



Problems with Advance Loss of Profits Claims

Those of you who populate the EC3 area of the City of London, either regularly or occasionally, cannot have failed to notice the amount of major construction work being carried out there over the last 18 months.

Sitting behind the construction work will be a variety of leases, agreements and construction contracts between the main contractor, sub-contractors and the Employer. The Employer is likely to be the Landlord, but may indeed be a Head Lessee who had agreed to lease the entire building from the Landlord who has ownership of the freehold. The physical and legal risks will of course be covered by Contractors' All Risks insurance but there will also most probably be Loss of Advance Rental coverages taken out by the beneficiaries of the rental income stream which will ultimately flow from such developments. Any delay in practical completion of these projects will result in a delay in rental income being accrued, and most Landlords and Head Lessees will wish to protect their profit and loss accounts and cash flow forecast from the effects of any significant delays.

Loss of Advance Rental insurance is just one of the family Loss of Advance Profits insurances offered to protect enterprises from the loss of income which may arise following the operation of an insured peril which leads to delay in the completion of a new facility. The coverages offered generally split down into four main headings:

- Loss of Advance Profits which is the coverage offered to manufacturing and service organisations.
- Loss of Advance Revenue which tends to be offered to enterprises with a high level of fixed costs, such as hotels and power stations.
- Loss of Advance Rental which, as previously stated, normally applies to property companies.
- Loss of Additional Interest which is a coverage offered to developers against prolongation of exposure to loan interest payments.



All of these coverages share certain common characteristics:

- They are all project-driven i.e. they apply to unique non-standard projects.
- They are generally linked to a CAR coverage by a Material Damage proviso.
- Their purpose is to insure loss of income resulting from an insured delay in commercial start-up of the project.

Very often these coverages are attached to massive projects, the partial or total failure of which would significantly affect the financial wellbeing of the enterprise undertaking them. When listed companies are involved, you have share prices involved and where you have share prices involved you will have the reputation of the Chairman, Chief Executive Officer and the Board effectively attached to the outcome of the project and/or the claim. Add to that the fact that the Board probably approved the project in the first place and you thus have the explanation as to why many of these claims have a significant political edge to them.

Given the significance and uniqueness of many of the projects, it is not surprising that problems with Advance Loss of Profits claims do arise from time to time. Generally these problems arise from two main sources:

- A failure to present or enquire into certain significant aspects of the risk, either by the Underwriter or Broker.
- Poor claims handling, with insufficient attention being paid to the Advance Loss of Profits risk and loss potential.

Dealing with the underwriting considerations first, one of the most common misconceptions is the effect the geographic location will have on the reconstruction of the risk. Geographic location is important because there may well be restrictions regarding which construction techniques can be used at what time, and indeed if the site is close to residential developments, it may well be that no construction work at all can be undertaken outside of certain hours.



Underwriters need to know whether they are dealing with leading edge or proven technology in respect of:

- Contractors' plant, which may well be custom plant unique to the project.
- Construction techniques, which hopefully have a successful track record behind them.
- Operating plant, and whether this is unique to the project, or whether it is commonplace.

Underwriters need to know whether the operating plant is new or whether it has already been proven in other locations, perhaps around the world.

Applicable to both Contractors' plant and the operating plant is the question of lead time should any major items be destroyed and require replacement. An example of plant with a long lead time would be the Thyssen escalators within the London Underwriting Centre which had an 18 month lead time and, following the serious fire in 1991, required to be replaced in their entirety. They were ordered immediately and stored off site so that they were available to be fitted as and when the programming demanded it.

As with the escalators at the LUC, many projects utilise plant and materials which are sourced overseas, and Underwriters will need to explore the lead time for such items and indeed if resupply from the original source is in doubt, what plans the Project Managers have for seeking an alternative.

In the case of major items coming by sea, Underwriters may be quite interested in the dates of intended transportation of such items, particularly if delays in shipment are anticipated. If you have agreed to cover the business income from a new container port and the ship-to-shore container cranes to be utilised in earning that income are due to be shipped from Italy in September, you might be reasonably interested, as an Underwriter, to know when the shipment will take place.

