Business Interruption and Income Protection Insurance

Business Interruption

This Guidance Note has been written by Nick Gillies, Partner and Stephanie Corban, Senior Associate, Hesketh Henry with additional commentary on the impact of COVID 19 written by the LexisNexis team.

What is Business Interruption insurance?

Business interruption (or business continuity) insurance alleviates the financial consequences that a business would otherwise face if an unexpected and harmful event (eg earthquake, fire or flood) occurs. Without business interruption insurance, a major loss or damage could result in the failure of the business.
Liability

Business interruption insurance is often included in a single policy with material damage cover. This is because cover for business interruption is usually dependent on damage or loss that is insured under a property insurance policy.

Some policies require the property damage and the business interruption to have occurred during the period of insurance. For other policies, it is sufficient if the event giving rise to the property loss or damage occurred during the period of insurance.

COVID 19 and Business Interruption insurance

With New Zealand now in COVID-19 Alert Level 4, many businesses are either operating at reduced capacity or are unable to operate at all. Many are experiencing a reduction in turnover or a complete loss of business. For those with Business Interruption insurance, some or all losses may be covered. As businesses face a period of uncertainty and the potential for job losses or closure, there may be an increase in the number of queries relating to policies of this type.

The important factor to consider is whether the effects of COVID 19 and the Level 4 lockdown are covered by the policy wording and the scope of cover. Does the policy include closure of premises due to government or local authority mandate? Is cover limited to sudden events such as fire or natural disaster? Does cover extend to interruption of the insured’s supply chain? Many policies are limited to cover linked to physical or material damage to property and may not extend to current circumstances.

Pandemics are often specifically excluded in policy wording as it is not possible to adequately quantify risk.

For further information relating to impacts of the COVID 19 pandemic on insurance, see the Insurance Council of New Zealand’s COVID 19 Virus site

For those requiring support outside of insurance, the Government has announced The Business Finance Guarantee Scheme through the banks to provide short-term credit to cushion the financial distress on solvent small and medium-sized firms affected by the COVID-19 crisis. The scheme will include a limit of $500,000 per loan and will apply to firms with a turnover of between $250,000 and $80million per annum. The loans will be for a maximum of three years and are expected to be provided by the banks at competitive, transparent rates. The Government will carry 80% of the credit risk, with the other 20% to be carried by the banks. Clients should contact their banks for further details. For further information, see the official announcement here.

What cover is provided?

A business interruption policy usually provides cover for the following:

- Loss of gross profit or gross revenue due to a reduction in turnover — This loss is calculated by considering the amount the business would have earned during the indemnity period if the interruption had not happened less the actual gross profit or gross revenue earned during that period.
- Reasonable additional expenditure for the increase in the cost of working — These are costs incurred following loss or damage that are aimed at mitigating the reduction in turnover and/or maintaining normal business operations. The costs of reinstating any physical damage to the insured's property are usually explicitly excluded from cover.
- Claim preparation costs — These are costs that are reasonably incurred by the insured to assess and prepare any valid business interruption claim (and may extend to any claim under the material damage section of the policy).

Other items that may be insured under a business interruption policy are:

- severance and redundancy payments;
- book debts (where the business is unable to collect the debt due to damage to the insured's records);
- penalty payments for breach of contract;
- redeployment costs;
- salaries and wages; and
- loss of lease goodwill.

A business interruption policy may also provide contingent cover for situations where the insured has suffered business interruption, but not as a consequence of any material damage to its own property. This might be due to:

- property damage in the vicinity (as defined in the policy) that affects access to the insured's premises;
- property damage suffered by a major tenant in the same retail block of shops;
- property damage suffered by a company that supplies essential services to the insured's premises (ie power or gas, water or sewerage disposal or telecommunications);
- property damage suffered by one or more of the insured's own customers or suppliers;
- access being prevented or hindered due to injury, danger or death at the insured's premises or in the vicinity of the insured's premises;
- the closure by a lawful authority of the premises on certain grounds (such as the accidental escape of hazardous material or fumes, or for reasons relating to sanitation); or
- the closure by a lawful authority of a transport route, port or airport.

It is worth noting that in New Zealand, most business interruption policies will contain exclusions relating to losses caused by any animal or human disease notifiable under the Heath Act 1956 and the Biosecurity Act 1993. Pandemics are generally excluded because it is not possible to quantify the risk to be able to price it.

Adjustments

In calculating the amount of any payment to be made under a business interruption policy, the insurer will make adjustments to take into account the trends, variations and other circumstances (positive and negative) which have affected (or would have affected) the operations of the business. The relevant factors may occur either before or after the start of the indemnity period. The adjustments are made with the aim of determining a final adjusted figure that represents, as close as is reasonably practicable, the results that the business would have achieved during the relevant period if the business interruption had not occurred.

