A BEGINNER’S GUIDE TO BUSINESS INTERRUPTION INSURANCE

INTRODUCTION
This is a beginners guide to the hot topic (in Canterbury anyway) of business interruption. In addition to a general overview of loss of gross profits cover, it touches on issues to be mindful of, common disputes and underwriting pitfalls. Each policy and every business have their own unique issues. If you need to make a claim, take some professional advice.

GENERAL OVERVIEW
Conceptually, loss of profit business interruption insurance is simple. It covers loss of gross profit: the reduction in turnover and the increased cost of working, during a period of business interruption.

In reality, the generic nature of the cover, irrespective of whether the insured is a service provider, retailer or manufacturer creates complexities which are often compounded by verbose language. Nonetheless, the starting point must always be the policy wording.

A business interruption claim is triggered by material or physical damage to insured property caused by an insured peril e.g. fire or earthquake. This needn’t be the building the business operates from. It could be the fit-out, plant, equipment or even just stock.

The material damage cover and the business interruption cover are usually included in one insurance policy. No material damage claim = no loss of profit cover.

Once triggered by insured property damage, the business interruption covered is the period of time the business is affected by that damage. The interruption must be due to the physical damage sustained, not by the peril insured against (i.e. the earthquake). The maximum indemnity period and a sum insured or insured gross profit will have been agreed at inception and will be shown on the policy schedule.

Note: if prevention of access cover has been bought, losses resulting from interruption as a consequence of damage to property in the vicinity of the insured business, preventing or hindering the use of or access to the business will be covered up to a stated sub-limit.

HOW DO YOU CALCULATE THE REDUCTION IN TURNOVER?
The turnover during the period of interruption is subtracted from the turnover achieved in the same period last year (the Standard Turnover).

Particularly for manufacturing businesses, a reduction in turnover has a corresponding reduction in the cost of business e.g. material costs, freight, packaging etc. Therefore, the difference, or reduction in turnover is multiplied by the rate of gross profit.

The rate of gross profit is the percentage of the business turnover that was gross profit in the previous financial year.

The sum of the reduction in turnover and the rate of gross profit would give a straightforward mathematical answer to the value of the first part of the claim.

Unfortunately though, it is not quite that simple. The definitions of Standard Turnover and the rate of gross profit usually include very broad adjustment clauses which allow trends and circumstances both before and after the property damage to be taken into account.

ADJUSTMENTS
The appropriate adjustments to be applied are dependent on the business. Business owners often seek an uplift for anticipated business growth. Other circumstances may also give rise to an uplift e.g. new marketing initiatives, changes in the business model, a lucrative new contract, or an increase in demand for the business’s goods or services (but for the damage) perhaps due to the nature of those goods or services, or the location of the business.
Conversely, insurers may seek a downwards adjustment. After Hurricane Katrina, insurers argued that depopulation, not property damage, was responsible for much of the reduction in turnover for many insured businesses. This has received support from the UK High Court. Deferral of turnover is another argument raised by insurers; namely that the turnover was not lost during the period of interruption, but just deferred until the business was up and running again.

This is by no means an exhaustive list. The trends and circumstances to be applied need to be carefully considered for each business. Global arguments should be resisted and any proposed adjustment scrutinized to assess whether it is truly appropriate.

A business owner seeking an uplift bears the burden of proving, on the balance of probabilities (i.e. that it is more likely than not) that the uplift is justified. For trends, the financial accounts for the two years before the damage should be analysed. An insurer seeking a downwards adjustment bears the same burden of proving that the deduction is justified.

Ultimately, the outcome must represent, as nearly as practicable, the results that the business would have obtained but for the damage. This is usually resolved through negotiation.

**TIME PERIOD FOR ANALYSIS**

Whether the actual turnover achieved during the period of interruption must be averaged over the entire indemnity period can be contentious.

This can have a significant effect on the resultant claim if the business performs well after the interruption (but still during the balance of the indemnity period), for example a café which has less competition post earthquake. Whether this argument will fly depends on the facts, the nature of the business, the policy wording and again, is a matter for negotiation.

**THE RATE OF GROSS PROFIT**

Calculation of gross profit, and therefore the rate of gross profit applied can have huge bearing on the ultimate claim outcome. Ordinarily, it is based on the previous financial year’s figures:

\[(\text{turnover} \times \text{closing stock}) - (\text{opening stock} \times \text{uninsured working costs}) = \text{gross profit}\]

Some policies list the uninsured working costs. Others have a more general approach. Where unspecified, uninsured working costs are those costs which are directly variable to turnover, for example, packaging costs. Where uninsured working costs are not defined, what to include should be carefully considered.

To further complicate matters, the definition of gross profit usually includes a further adjustment provision. For manufacturers, an adjustment can be made if the cost ratio for the business has changed since last year, e.g. there has been a change in the material costs (or “cost of goods sold”).

If the cost of goods sold has significantly increased, the gross profit and therefore, the rate of gross profit will drop and the ultimate claim response will be lower. If the cost of goods sold has reduced, the converse occurs.

**THE INCREASED COSTS OF WORKING**

This covers the cost of mitigating the reduction in turnover claim. The cover is referable, not as you might have thought, to costs incurred during the indemnity period, but the reduction in turnover avoided during the indemnity period.

For example, if a business fits out alternative premises 10 months into a 12 month indemnity period, only the portion of the fit out costs that reduce the loss or reduction in turnover during the remaining two months of the indemnity period will be covered.

Accurate bookkeeping is essential to keep record of these costs, if possible, by reference to the diminution or loss of turnover saved.

**POLICY COVERAGE ISSUES**

While the business interruption policy wordings are quite standard, there are two potential pitfalls that can have a huge impact on survival of the insured business.

1. the insured gross profits; and
2. the indemnity period.

If the length of the period indemnity is more than 12 months, the gross profit must be adjusted accordingly; an 18 month indemnity period requires 150% of the business’s annual gross profit. Any growth trends should be included too, not only for the period of insurance but also the maximum indemnity period on top of that.
The appropriate indemnity period differs from business to business. A professional business, like a firm of accountants, will ordinarily require a fairly short period to get back up and running after the physical damage was sustained. Some computers and some premises and you're away; so a matter of months should be adequate. Other businesses, particularly those with expensive or unique premises or equipment may require a significantly longer indemnity period.

**CONCLUSION**

The Canterbury Earthquakes have created a complex business interruption environment. Most BI policies don't handle sequential events well. The fact businesses are affected not only by their material earthquake damage, but also the overall effect of the earthquakes on the Canterbury economy provides fertile ground for adjustment disputes. There is little New Zealand case law to provide guidance.

The key to a successful business interruption claim is good financial record keeping and good advice, so if you need advice specific to your business and your policy, contact your lawyer, your accountant or your insurance broker.

Emily Walton - Associate  
Telephone: 64 3 379 7622  
Facsimile: 64 3 353 0247  
Mobile: 021 972 155  
Email: emily.walton@wynnwilliams.co.nz

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