

Refinery Claims: Discontinuance Considerations

Various coverage considerations may arise in the event that an Insured decides to discontinue operations at a refinery following a significant incident.



Introduction

This article considers certain factors relating to First Party Property Damage and Business Interruption policy coverage in the event of the discontinuance of operations at an oil refining business after a significant incident has taken place.

So far as refinery Property Damage coverage is concerned, there is a significant degree of commonality amongst underwriting markets worldwide with regards to policy wordings. Such coverage ordinarily being based upon an "All Risks" policy form, the basis of cover reflecting the value of the assets at risk.

However, in respect of Downstream Business Interruption risks, there is no one standard policy form. Accordingly, this can give rise to a multitude of different policy wordings. In particular, the difference in Business Interruption policy wordings is highlighted when comparing underwriting practices in the U.K. marketplace to the approach adopted in the U.S.

Property Damage

Reinstatement

In accordance with longstanding case law, if the underwriters pay insurance money to the Insured the underwriters cannot require the Insured to spend the money reinstating the property. (*Rayner v Preston (1881) 18 Ch D 1 (CA)*).

Accordingly, so far as the receipt and disposal of insurance proceeds is concerned, an Insured has considerable latitude in the event they elect to discontinue the operation of the insured property following an incident.

However, the Insured should ensure that the freedom to dispose of the insurance proceeds is not restricted by any statutory or contractual obligations. For example, so far as the relationship with any mortgagees is concerned, are there any obligations to reinstate?

In the context of property insurance, the word "reinstatement" can also refer to

an alternative method for underwriters to provide indemnity. Specifically, where underwriters undertake to restore or rebuild a damaged property instead of paying the Insured money. Except when granted by statute, such an option is only available to underwriters if expressly stipulated in the insurance contract. In view of the nature of the subject-matter insured and the complexities surrounding this method of indemnity, such reinstatement terminology is rarely seen in oil & gas insurance contracts.

Actual Cash Value

The common use of *Replacement Cost Basis* clauses in refinery Property Damage policies ensures that the actual replacement cost is the usual stipulated measure of indemnity. Accordingly, when property is replaced or reinstated, the amount recoverable under the policy should not be subject to a discount for depreciation.

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However, via an *Actual Cash Value* definition, refinery Property Damage underwriters seek to apply a discount, in respect of depreciation, to any claims settlement when the insured property is not repaired or replaced.

Individual policy wordings can seek to introduce exceptions to the aforementioned practice of deducting an allowance for depreciation when the insured property is not repaired or replaced. Examples of such exceptions include instances of total loss and contractual obligations to insure specific property for stipulated values.

Total Loss

When policy terminology seeks to avoid the aforementioned depreciation discount, in the event of the *total* loss of property insured, it is important to recognise that *partial* loss can refer not only to damage but also to a total loss of part of the subject-matter insured. This distinction may be especially important if significant damage is sustained at one unit within a refinery, with the balance of the refinery continuing to operate even if activity at the damaged unit is discontinued.

Accordingly, when declaring insured values and subject-matter insured, it is essential to ensure clarity of intent regarding total loss scenarios, subsequent decisions not to replace the subject-matter of the claim and a desire to minimise the impact of the depreciation allowance.

Irrespective of an Insured's reinstatement strategy, careful consideration regarding the format for declaring insured values can expedite the claims adjustment process in the event of the total loss of one unit within a larger complex.

Stipulated Values

Via a *Stipulated Values* clause, certain policy forms will expressly seek to ensure that the calculation of a

claimable loss takes into account any contractual obligations, on the part of the Insured, to arrange coverage for a stipulated amount. Furthermore, such express terminology will seek to provide coverage on a *Replacement Cost Basis* even if the property is not reinstated i.e. settlement without the depreciation discount.

In assessing the applicability and terminology of a *Stipulated Values* clause, the Insured should carefully consider the relevant contractual obligations.

Business Interruption

So far as Business Interruption coverage is concerned, discontinuance of a business (or part thereof), after an incident has taken place, requires careful consideration of the *Claims Conditions – Action by the Insured* clause, unless the policy contains a special *Discontinuance of Business* clause.

Discontinuance of Business Clauses

As highlighted in the Introduction section above, in the Downstream oil & gas underwriting markets there is no one standard Business Interruption policy form. It will also be recalled that, with regards to Business Interruption cover, there are certain fundamental differences in underwriting practices between the UK and US insurance markets.