Indemnity and deferment periods

Business interruption losses are paid from the date of the loss or damage and expire when either the business's turnover has returned to pre-loss levels or the indemnity period ends, whichever occurs first.

The insured selects the indemnity period. Factors relevant to that selection include the likely availability of alternative premises, the expected timeframe for repairing or replacing machinery, equipment or stock, the potential impact on market share and the premiums.

A business interruption policy may also specify a deferment period, which must elapse before a claim can be accepted. The deferment period can vary depending on the cause of the loss or damage.

Income protection

Income protection insurance provides ongoing financial support for an insured who has suffered an injury or illness which prevents him or her from earning. A regular benefit is paid until the person returns to work or the expiry of the agreed benefit period. The benefit period may be a set number of years or until a specified age.

The most common types of income protection insurance are “indemnity value” and “agreed value” policies:

- An “indemnity value” policy will pay up to 75 per cent of the insured's gross income. When a claim is made, the insured will need to provide evidence of his or her earnings in the 12 months prior to the illness or injury (or other timeframe specified in the policy). The monthly benefit is normally considered taxable.
- An “agreed value” policy will pay up to 55 per cent of the insured's gross income. The level of income is agreed in advance and specified in the policy. As a result, proof of actual income is required prior to the policy inception. The benefit paid is not normally considered taxable because it is not a payment that is calculated according to a loss of earnings.

The 75 per cent and 55 per cent thresholds are current industry standards. They aim to provide financial support and incentivise an insured person to return to work as soon as reasonably possible.

An indemnity value policy tends to suit wage and salary earners who have a reasonably high degree of certainty about their annual income. By contrast, an agreed value policy may appeal to the self-employed as their ***income*** tends to be variable and there is certainty of cover.

In addition to death, illness or injury, insurers sometimes offer redundancy cover as an optional benefit to a life, income protection or mortgage repayment insurance policy.

High risk occupations usually attract higher premiums, or they may not be insurable in some cases.

Mental health disorders (eg anxiety, chronic fatigue syndrome, depression, stress and fatigue) are sometimes excluded. Alternatively, insurers may offer a discount on the premium for excluding these or they may limit the applicable benefit period. This is an important consideration given that a significant number of income protection claims relate to mental health.

Income protection policies include what insurers call a “waiting”, “stand down” or “qualifying” period. This is the time between when the insured becomes unable to work due to illness or injury and the first benefit payment being made under the policy. The insured usually chooses the waiting period, which could by anything from two weeks to two years or more. A shorter waiting period usually results in a higher premium.

COVID 19 and Income Protection - Government support

Various schemes have been implemented by the Government to address the effect of COVID-19 on businesses. These include:

- the Wage Subsidy Scheme (modified on 27 March 2020);
- the Leave Payment Scheme (no longer available from 3 pm on 27 March 2020); and
- Cash Flow and Tax Measures.

Wage Subsidy Scheme

Employers, sole traders, contractors or self-employed people significantly impacted by COVID-19 can apply for the Government Wage Subsidy Scheme while New Zealand remains at COVID-19 Alert Level 4.

To qualify for the subsidy:

- the business must be registered and operated in New Zealand;
- employees must be legally working in New Zealand;
- as a result of COVID-19, the business must have experienced at least a 30% decline in actual or predicted revenue for a month (between January – 9 June 2020) when compared to the same month last year;
- the business must have taken active steps to mitigate the impact of COVID-19 (for example engaged with a bank or industry body, or used any cash reserves); and
- employees named in the application must be retained for the duration of the subsidy.

The Wage Subsidy will be paid in a lump sum for a period covering 12 weeks per employee. The subsidy is for $585.80 per week for employees who work 20 or more hours a week and $350.00 for employees who work fewer than 20 hours a week.

If the Wage Subsidy is received, reasonable efforts must be made to pay employees named in the application at least 80% of their income. If that is not possible, employees must be paid at least the rate of the subsidy that applies to that employee. Where an employee’s usual wage is less than the subsidy, they must be paid their normal wages and any difference should be used for other affected employees.

Those who had already applied for the Wage Subsidy prior to the modified Wage Subsidy announcement on 27 March 2020 do not need to re-apply.

See Work and Income for more details.

Cash Flow and Tax Measures

The Inland Revenue Department have also introduced particular business cash flow and tax measures to assist in the COVID-19 pandemic circumstances: details are available on the IRD website.

See also: Unite Against COVID-19: Financial Support.

As the COVID 19 pandemic is an unprecedented global event, it is not yet clear how individual insurers and underwriters will approach claims for Business Interruption or Income Protection or how broad their interpretation of policy wording may be. There are also questions around what impact government subsidies and interventions will have on the quantification of loss. It is likely that it will require more time, and potentially litigation, to obtain any firm answers.