You might conceivably be unhappy if you had known, following a construction delay, about a shipment through the Bay of Biscay during the January storms when the original



shipment was planned for September. This of course actually happened, with predictable results. A case where a relatively small Material Damage claim led to a massive Loss of Advance Profits claim.

The next key areas are the Commercial and Financial aspects of the venture. One of the most crucial areas is the Insured's experience and reputation in their particular field, and, more importantly, the track record of the Management Team who have control of this project. I define "Management Team" as including, not only the Insured's employees but the also the various consultants that the Insured have engaged to make sure the project is managed efficiently and effectively. Should a major incident occur, it is these people who will have to perform to bring the project back on track and thus minimise or even extinguish the delay in start-up. Furthermore, should there be a delay in start-up, what is their likely track record with regard to running similar businesses in the past; how successful have they really been?

Whilst on the subject of business recovery, Underwriters will need to know whether this is a brand new venture or whether this is the replacement of old facilities, which might be able to be kept running should an incident leading to a delay occur. In the case of a brand new venture it is always fascinating (and often concerning) to drill down into the area of potential customers and this leads us into the province of the feasibility study and the accountant's report. Leaving aside the fact that one would expect an Underwriter to at least call for a copy of an original feasibility study to check that one actually exists, there seems to be comfort placed on the fact that such studies have attached to them an accountant's report "certifying" certain details within such studies. All such reports do is confirm that the figures within the feasibility study add up and that, subject to the assumptions which are the sole responsibility of the Directors, the figures based entirely on those assumptions have been properly presented. To be fair to those firms providing such certificates, they do not and have never pretended their documents to be anything other than that which I have described. It is nevertheless amusing how often the existence of such certificates are used to try to browbeat.

The final area of underwriting considerations I want to consider is in respect of the parties and contracts. Underwriters will be interested to know who the main contractors are,



hopefully a reliable major company, and whether or not the architects, surveyors and consulting engineers are of similar standing. The nature of the contract between the Employer and the main contractors will also be of significance and in particular the Underwriters should enquire as to how any delay damages specified within the contract have been calculated. Perhaps if Underwriters asked the question prior to a loss, they might obtain a full and frank explanation; one of the most sadly predictable areas of amnesia after a claim has been notified is with regard to the explanation of how a figure for delay damages, which undoubtedly bears no relation whatsoever to the financial impact of the delay, has been calculated within a contract.

As regards those from whom the income is to be derived, Underwriters might like to know whether or not lease agreements have been signed or intentions to sign have been signed and indeed whether customer contracts are in place or whether there is at least a timetable for such contracts to be put in place.

The final contract, of course, which needs careful drafting, is the Insurance Contract. In particular it might be useful if the contract definitions were correctly drafted, particularly those in respect of business income and the commencement of the indemnity period. For example, it is no good defining an indemnity period as commencing at the date of the damage. Also I have seen situations where terrible problems have resulted where "net" definitions of income have been used where the assumption has been made, erroneously that certain outgo will cease in variable proportion to income.

Unfortunately the worst two examples I have seen of bad drafting in respect of these particular areas occurred within the one policy. The post loss underwriting that went on was made easier by the fact that it was a policy drawn up by Insurers to insure themselves.

The other major area where things can go wrong with Loss of Advance Profits claims is in respect of claims handling. This might partly be explained by the way such policies are often tacked on to CAR policies.

The emphasis is placed on the construction policy throughout the underwriting process and the claims process; the loss will go to a CAR adjuster who may not initially



concentrate upon the loss of profits aspects and worse, may not be minded to bring in the correct expertise to deal with that particular aspect.

The fact is that, in virtually every serious construction site incident, the loss of profits aspect has by far the greater major loss potential and it is this aspect that should therefore drive the decision-making process in respect of the management of the reinstatement works. This does not always occur.

