

Ask Mike #09-08

Subject: Business Income – Monthly Limit Option

Q. In a recent Commercial Lines Department “Technical Update” meeting, a question came up about the Business Income Monthly Limit Option. Using the 1/3 option as an example, some stated that this means the insured only has 3 months of coverage (or 4 months with the 1/4 option, or 6 months with the 1/6 option).

Other people in the meeting said this wasn’t necessarily always true, but they couldn’t really explain why. Also, we’re not sure how monthly limit is different from coinsurance, and why it’s used.

A. Confusion over the monthly limit option is common; and, taken at face value, it seems logical that a 1/3 limit would last for 3 months. However, this is not always the case.

It’s important to put the monthly limit option into a broader context. Business Income coverage is primarily written on a coinsurance basis. The monthly limit option is one of the alternatives to coinsurance, along with the maximum period of indemnity option, and the agreed value option.

One reason these three alternatives to coinsurance are often utilized is to avoid the potential for a coinsurance penalty, especially when the consistency and predictability of the financial operating results of a business are unknown or uncertain.

To better understand how the monthly limit option works, here is an excerpt from the Business Income And Extra Expense Coverage Form (CP 00 30 04 02):

E. Optional Coverages

If shown as applicable in the Declarations, the following Optional Coverages apply separately to each item.

2. Monthly Limit Of Indemnity

- a. The Additional Condition, Coinsurance, does not apply to this Coverage Form at the described premises to which this Optional Coverage applies.
- b. The most we will pay for loss of Business Income in each period of 30 consecutive days after the beginning of the "period of restoration" is:
 - (1) The Limit of Insurance, multiplied by
 - (2) The fraction shown in the Declarations for this Optional Coverage

That is the entire insuring agreement for the monthly limit option. (The remainder of the language in the monthly limit option provides an example of how the monthly limit works.) So, as you can see, the only stipulation in the insuring agreement is *how much is paid per month*, not how many months coverage lasts. If less is paid each month than the maximum available, there is more money left over for future months.

The example given in the CP 00 30 illustrates how the monthly limit option works for a loss lasting 3 months, with the 1/4 option selected. That's fine as far as it goes, but it doesn't address the main point of confusion about the monthly limit option in general – which you raised – that the fraction selected (actually, the denominator in the fraction) determines how long coverage lasts. Here are some examples of how the fraction selected does not dictate how *long* coverage lasts.

Assume \$150,000 of business income coverage, with the 1/3 option selected. Referring to the insuring agreement in the excerpt above, here is how the amount of insurance paid is determined: “*The most we will pay for loss of Business Income in each period of 30 consecutive days... is the Limit of Insurance (\$150,000), multiplied by the fraction (1/3).*” In this case, the maximum paid per month is \$50,000. Does that mean that there is only 3 months of coverage? In some cases yes, and in other cases no. Here are some examples.

Example #1 – coverage lasts 3 months.

<u>Month</u>	<u>BI Loss</u>	<u>BI Paid</u>
1	\$50,000 (or more)	\$50,000
2	\$50,000 (or more)	\$50,000
3	\$50,000 (or more)	\$50,000
4	\$50,000 (or more)	\$0 (Limit of Insurance exhausted.)
Total	\$200,000 (or more)	\$150,000 (Limit of Insurance.)

Example #2 – coverage lasts 5 months.

<u>Month</u>	<u>BI Loss</u>	<u>BI Paid</u>
1	\$50,000 (or more)	\$50,000
2	\$30,000	\$30,000
3	\$40,000	\$40,000
4	\$25,000	\$25,000
5	\$35,000	\$ 5,000 (Balance of Limit of Insurance.)
6	\$45,000	\$0 (Limit of Insurance exhausted.)
Total	\$225,000 (or more)	\$150,000 (Limit of Insurance.)

Example #3 – coverage lasts 2 months.

<u>Month</u>	<u>BI Loss</u>	<u>BI Paid</u>
1	\$80,000	\$50,000
2	\$75,000	\$50,000
3	\$0	\$0
Total	\$155,000	\$100,000

In all three examples, the insured has the potential for significant underinsurance. For this reason, most experts recommend that the monthly limit option is best used for insureds with very consistent monthly exposures, such as risks where business income is derived from rents.

One possible reason for the misunderstanding about the monthly limit option is that people sometimes get it confused with the maximum period of indemnity option. In the maximum period of indemnity option, the limitation is based on a specified number of days (120), but with no set limit as to how much can be paid at any given time.

Lastly, note that in the monthly limit option in the Business Income And Extra Expense Coverage Form (CP 00 30 04 02), the fraction selected only applies to business income, and not extra expense coverage.