

# Memo

**From:** HG Busby & Associates, LLC

**Re:** Business income losses when the insured was operating at a loss

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Business income loss coverage defines business income as:

1. Net income (net profit or loss before income taxes) that would have earned or incurred; and
2. Continuing normal operating expenses incurred, including payroll

A copy of form CP0030 is attached as *Exhibit A* for reference purposes.

When an insured was unprofitable prior to the loss and was expected to continue operating unprofitably during the loss period, mistakes sometimes arise when interpreting or applying the coverage. Specifically, insureds, agents, public adjusters or even adjusters will sometimes conclude that an insured is at least entitled to recover its continuing expenses. The theory behind this argument is often the following “since the coverage is two-pronged, the net income portion should be ignored because an unprofitable business does not have net income. Ignoring the net income portion leaves the coverage at continuing expenses. “

Interpreting the coverage to include only continuing expenses for an unprofitable business results in an erroneous loss figure. First of all, from a policy standpoint, the coverage clearly says net profit or loss. Therefore, if the insured was expected to incur an operating loss during the restoration period, the business income loss calculation should start with a negative number. Next, the policy contains the conjoining word “and” which explicitly states that the net operating loss (a negative number) should be combined with continuing expenses. Therefore, the resulting net number will have to be less than continuing expenses alone. Thus, an insured is not at least entitled to recover continuing expenses.

The fallacy of expecting a recovery of continuing expenses is also demonstrated when it is reviewed from an economic standpoint. For instance, consider the following scenario for an unprofitable business:

	Had no loss occurred	Actual
Sales	\$100	\$0
Cost of sales	50	0
Gross profit	50	0
Operating expenses		
Abating	30	0
Non-abating	40	40
Total	70	40
Net loss	<u>(\$20)</u>	<u>(\$40)</u>

Under this scenario, the insured's continuing expenses are \$40. Hence, the insured may believe that it is at least entitled to receive \$40 under the business income policy. However, the correct application of the policy is shown below:

Net loss had no loss occurred	(\$20)
Plus: continuing expenses	<u>40</u>
Business income loss	<u><u>\$20</u></u>

As shown, the business income loss is \$20, which is less than continuing expenses of \$40. A \$40 recovery would make the insured better off than if no loss occurred, which is inconsistent with the intent of the policy. The "better off" position is illustrated below:

	<u>Insurance recovery</u>		
	Had no loss occurred	Only continuing expenses	Correct amount
Sales	\$100	\$0	\$0
Cost of sales	<u>50</u>	<u>0</u>	<u>0</u>
Gross profit	<u>50</u>	<u>0</u>	<u>0</u>
Operating expenses			
Abating	30	0	0
Non-abating	<u>40</u>	<u>40</u>	<u>40</u>
Total	70	40	40
Net loss	(\$20)	(\$40)	(\$40)
Insurance recovery	N/A	40	20
Net loss after insurance recovery	<u><u>(\$20)</u></u>	<u><u>\$0</u></u>	<u><u>(\$20)</u></u>

In the event that the insured is operating at a loss, and abated expenses exceed continuing expenses, the insured has not incurred business income loss. An example of such a situation is shown below:

	Had no loss occurred	Actual
Sales	\$100	\$0
Cost of sales	<u>50</u>	<u>0</u>
Gross profit	<u>50</u>	<u>0</u>
Operating expenses		
Abating	60	0
Non-abating	<u>10</u>	<u>10</u>
Total	70	10
Net loss	<u><u>(\$20)</u></u>	<u><u>(\$10)</u></u>

Based on the figures reflected in the table above, the business income loss would be calculated as follows:

Net loss had no loss occurred	(\$20)
Plus: continuing expenses	<u>10</u>
Business income loss	<u><u>(\$10)</u></u>

As shown, the insured was expected to lose \$20 had no loss occurred. However, the insured actually lost \$10 (the amount of continuing expenses). Thus, because of the un-profitability of the business and the cost structure, the business was better off because of the loss. Therefore, there is no business income loss.

Additional information on this subject is attached as follows:

- **Exhibit B** – “How to Deal with Absence of Profits” from FC&S bulletins.
- **Exhibit C** – Opinion summary for the case of Liberty Mutual Insurance Co. vs. Sexton Foods.