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DEPRECIATION IS NOT TO BE DEDUCTED AS A "SAVING" IN CALCULATING BUSINESS INTERRUPTION CLAIMS

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Legal Briefings – By **Mark Darwin**

Whether a reduction in non-cash costs such as depreciation following insured damage amounts to a "saving" to the policyholder which is to be deducted from insured Gross Profit in calculating business interruption losses is an issue which has been debated by claims professionals for many years.

The NSW Court of Appeal[1] has now unanimously resolved the debate in favour of policyholders, holding that depreciation is not a charge or expense "payable" out of Gross Profit according to the formula under an ISR Policy, and therefore should not be deducted as a "saving", even if this means a qualification to the principle of indemnity.

THE CLAIM

The policyholder owned a warehouse whose roof collapsed in a storm, damaging stock, plant and equipment. The damage and consequential business interruption loss was claimed under a typical ISR policy, which insured "Gross Profit" in the following form:

> *"The insurance under this chapter is limited to loss of Gross Profit due to (a) reduction in Turnover and (b) Increase in Costs of Working, and the amount payable as indemnity under this Policy shall be:*

> *(a) in respect of the reduction in Turnover: the sum produced by applying the Rate of Gross Profit to the amount by which the Turnover during the Indemnity Period shall in consequence of the Damage fall short of the Standard Turnover*
>
> *…*
>
> *less any sum saved during the Indemnity Period in consequence of the Damage in respect of such of the charges and expenses of the Business payable out of Gross Profit."*

The parties agreed that the policyholder would have ordinarily made provision in its accounts totalling $1.5m for depreciation of plant and equipment destroyed in the incident, but that it did not do so during the Indemnity Period (because of the Damage). The question was whether any amount should be deducted from the claim for the depreciation "saved" since it was not booked in the accounts due to the interruption.

At first instance, the trial judge had (without a detailed consideration of the issue) followed a single judge's decision of the UK's High Court known as *Synergy,*[2] holding that depreciation which was no longer booked as an expense in the P&L was "saved" and therefore should be deducted from the insured Gross Profit payable to the policyholder.

COURT OF APPEAL DECISION

The NSW Court of Appeal unanimously reversed the trial judge's decision, and expressly rejected the reasoning of the judge in *Synergy*. Meagher JA (with whom Beazley P and Leeming JA agreed) analysed the true nature and impact of depreciation on profit, noting depreciation to be the systematic allocation of an asset's cost as a series of expenses over its useful life, which appears in the P&L statement as an expense, and reduces the carrying value of the asset in the Balance Sheet, but which has no direct impact on cash flows.

In recognising that the ISR Policy's formula for the assessment of insured loss qualifies the principle of indemnity insofar as it might depart from perfect indemnification in some contingencies, the Court held that attention must be focussed on the language describing the method for ascertaining the loss as coloured by its immediate and commercial context.[3]

In that regard, the Court noted that the calculation of loss of Gross Profit under the ISR Policy involved three integers:

1. Reduction in Turnover, to be determined by a formula;
2. Increased Costs of a particular description, also to be determined by a formula; and
3. any sum saved … in respect of such charges and expenses of the Business payable out

of Gross Profit. [emphasis added]

The Court held that the focus on what is "saved" and the use of the word "payable", rather than "deducted", suggested the **exclusion of charges and expenses that are not liable to be paid away**, such as depreciation. Noting that the Flaux J in *Synergy* had recognised this textual consideration but then ruled otherwise on the application of the indemnity principle, the NSW Court of Appeal held that the indemnity in the ISR Policy is not against "actual loss", rather it contains a formula and there was nothing in the context of the clause which required any departure from the language used.

Finally, the Court held that any debate on whether this would result in the policyholder being over or under indemnified is an enquiry of the kind that the formula in the policy would be expected to foreclose (i.e. that it is irrelevant – just apply the formula).

A more detailed version of this article which explains the adjusting impacts of this decision has been republished on Insurance News.com, a leading local resource. Insurance News.com article can be accessed here.

ENDNOTES

1. *Mobis Parts Australia Pty Ltd v XL Insurance Company SE* [2018] NSWCA 342.
2. *Synergy Health (UK) Ltd v CGU Insurance Plc* [2010] EWHC 2583 (Comm).
3. *Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd* (2015) 256 CLR 104.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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