are clear. Coverage-specific policies are a hallmark of captive insurance. Coverages that are not readily available or too expensive in the commercial market can be tailor-made inside the captive.

It is important for business owners to have a qualified, interdisciplinary team at the helm to determine what risks should be considered when writing coverages. Many captive managers only handle the clerical duties associated with the formation of a captive insurance company. They may be licensed CPAs, but they often do not have the expertise to manage the tax, insurance, regulatory, and legal aspects of captive management. Some claim to have turnkey services in-house, but they might offer these services a la carte. Some exclude these important services altogether and are only noted in the fine print.

Business interruption coverage is not an issue that should be taken lightly. The right captive planning in writing these coverages means the difference between business survival and death in cases of major business interruption disasters. It could be your safeguard against anything that threatens your operations, rain or shine.