The other areas I wish to cover with regard to claims handling of these types of claims are in the areas of:

- Coverages
- Mitigation
- Measurement
- Management

Dealing with coverage first, it is of great help to the adjuster if a policy wording is in fact available, or better still a policy wording, agreed between the Broker and the Underwriter, preferably before the loss occurred. It is also helpful to know which department within the Insurance Company has agreed to take on the risk, and that the department is agreeable to booking the risk. There is nothing more depressing than being caught up in an internal political row between Insurance Company departments when trying to obtain coverage instructions and authorisation for significant mitigation measures.

Equally frustrating and more common in these days of consideration is the game of “chase the file”. This is not of course confined to Advance Loss of Profits claims, but is an across-the-board phenomenon where one tries to find out which department is dealing with a case after offices have been closed. This sort of thing is more likely to affect the longer running cases where a file might move two or three times, either physically or in terms of the claims handling personnel, or both.



To finish coverage issues, it is always useful to have full details of the Market where the risk has been placed. This is particularly relevant when Market meetings need to be called.

In respect of loss mitigation, as I have stated previously, because of the major loss potential of these types of coverages, it is the loss of profits aspect that should drive decision making. The first question to ask is whether any mitigation is indeed possible. This will depend on how close to practical completion the project is and the key document, as with much of the handling of these types of claims, is of course the programme.

The profile of the programme will drive much of the decision making and in particular the critical path. It is absolutely crucial to gain an early understanding of the programme and the critical path and from there to determine whether the critical path is capable of taking acceleration.

In parallel to this must be an analysis of the contractual demarcation. There may well be different main contractors for shell and core and fit-out works and the contractual documentation will say that one precedes the other and n'er the twain shall meet! This is very clean as far as the contract lawyers are concerned, but it does nothing to help mitigate an Advance Loss of Profits claim. Legal advice needs to be taken as to how such contractual documents can be amended so that the main contractors can work side by side, shortening the critical path.

There are many mitigation measures which can be taken to reduce an Advance Loss of Profits claim. These of course will vary depending on the project, but broadly, firstly to speed up reinstatement and repair, adjusters should be looking to spend money on overtime, premium payments to suppliers for critical plant and materials, to swap packages between contractors where it will be more efficient, to explore the use of alternative materials, to suggest off-site fabrication of some items, particularly M&E equipment, and, as stated earlier, a thorough programme review to ensure that the programme is logical and most efficient.



Measures to recover turnover once trading has started, albeit late, include structured advertising, special discounts, accelerated products launch and development, and perhaps a special opening event to gain further publicity.

As regards loss measurements, one of the initial enquiries one would make will be into the site minutes to determine the state of play in the months before the incident occurred. In respect of major projects, the monitoring of site minutes by nominated adjusters is money extremely well spent by Insurers, since, in the event of a major incident, the adjusters will know precisely the current state of play of the project, what delays have already occurred and thus will be able to make a judgement on the potential delay the reported insured incident may have on the project as a whole.

In terms of the actual financial measurement of these losses, it is important to get to grips early with the original feasibility study and to make detailed enquiries into the current market conditions within the Insured's target market. Much can change within a few years from when capital expenditure proposals were signed off.

It is extremely important to drill down into the market as early as possible. Support from forensic accountants, and commercial and technological consultants within the Insured's sphere of operations may well be required.

Indeed, time and money spent at the start of investigating such claims is inevitably time and money well spent in my experience to ensure a complete management of the loss. It is most important to assemble a trusted and experienced team to investigate these losses. In respect of programming you will need to employ programming consultants, in respect of engineering and construction solutions you will need to employ a team of engineering consultants.

In respect of the actual measurement work it is highly likely that forensic accountants and consultants to provide expert witness standard testimony will be required if the Insured's claim is ultimately to be properly measured. To reiterate the point, it is also in Insurers' best interests to nominate a firm of loss adjusters who have the ability and the authority to



monitor the progress of a major project throughout its life, so that if a major incident occurs, people will be in place with knowledge to protect Insurers' interests.

Andrew King