Business interruption insurance — tips and traps

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- BI policies are used to cover business for loss of gross profit plus costs incurred while it returns to its pre-loss position, but many pitfalls exist in interpretation and definitions
- Court holds that damage had occurred, even when a component functioned precisely as it was designed
- Essential to demonstrate a casual link between damage and the losses claimed

Most businesses have insurance cover to protect their physical assets. However, when premises or property suffer damage as a result of fire, storm or other event, rectification of the physical damage is only part of the dilemma. In addition to the physical losses, the business will likely suffer financial loss while the physical damage is repaired.

Fixed costs such as rent and wages will still need to be paid while the business gets back on its feet. Even after the damage is repaired, the business may take many months to return to its pre-loss financial position. None of those financial losses are covered by a standalone property damage insurance policy.

Business interruption (BI) insurance is designed to protect the financial position of a business and to return it to the financial position that existed prior to the loss. A BI policy essentially covers the business for loss of gross profit (based on the reduction in turnover resulting from the property damage) plus additional costs of business incurred while it returns to its pre-loss position. The trigger for cover will usually be loss or damage to property owned or occupied by the business. Hence, BI insurance is typically coupled with a property damage cover in the form of an industrial special risks (ISR) or business pack policy.

While the concept itself is relatively straightforward, BI insurance claims can be one of the more tricky types of claim faced by a business. Issues common to many BI insurance claims include:

- whether there has been *damage* to trigger the cover
- whether the BI losses claimed arise from that damage and
- how the BI losses should be calculated.

Some of those issues were considered in *Mainstream Aquaculture Pty Ltd v Calliden Insurance Ltd* [2011] VSC 286 (*Mainstream*) and the numerous decisions in *Tropical Reef Shipyard Pty Ltd v QBE Insurance (Australia) Ltd* (*Tropical Reef*).

Mainstream

Mainstream operated a commercial fish breeding business. Electricity for the business was provided by a substation located on Mainstream's premises. The business relied on uninterrupted electricity supply to run the pumping systems that delivered oxygen to the fish. The electricity supply to the business was interrupted due to a power outage that caused a fuse to '*trip*', switching the supply from mains power to a generator. The generator failed to provide alternative power to the premises and the resulting power interruption led to the death of the fish.

Mainstream held a BI insurance policy providing cover for BI losses arising out of property damage. The insurer denied Mainstream's claim for cover for its business interruption losses on the basis that '*tripping*' of the fuse was not '*damage*'. The insurer argued that, by '*tripping*', the fuse had fulfilled its fundamental purpose and could, therefore, not be said to be damaged. The insurer also relied on an exclusion clause in the policy which excluded cover for any loss or damage caused by mechanical, electrical or electronic breakdowns or breakages (the mechanical breakdown exclusion).

The decision

The key inquiry was whether there was 'damage' to the fuse such as to trigger cover. Mainstream argued that:

- damage occurred when the fuse 'tripped' due to a surge in electrical current or
- the connections to or within the fuse housing were loose, causing overheating and deformation such that the fuse 'tripped' at less than its rated capacity.

The court referred to a number of legal authorities that have considered the meaning of '*damage*' including *Switzerland Insurance Australia Ltd v Dundean Distributors Pty Ltd* [1998] 4 VR 692, in which it was held that:

- damage occurs when the subject matter is interfered with in such a way as to render it less useful or less valuable and
- damage to property is a physical alteration or change, not necessarily permanent or irreparable, which impairs the value or usefulness of the thing said to be damaged.

The court held that the fuse, once ruptured, had been physically altered and was therefore '*damaged*' despite the fact that it was designed to '*trip*' to stop a potentially damaging overload of current. The court also considered that if the fuse was damaged by overheating due to the loose connections that would also fall within the meaning of '*damage*'.

The insurer argued that the mechanical breakdown exclusion was triggered because:

- the generator's failure to provide alternative power to the premises constituted an electrical breakdown or
- damage to the fuse constituted an electronic breakdown or breakage.

The court rejected those arguments and found that:

- damage to the property and consequent business interruption losses could not be said to have been 'caused by' the generator's failure to activate and
- 'damage' to the fuse cannot also be said to be a 'breakdown' or 'breakage'. To hold otherwise would have meant that the exclusion would operate to prevent all claims based on a power supply failure and which require property damage, because any electrical failure giving rise to damaged property is necessarily mechanical, electrical or electronic in nature.

Tropical Reef

Tropical Reef Shipyard Pty Ltd (TRS) operated a commercial slipway that suffered damage on various occasions in 2006 and 2007. TRS made claims in relation to the incidents under two BI policies issued by QBE Insurance (Australia) Ltd (QBE). The insuring clause in each policy provided that:

> For each week [QBE] will pay an amount based upon Weekly Calculations not exceeding the Weekly Sum Insured ... in respect of loss of Turnover suffered by [TRS] during the Indemnity Period ... [such payment is to] be made every seven days whenever practicable...