In order to provide a commentary on claims adjustment practices, following a post-loss business discontinuance, reference can be made to certain standard commercial Non-Marine Business Interruption clauses.

Historically, UK Non-Marine Business Interruption underwriting markets have offered a *Discontinuance of Business* clause where such an eventuality may be foreseen. Such clauses would expressly provide that *"If the Business is discontinued after the occurrence of the insured event, the indemnity will be paid for the period (up to the Maximum*

Indemnity Period) which would normally have been required to bring the Business back to normal."

However, the aforementioned *Discontinuance of Business* clauses would often expressly state that if the Insured controlled the circumstances surrounding the discontinuance of the business then the indemnity would not be payable in full. Coverage often being expressly restricted to unavoidable incurred expenses. Accordingly, due to this restriction, such clauses are not commonplace. Instead, Insured's preferring to seek to negotiate a settlement under the policy based on a favourable interpretation of the *Claims Conditions – Action by the Insured* clause. (See below.)

However, certain standard US commercial Non-Marine Business Interruption policy forms contain terminology, favourable to the Insured, expressly addressing the discontinuance of a business. For example, the *Loss Determination* clause contained in the *US Business Income (and Extra Expense) Coverage Form – Commercial Property (CP 00 30 06 07)* provides as follows:

If you do not resume "operations", or do not resume "operations" as quickly as possible, we will pay based on the length of time it would have taken to resume "operations" as quickly as possible.

"Operations", in the aforementioned policy form, is defined as "... business activities occurring at the described premises." It should be noted that if significant business activities take place at one premises then, post-loss, there could be a discontinuance of part of the business, leaving the balance of the operations to continue. Accordingly, as applicable, further clarity could be sought when negotiating the terminology of a favourable *Loss Determination* clause.

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Absent of a favourable *Loss Determination* style clause, policy coverage will need to be negotiated based upon what is deemed reasonably practicable.

Claims Conditions – Action by the Insured Clauses

Notwithstanding the variation in terminology of Downstream Business Interruption insurance contracts, all such policy wordings would ordinarily be expected to contain a form of words expressly detailing the actions required of the Insured in the event that a claim may be made under the policy.

For guidance purposes, the following extract from the *Claims Conditions – Action by the Insured Clause* contained within the Association of British Insurers Standard U.K. "All Risks" Policy Form (Business Interruption) can be referred to. Consideration of the following terminology will serve as a basis to assess the Insured's approach to coverage, in the event that they elect to discontinue business activities.

"In the event of any loss destruction or damage in consequence of which a claim is or may be made under this policy the Insured shall with due diligence carry out and permit to be taken any action which may reasonably be practicable to minimise or check any interruption of or interference with the Business or to avoid or diminish the loss."

Based upon the above detailed terminology, clearly a discontinuance of business operations could be contended to be a failure to "minimise ... interruption of ... the Business." However, it will be noted that the clause also provides the Insured with an alternative to minimising any interruption to the business i.e. "**or** to ... diminish the loss." (Emphasis added.)

Accordingly, the Insured could contend that the decision to discontinue the business operations, either entirely or in respect of a particular unit, constituted a reasonably practicable action to diminish the loss. In order to successfully negotiate a compromise settlement with underwriters, an estimate of insurers' potential liability (had activities been rehabilitated) needs to be compared with the actual loss sustained by the Insured. Numerous factors will need to be taken into account including the length of the indemnity period, had the business operations been rehabilitated, and savings in standing charges due to the discontinuance.

Perhaps one of the most significant factors in successfully negotiating a settlement on the aforementioned basis is the ability of the Insured to demonstrate that they acted expeditiously in their decision-making process regarding the discontinuance of business operations and in concert with underwriters and their advisers.

Resumption of Operations Clauses

Downstream Business Interruption policy wordings may contain *Resumption of Operations* clauses. Although there is no set standard terminology for such clauses, the wording of the clause may enable a similar approach to claims adjusting to be adopted as outlined above in respect of the *Claims Conditions – Action by the Insured* style clauses. However, such *Resumption of Operations* clauses can lack the clarity, favourable to the Insured, afforded by the *Loss Determination* clause within the aforementioned *Business Income (and Extra Expense) Coverage Form – Commercial Property*.

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