The proceedings

The first decision considered the correct method for calculating loss of turnover under the policies. Finkelstein J held that the policies required loss of turnover to be calculated on a weekly, rather than annual, basis.[1]

That interpretation effectively rejected QBE's method of calculation, resulting in a potential windfall gain for TRS because its calculations for loss of turnover differed from QBE's by up to $9.9 million.

After QBE unsuccessfully attempted to appeal,[2] TRS filed an amended statement of claim proposing two methods for calculating loss of turnover. QBE responded by filing a notice of motion seeking summary judgment, on the basis that these alternative methods of calculation did not conform to the policy requirement that '*turnover*' meant money '*paid or payable*'.

Finkelstein J agreed with QBE, noting that turnover was to be determined by reference to what was '*paid or payable*' in the relevant period. Finkelstein J defined '*paid or payable*'.

> An amount is 'paid' when it is received. An amount is 'payable' when it becomes owing, which is generally speaking not until an invoice is issued.

However, he allowed TRS to file a further amended statement of claim in accordance with a six-step methodology set out in the reasons for judgment.[3]

TRS attempted to file an amended claim which included both a method which TRS contended adhered to Finkelstein J's six-step methodology (the primary method), as well as an alternative method of calculation (the alternative method).

Gordon J held that the primary method did not follow the policy requirement that the loss of turnover be calculated on a weekly basis because it failed to establish a causal link between the damage to TRS's property and its loss of turnover in a particular week. Gordon J found it unnecessary to consider whether the alternative method could be retained since she held that issue had already been resolved in the earlier proceeding.[4]

Application to appeal

TRS successfully appealed the orders made by Gordon J.[5] Gray J held there was sufficient doubt about Finkelstein J's approach to the meaning of '*paid or payable*' to grant TRS leave to appeal. Gray J noted that Finkelstein J's definition could result in a commercially disadvantageous result for QBE if calculations were made on a weekly basis in circumstances where invoices were issued monthly. It was held that a fairer and more commercially desirable result could be achieved by adopting a mechanism that allocated turnover contained in an invoice issued at the end of the job across the weeks during which that job was carried out. Gray J noted that the terms of the policies did not preclude the adoption of this method.

Appeal to the Full Federal Court

On appeal, the Full Federal Court held that Finkelstein J erred in determining that TRS had no reasonable prospect of success because Finkelstein J's interpretation of money '*paid or payable*' incorrectly precluded TRS's method of allocating sums that had become payable in a particular week.[6] The court considered that the appropriateness of TRS's methodology warranted the attention of the court in a final hearing.

The court also held that Gordon J's finding that TRS had not established a link between the damage to its property and loss of turnover was insufficient to prevent TRS from running its case. The court noted that although it may ultimately be established that there was no causal link, such questions should be resolved by the trial judge.

Comments

The trigger cover under a BI policy is typically '*damage*' or '*physical damage*' to insured property. The distinction between '*damage*' and '*physical damage*' is important. In finding that a tripped fuse was damaged even though that damage was a function of its designed use, the decision in Mainstream applied a wide interpretation to the term '*damage*' in the context of a BI policy (and arguably one beyond which the policy was designed to cover).

The line of legal authority followed in *Mainstream* held that impaired utility or functionality on its own may constitute damage. There is arguably a tension between that line of authority and the decision in *Transfield Constructions Pty Ltd v GIO Australia Holdings Pty Ltd* [1997] 9 ANZ Ins Cas 61-336, in which the court found that loss of usefulness alone is insufficient to establish physical damage. However, that decision considered an insuring clause that provided cover for '*physical damage*' rather than just '*damage*', which might be a pertinent distinction. Since the court in *Mainstream* held that the fuse was physically altered, it seems unlikely that the decision would have been any different if the policy trigger had been '*physical damage*'.

The ongoing saga in *Tropical Reef* highlights some of the difficulties faced while calculating business interruption losses. The insurer would no doubt have thought that its wording was sufficiently clear. However, that the matter was the subject of six separate judgments by the Federal Court without reaching a final determination suggests otherwise. The amount of time and money already spent in this matter should be a warning to all. For insurers it is a timely reminder that a policy should clearly reflect the insurer's intention of how BI losses should be calculated to avoid the type of confusion and misunderstanding that has occurred here. It also highlights:

- the importance for businesses to demonstrate a causal link between the property damage and the BI losses claimed and
- that, even when that link is established, BI losses are often not easily calculated and organisations may benefit from the assistance of expert BI claims preparers.

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Notes

1 [2009] FCA 1088
2 [2009] FCAFC 161
3 [2010] FCA 1093
4 [2010] FCA 1439
5 [2011] FCA 592
6 [2011] FCAFC 145